REVENUE-RAISING PROPOSALS IN THE ADMINISTRATION'S FISCAL YEAR 2000 BUDGET

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

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REVENUE-RAISING PROPOSALS IN THE ADMINISTRATION'S FISCAL YEAR 2000 BUDGET

TUESDAY, APRIL 27, 1999

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC

The hearing was convened, pursuant to notice, at 10:05 a.m., in Room SD–215, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Also present: Senators Breaux, Conrad, and Mack.

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will please be in order.

We have a full slate of witnesses this morning. So I will be brief. Our hearing today will focus on the revenue-raising proposals in the administration's fiscal year 2000 budget.

Since I became chairman of the committee, I have acted to counter tax shelters and close tax loopholes. I intend to continue on this path as long as problems arise. We will carefully scrutinize the revenue-raisers, and only accept those that do not harm significant, legitimate business transactions.

The House and Senate tax-writing committees have been asked to achieve up to $778 billion in tax cuts over 10 years. Under the Budget Resolution, as it now sits, fiscal year 2000 has no net tax cut. Therefore, to the extent we wish to have tax cuts in fiscal year 2000, we will need revenue offsets.

Many of the administration's revenue-raising proposals we have seen before, they have been proposed frankly year after year and been repeatedly rejected by Congress. The administration knows that given the adverse influence these revenue-raisers will have on Congress, Congress will stand against them. Nevertheless, they continue to send them to Capitol Hill.

Today, we will listen to three panels representing the views of the Treasury Department, practitioner groups, and affected parties. One of the most discussed set of revenue-raisers relates to the generic corporate tax shelter proposals. I share Treasury's concern about the proliferation of corporate tax shelters. However, I am troubled that Treasury's approach may be overly broad and may possibly subject legitimate business transactions to tax shelter penalties.

Treasury has acknowledged that the proposals are evolving and not set in stone. So I look forward to Treasury's white paper on the issue. I look forward to hearing from our witnesses today on these and other revenue-raisers contained in the administration's fiscal year 2000 budget.

Senator Breaux?

OPENING STATEMENT OF HON. JOHN B. BREAUX, A U.S. SENATOR FROM LOUISIANA

Senator BREAUX. Thank you, Mr. Chairman, for having this hearing and giving us an opportunity to discuss with Treasury officials about their proposals, which are numerous.

I always find it very interesting when we look for revenue-raisers, the first place we look to is to try and close tax loopholes, and we always get into the battle of what is a tax loophole versus what is a tax incentive. I have decided the simple definition is that if you get it, it is an incentive; if you do not get it, it is a loop hole. So that is sort of a basic definition, and maybe we will talk about the more detailed ones. I find that it is always an ability to close loopholes that do not serve a purpose or even tax incentives that do not serve a legitimate purpose.

I was struck by an ad in The Wall Street Journal, Mr. Lubick, just the other day, of all places, "Protect your assets. Find your own offshore tax haven. Enjoy a new way of life. Live simply and easily, making tax-free fortunes using the world's most exotic places." That made me want to clip out the coupon, retire from the Senate, and go to the islands. "Picture yourself in lush surroundings, with time and money to do everything you want to do." I can picture that. [Laughter.]

Senator BREAUX. "Whenever you want to do it with no cares or worries, and you can do all this legally and in complete privacy," I will bet, "using the world's offshore money havens." I mean, this is really an ad for potential fraudulent activities on behalf of people who look for these things. These are things that really, if they do exist, it is appropriate and proper for Congress to take a look at it and to eliminate it.

The concern I have seriously is about some of the suggestions, notably the S corporation ESOP proposal, which was created to encourage employee stock ownership plans, which I believe in very strongly, coming from the history of Russell Long and what Senator Long did in this area. I am very concerned that the proposal that you all have would potentially eliminate S corporations participating in the ESOP plans, and I am willing to explore with Treasury ways to prevent any potential abuses, but not to kill the whole program, which I feel very strong about.

There are some other questions we are going to get into, but thank you all for being with us.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Breaux.

We will now proceed. We are very pleased to welcome Donald Lubick.

Senator CONRAD. Mr. Chairman, might I just have a word?

The CHAIRMAN. Sure. Please proceed, Senator Conrad.

OPENING STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. Thank you, Mr. Chairman.

First, I would ask my colleague, Senator Breaux, if you are not doing anything with this coupon, I wonder if I might use that. It sounded pretty good.

The CHAIRMAN. It is warmer than North Dakota. [Laughter.]

Senator CONRAD. Now be nice. Be nice, Mr. Chairman. Remember that you are from Montana.

The CHAIRMAN. Yes, sir.

Senator CONRAD. This island, I do not know what island this is, but they have got an awfully nice picture of it there.

I want to thank the chairman for holding this hearing because I think it is important, and I want to thank the administration for attempting to outline a strategy and a plan for preventing abusive tax shelters because abusive tax shelters hurt everyone. They complicate the Code. They divert resources into non-economic activities in order to mind the Code, rather than actually providing some economic function, and they really create contempt for the tax system. So trying to find a way to eliminate abuse of tax shelters is in all of our interests, and I want to salute the administration for making what I think is a good-faith effort here.

I think we are going to have to work with Treasury, we are going to have to work with practitioners, and we are going to have to work with taxpayers to try to find a way to hone in on this question because it is not easy.

I would say, when I look at the descriptions Treasury has come up, I think they are a good first cut, and I think we are going to have to work it further because, in some ways, when we use language like "insignificant," "The expected pre-tax profit of the transaction is insignificant relative to the expected tax benefits," we are going to have to get more precise so that the practitioner community and taxpayers really understand what is intended.

Mr. Chairman, one other thing I think we should acknowledge is that the debate about the fiscal year 2000 budget, both on the revenue side and the expenditure side, is fundamentally one about priorities, and I think most of us on this committee, most in Congress, certainly most in the country, do not want to see somebody getting out from under their legitimate obligations. That is not in any of our interests, and it is not fair. So that is something that we really need to put a focus on, and, again, I want to commend the administration for making a serious effort in that regard.

If I could just say a final word, it would be some of the specific proposals that have been advocated here do trouble me, especially in the life insurance area. I know it is in the old blue book, and we all go to that when we are looking for offsets.

My own conclusion has been we have got a tremendous savings shortage in this country. One thing we are not doing a good job of is savings, and I believe any tax cut plan that we come up with this year, and there will be one, ought to be geared towards expanding incentives for savings and investment. That makes good sense.

The CHAIRMAN. Amen.

Senator CONRAD. So, in this insurance area, I really think those are savings vehicles, and unless we are finding something that clearly is abusive, and no doubt there are areas that deserve our attention, some of the broader attempts to further tax the insurance industry that is already the most heavily taxed industry in the country and one that does provide savings vehicles, I think are mistaken, but I, again, want to conclude by commending the administration for offering a framework designed to help us understand what are abuse of tax shelters. I think the members on this committee are especially sensitive to abuse of tax shelters and want to see them eliminated wherever possible.

I thank the chairman.

The CHAIRMAN. Thank you, Senator Conrad.

It is now my pleasure to introduce the Assistant Secretary for Tax Policy, Donald C. Lubick. We are also very pleased to have here Jon Talisman, who I understand will assist at the witness table. We are glad to have you as the former chief tax counsel for Senator Moynihan.

Welcome, gentlemen. Please begin.

STATEMENT OF HON. DONALD C. LUBICK, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC, ACCOMPANIED BY JON TALISMAN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. LUBICK. Thank you, Mr. Chairman, Senator Breaux, and Senator Conrad. Thank you, Senator Conrad, for giving a couple of pages of my testimony in your statement.

It is a pleasure to be with you again to talk about the revenue-raising proposals in the President's fiscal year 2000 budget. You and the chairman have alluded to the need to encourage savings, and I hope at some time, we may appear before you to discuss our USA plan which we think is directly responsive to the problem that you allude to.

My written statement for the record refers to our dramatically improved economic situation in which we have moved from record deficits to unified surplus and to the reduction in the Federal income tax burden for most Americans to levels not seen for a score or more years. It also refers to the President's proposals for use of the anticipated surpluses, as well as detailing a number of targeted initiatives that he proposes to deal with pressing national priorities under our familiar constraints of full current funding.

I will not elaborate on them because your invitation calls upon me to address our revenue-raising proposals.

I would, however, like to note that this package of incentives in the budget is fully funded by the revenue offsets to be discussed today.

Mr. Chairman, our proposals are intended to promote sound tax policy by addressing inefficiencies and deficiencies in the current tax system. We are not increasing rates, nor in most cases are we repealing exclusions, deductions, or credits.

Rather, many of our revenue measures would curtail corporate tax shelters, providing incentives for corporate taxpayers to invest their money in ways that produce an economic return apart from

tax considerations, not in ways that produce an after-tax return lacking in economic merit.

Other proposals in our budget patch leaks in the tax law in the areas of financial products, corporate taxes, pass-through entities, tax accounting insurance, taxation of international transactions, and the like.

Mr. Chairman, last year, you dealt with improving the fairness and integrity of Federal tax administration in the IRS Restructuring and Reform Act of 1998.

In 1986, the Congress offered a cure with instant results for the corrosive effects of tax shelter activities that were eating away the individual income tax space, swamping the Internal Revenue Service in the docket of the Tax Court, with audit complexity and litigation, and instilling a cynical attitude toward the tax law among many Americans that threatened our historic reliance upon self-assessment as the mainstay of compliance.

We come to you now with a similar problem affecting the integrity of the tax system, the recent proliferation of corporate tax shelters that merits immediate attention. With your help, we hope to curtail the development, marketing, and purchase of corporate tax shelters frequently sold as products off the rack to produce a substantial reduction in a corporation's tax liability.

What are the reasons for our concern? As Senator Conrad has said, first, corporate tax shelters erode the corporate tax base. Second, the ubiquity of corporate tax shelters breeds disrespect for the entire tax system, both by those who participate in the tax shelter market and by others who simply perceive unfairness, a view that well-advised corporations can and do avoid their legal tax liabilities by engaging in tax-engineered transactions that may cause a race to the bottom. If unabated, this will have long-term consequences, even far more important than the short-term revenue loss we are experiencing.

Finally, significant resources, both in the private sector and the Government, are currently being wasted on this uneconomic activity. Private sector resources used to create, implement, and defend complex sheltering transactions are better used in productive activities.

Similarly, the Congress, particularly the tax-writing committees and their staffs, the Treasury and the IRS all expend significant resources to address and combat these transactions.

Many others in the tax community who are knowledgeable and concerned with the integrity of the system share these concerns. You will hear from some of them today.

For example, in the 1998 Griswold Lecture before the American College of Tax Counsel, James Holden, a regent of that organization, stated, ". . . the marketing of these products tears at the fabric of the tax law. Many individual tax lawyers with whom I have spoken express a deep sense of personal regret that this level of Code gamesmanship goes on."

To date, most attacks on corporate tax shelters have been targeted at specific transactions and have occurred on an ad-hoc, after-the-fact basis, through legislative proposals, administrative guidance, and litigation. In the past few years alone, Congress has passed several provisions to prevent tax shelter abuses.

They include: provisions to prevent the abuse for tax purposes of corporate-owned life insurance; the elimination of the ability to avoid corporate-level tax through the use of liquidating REITs, which passed late last year. And we at the Treasury estimated that this legislation alone, to eliminate only one tax shelter product, saved the tax system upwards of $30 billion over the next 10 years. Both the Senate Finance Committee and the House Ways and Means Committee have passed legislation this year aimed at Section 357(c) basis creation abuses.

Mr. Chairman, we very much appreciate these efforts and your restatement of your objective in your opening, and we are pleased that members of this committee have promptly addressed corporate tax shelters that we or others have brought to your attention.

At the same time, we at Treasury have taken a number of administrative actions to address corporate tax shelters. On the regulatory front, we have issued guidance on stepped-down preferred stock transactions, lease strips, and foreign tax credit abuses. Most recently, we have brought to light lease-in/lease-out transactions, so-called "LILO schemes." These transactions, through circular property and cash flows, offered participants millions in tax benefits with no real economic risk. The notion of a U.S. multinational leasing a town hall from a Swiss municipality and then immediately leasing it back to the municipality is surely odd on its face. Finally, we have recently won two important cases, ACM and ASA, after many, many years of litigation.

What you find over time, however, is that addressing corporate tax shelters, transaction by transaction, is like a greyhound in pursuit of a mechanical rabbit. We never really catch up. Because it is not possible to identify and address all current and future sheltering transaction, it leaves us barely scratching the surface of the problem.

Taxpayers with an appetite for corporate tax shelters simply move from those transactions that are specifically prohibited by the new legislation to other transactions, the treatment of which has not been definitively proscribed.

Second, legislating on a piecemeal basis further complicates the Code and conceivably permits some to call into question the viability of common-law tax doctrines, such as sham transaction, business purpose, economic substance, and substance over form.

Finally, using a transactional legislation approach to corporate tax shelters may embolden some promoters and participants to rush shelter products to market on the belief that any reactive legislation would be applied only on a prospective basis.

Most corporate tax shelters rely on one or more discontinuities in the tax law, or exploit a provision in the Code or Treasury regulations in a manner not intended by Congress or the Treasury Department. In doing so, it appears that they have forgotten what was the basic truth as long ago as when you, Mr. Chairman, and Senator Chafee and I studied law at the same place at the same time and were schooled by reading the opinion of Learned Hand, 65 years ago in *Gregory* in which he stated, "It is quite true...that as the articulation of a statute increases, the room for interpretation must contract; but the meaning of a sentence may be more than that of the separate words, as a melody is more than the

notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create."

Corporate tax shelters appear in the guises of Proteus. For this reason, a single formulation to define them is difficult, if it is to be comprehensive. Nevertheless, at Treasury, we have identified a number of common characteristics of tax shelters. For example, through hedges, circular cash flows, defeasements or other devices, corporate participants in a shelter often are insulated from any risk of economic loss or any opportunity for economic gain with respect to the sheltering transaction.

Thus, one hallmark of a corporate tax shelter is a transaction without significant economic substance entered into principally to achieve a desired tax result.

Similarly, the financial accounting treatment of a shelter generally is significantly more favorable than the corresponding tax accounting treatment. That is, the shelter produces a tax loss that is not reflected as a book loss. Corporate tax shelter schemes are often marketed by their designers or promoters to multiple taxpayers and often involve property or transactions unrelated to the corporate participant's core business.

Many corporate tax shelters involve arrangements between corporate taxpayers and persons not subject to U.S. tax, such that the latter tax-indifferent parties absorb the taxable income from the transaction, leaving corresponding tax losses to be allocated to the taxable corporation. Tax indifferent parties in effect rent their tax-exempt status in return for an accommodation fee or an above-market return on investment. Tax-indifferent parties include foreign persons, tax-exempt organizations, Native American tribal organizations, and taxpayers with loss or credit carry-forwards. My written testimony provides further elaborations of these and other common characteristics.

These themes run through our budget proposals, and we hope help us focus on finding a more global ex ante solution to the corporate tax shelter problem. Our budget contains two types of proposals aimed at corporate tax shelters. First, we propose specific remedies for certain tax shelter transactions, of which we are presently aware, and second, we have proposed a set of more general remedies aimed at impeding the growth of future tax shelters. These proposals are intended to change the dynamics on both the supply-and-demand side of this market, making it a less attractive one for all participants, merchants of abusive tax shelters, their customers, and those who facilitate the transactions. All the participants to a structured transaction should have an incentive to ensure that the transaction comports with established principles.

The Treasury Department recognizes that applying various substantive and procedural rules to a corporate tax shelter or a tax-avoidance transaction requires careful definitions of such terms. Critics of the proposals have suggested that the definitions in our budget proposals are too broad or may create too much uncertainty and, thus, may inhibit otherwise legitimate transactions.

Much of this concern is no more than a debate on rules against standards. Bright-line, safe-harbor tests, although appropriate in some circumstances, encourage aggressive positions in playing the examination lottery.

As Professor James Eustice wrote, "I personally have viewed some transactions that seem to me fly only by principles of levitation. . . . [E]xcessive concentration on technical matters to the exclusion of the broader issues has obviously raised the level of complexity throughout the entire tax system."

Standards, in contrast, require the application of common olfactory sense. Some level of uncertainty is unavoidable with respect to complex transactions. Moreover, a degree of uncertainty may be useful in discouraging taxpayers from venturing too close to the edge, and thereby going over the edge of established principles.

Let me assure you, however, the Treasury Department does not intend to affect legitimate business transactions. It looks forward to working with the tax-writing committees in refining the corporate tax shelter proposals, particularly the definition of "corporate tax shelter."

We have announced, and repeat here, that we will work with Congress and the corporate community to refine our definition in a manner that will protect from penalty any legitimate, normal-course-of-business transactions.

Deputy Secretary Larry Summers, in his speech to the Tax Executives Institute, recently spoke of the importance of building a culture of compliance. He announced an intention to develop an intensive and extensive dialogue with practitioner groups, the tax bar, the accounting profession, and corporate tax executives, so that we can come to common understandings of the norms of appropriate behavior in this area. This dialogue has already begun. We have met with and are evaluating comments from many different interested individuals and groups.

We thank those who have commented to date and are grateful that many expressed their support for taking action.

Some have suggested that advanced disclosure to the IRS should be sufficient to avoid the penalty and have asked us to consider the establishment of an advanced ruling procedure. Under such a procedure, if a transaction is fully disclosed to the IRS in advance, it would be made possible to obtain an expedited ruling from the Service on the tax shelter penalty question without determining the underlying substantive liability questions.

Others have suggested that an issue escalation mechanism, such as coordinated review of corporate tax shelters, be implemented. This could be facilitated by the in-process reorganization of the IRS. We are currently considering these suggestions. We also look forward to analyzing the comments raised by others in testimony presented to this committee. We will develop and discuss these and other issues in our White Paper on corporate tax shelters under the direction of Mr. Talisman, which we expect to issue soon.

I also want to mention that our budget contains a number of specific provisions that, as we have alluded to, would close unintended and unjustified leaks in the Tax Code. These proposals have great merit. They are discussed fully in my prepared remarks. It is my request that they be made a part of the record for this hearing.

The CHAIRMAN. Without objection.

Mr. LUBICK. In conclusion, Mr. Chairman, Senator Breaux, Senator Conrad, and members of the committee in absentia, the administration looks forward to working with you as you examine

these proposals. We hope that you reach the conclusion that they are all meritorious and that this committee will approve them.

We stand ready to attempt to answer any questions that you may have.

[The prepared statement of Mr. Lubick appears in the appendix.]

The CHAIRMAN. Let me start out, Mr. Secretary, by asking you a couple of administrative questions.

The IRS Restructuring Act requires Treasury to conduct a study on penalties and interest and report to Congress by July 22nd of this year. I am interested in knowing about the status of this report because I attach great importance to this study and want it to be on time.

Mr. LUBICK. We certainly share your sense of the urgency and priority of this, Mr. Chairman. There are a number of studies that are mandated for the same date.

We have formed a working group of Treasury and IRS personnel. We solicited public comments, both we and the Joint Committee operating in parallel. We have received a number of them, including from the American Bar Association, the AICPA. We are in the process of reviewing and analyzing them.

This report, we know because of your interest, is our highest priority. We are gathering information from other sources within the IRS. The target date is still in mind. We certainly hope that we will either reach it or achieve a final report not much thereafter.

We certainly have full expectation that we will have it available for you prior to your return after the August recess.

The CHAIRMAN. I join you in that hope. I think it is critically important.

I would also like to ask you about the legislation we enacted in 1997 to curb the use of confidential tax shelters.

The registration requirements are effective after Treasury issues guidance. Such guidance has not been issued, and I wonder what your comment on that is.

Mr. LUBICK. I am going to ask Mr. Talisman, who is in charge of this whole regulation process, to explain to you the reason why you do not have it today.

Mr. TALISMAN. He is going to punt all of the tough questions over to me, I think.

Thank you, Senator.

Mr. LUBICK. He is our best receiver.

Mr. TALISMAN. The corporate tax shelter registration requirements had three components. There were three criteria before you were subject to it.

One of the conditions was a condition of confidentiality. It is our understanding that most tax shelters now are not being promoted under conditions of confidentiality in order to avoid those restrictions and, therefore, would not be subject to the registration requirements.

However, at the same time, as we were examining this issue in the context of issuing regulations, we also were concerned that as we were attempting to advance the ball with our proposals, we wanted to make sure that a definition of corporate tax shelter comported with what we were proposing to Congress otherwise. We also need to limit our approach with respect to corporate tax shel-

ters, so that we do not hit legitimate transactions and get inundated with materials in case these transactions were being promoted under conditions of confidentiality.

So we are examining the issue. We intend to issue regulations relatively shortly after we have also, again, issued the White Paper, fully developed, and digest the comments we are going to be receiving from the panelists today and from other comments that we have received.

The CHAIRMAN. What do you mean by shortly? A month or 6 months? A year?

Mr. TALISMAN. No, no. I would expect that we would have them out sometime this summer, and again, the question will be what is the utility if people are avoiding the requirements by not maintaining conditions of confidentiality, since that is a requirement of the registration, but, again, there is a definition in there that a significant purpose of tax avoidance is the definition of a shelter. That is one of the components, and so we need to define that term for purposes of 6111 and Section 6662.

The CHAIRMAN. Let me ask you, Mr. Secretary, why should Congress provide the IRS and Treasury substantial discretion by providing a greatly expanded Section 269 to disallow deductions, credits, exclusions, or other allowances contained in a tax avoidance transaction, given the current use, or perhaps I should say lack of use, of Section 269?

If revenue agents are not using the current law effectively, why not?

Mr. LUBICK. I think the problem, Mr. Chairman, is that the courts have construed that section quite stringently, and it has been very difficult for agents to succeed in litigation over this matter because the statute speaks in terms of the principal purpose of securing a deduction that otherwise would not be available.

I know I, myself, during private practice, found it not very difficult to come up with a number of plausible and ostensible reasons, even though the tax purpose predominated. It was quite easy to avoid the section.

The CHAIRMAN. Yes.

Mr. LUBICK. Again, if we are talking about an amendment, which is dealing with a tax shelter and if the definition of tax shelter is appropriately circumscribed, it seems to me that does not give any undue amount of discretion to the revenue agents. The threshold is one that assumes the answer, the transaction is an inappropriate one.

No tax benefit intended by the Congress would fall within the definition of "tax shelter." We have stated that quite clearly in the specifications. Those things that might otherwise fall within the definition of tax shelter, where the hope of economic profit is not present, such as, for example, low-income housing, which were specifically intended by Congress to operate the way in which they do, those are excluded in our definition altogether.

So I do not see that this is a situation where there is extensive discretion given to the agent, and it seems to me the proposed definition, combined with the limitations on it, means that it would make Section 269 a more workable tool as Congress, I believe, originally intended.

The CHAIRMAN. I have to say that this bothers me. In the restructuring bill we did last year, we were trying to make things clearer and more definite.

We found that the use of discretion has resulted in wide differences as to how people interpret the law, and I just find it very troublesome to give even broader authority. Business, admittedly, most big business particularly, have experts to guide them, but I have to tell you, I am troubled by giving even broader discretion to the Treasury and IRS.

Let me ask you this. Some of our witnesses today believe requiring a high-level corporate officer to investigate and disclose the underlying facts of the transaction would help chill the use of corporate tax shelters.

It is argued that holding the corporate officer accountable for any misstatement will make corporate officers think twice about engaging in particular activity.

While Treasury also favors enhanced disclosure, what are your views on this approach?

Mr. LUBICK. I certainly think that is an idea worth offering and worth studying, and I think in a system such as ours that is dependent upon self-assessment, a requirement of full disclosure is not at all unwarranted. I think you established in the Revenue Restructuring Act the notion that the Service has to lay its cards on the table and play fair and square, and I think it is probably within reason appropriate for taxpayers to lay their cards on the table so that we can arrive at the correct result.

To the extent any person engages in willful concealment, I think it is certainly appropriate that that not be countenanced and that that be penalized under the Tax Code. So I think that is a suggestion that is worth exploring.

On the other hand, I have some sympathy for corporate officers. I would not want indictments for perjury being used with great frequency for good-faith attempts to comply.

If you are concerned with willful concealment, I think that is quite serious. On the other hand, there has got to be a reasonable standard that allows one to carry on normal business activities without the pursuit of the Criminal Investigation Division in every instance.

The CHAIRMAN. My time is up. Let me ask one more question, which involves international tax policy.

We held our first hearing on the area of globalization. I am concerned at the same time that we are striving to open new markets for our American exports and investments abroad through our international trade policies, these policies may be undercutting our ability to penetrate these markets.

For example, the administration's budget has repeatedly contained an export source rule proposal that Congress has rejected 2 years in a row. How would this tax increase help our companies?

Mr. LUBICK. Mr. Chairman, I am quite interested in this subject, and we, as you know, are preparing a study and a paper on trying to make sure that we do not have too many people answering Senator Breaux's ad. It is not your ad. You did not place the ad, I know. [Laughter.]

Mr. LUBICK. We do not want you to respond to it either, Senator Breaux.

At the same time, we recognize there are three major considerations that are involved here. One is fairness of allocation of the tax burden on our citizens, both those that operate domestically and those that operate abroad. There are businesses that operate domestically and those that operate from abroad, and then we are concerned, as you have alluded to, with the role of our businesses in the world.

I think at this stage, we are the most competitive nation in the world, and we want to do everything we can to retain that position that we have achieved so successfully.

It is quite obvious that in 1950, when we were the survivors of a major world war and the other economies of Europe and Japan were in ruins and rebuilding that we were going to dominate, but as we helped those countries reestablish themselves and build global markets, our share of those markets necessarily had to decline.

In absolute terms, however, I think our companies continue to be the most successful in the world, and they themselves indicate that they do it because they have advantages that in turn in no way upon taxation.

The export source rule, we have a provision that was introduced in the Code to deal with problems of a bygone age when double taxation was a serious problem.

Since that time, we now have a vast network of treaties that have virtually eliminated the problem of double taxation. So the original purpose, which that section served, no longer obtains in today's world.

In point of fact, the export source rule provides benefits primarily for multinational corporations in high-tech countries that have excess foreign tax credits and enables them to soak up some of those credits by attributing to foreign sources, income that would not normally be classified as foreign source under the normal rules. That, it seems to me, is devoting a lot of revenue into a particular area where our exporters who operate from the United States do not receive the benefit of it.

It seems to me, we cannot really afford inefficient subsidies that are artificial, and I think that is what lies behind that proposal, Mr. Chairman.

The CHAIRMAN. Thank you. My time is up.

Senator Breaux?

Senator BREAUX. Thank you, Mr. Chairman.

Thank you, Mr. Secretary and Jon, for your presentations.

Seriously, on that advertisement, has anybody at Treasury ever sent in the $29.95 and get the book and just go down the list and see if everything they have in an entire book of offshore tax havens and loopholes are legal, legitimate, and whether, if they are these type of recommendations, they should be the subject for consideration?

Mr. LUBICK. I will have to ask the General Counsel if we can spend appropriated funds for that.

Senator BREAUX. I will tell you what, I will let you all read my copy. [Laughter.]

Mr. LUBICK. Jon?

Mr. TALISMAN. Actually, I was on an airplane and saw that same advertisement about 3 weeks ago and pulled it.

Mr. LUBICK. Did you send in your own?

Mr. TALISMAN. Someone has volunteered to purchase it on my behalf.

Senator BREAUX. Seriously, these people apparently have a collection, and it is in book form of off-shore loopholes. It looks like it would be at least a good beginning for us to take a look at what policy recommendations need to be made to change it, if it is in fact not legitimate.

Mr. LUBICK. Senator Breaux, we are very, very active in the OECD, and I think we have finally, after a long period of time of being profits in the wilderness, gotten the attention of our major trading partners. We have a project on harmful tax competition, and we are dealing with all of the exotic and perhaps not so exotic areas that are known as tax havens.

I am very hopeful that we can attack this problem on an international basis and on a cooperative basis. I think it is very important that we not be——

Senator BREAUX. I do not want to interrupt you too quickly. I appreciate the OECD, but these are U.S. people and U.S. citizens subject to U.S. tax laws that are using these rules and regulations apparently to accomplish a tax haven.

Mr. LUBICK. We are assiduously working to try to ferret them out and to see what we can do about it. We have a number of proposals dealing with international cross-border shelter activities in our program.

Senator BREAUX. Jon, if you have looked at it and had this same reaction, I would like to see some kind of communication back to me saying we have looked at this. We are advertising loopholes here. "Send in the money. We will tell you where the loopholes are" is what essentially they are saying.

Mr. TALISMAN. Yes. Senator Breaux, also, in 1997, the Treasury came forward with proposals regarding foreign trusts that were locating abroad in tax havens. Obviously, we do not have the audit years on that. We are examining and focussing efforts on those sorts of abuses as well.

We are very aware of the issue, as you have raised it, and we will be happy to comment back to you as we get greater understanding of that.

Senator BREAUX. I appreciate that.

I obviously think that is something we ought to focus in on, particularly because of the blatantness of advertising loopholes.

Let me talk to you about a couple more specifics. As you know, I mentioned in my opening comments the proposal apparently on the S corporations dealing in the employee stock ownership plans.

I appreciate the proposal if you are going after real abuses in the program. Are there in fact real abuses that you can document now, or are these perceived possibilities of abuses?

It seems to me in answering that question, what you have done in a broad brush is to wipe out companies that are legitimately using this to encourage savings and retirement plans and participation in increasing their productivity as part owners of a company. That is something that I feel very strongly about, and a num-

ber of members of this committee and this Congress feel very strongly about.

So I guess my question is: What abuses are we trying to eliminate by the proposal on S corporation taxation and ESOP programs?

Mr. LUBICK. I think we agree with you that an ESOP should be a permitted S corporation shareholder and should receive the same treatment as any individual S corporation treatment.

Unfortunately, in 1997, I think we got the principle right, but I think we went a little too far. I think we have been working with your staff to try and get it right.

An S corporation pays no corporate income tax, but its shareholders pay tax currently on the income derived by the entity. As a result of paying that tax, the shareholders receive an increased basis in their stock and an account is set up from which distributions can be made without a second level of taxation.

That is exactly the model which we think is the correct answer to put the ESOP on the same basis as their fellow individual shareholders. Pay the tax currently, and pay it only once, not a second time.

We do have information, and Mr. Talisman has been gathering that in his files, of widespread attempts to exploit this as a device to secure deferral for a very, very long time of the first level of tax, not so much for the rank-and-file employees, but for the owners of the corporation who are employees and also participants.

Senator BREAUX. Tell me what you are looking at trying to eliminate.

Mr. TALISMAN. Again, we have a number of marketing materials, et cetera. We understand that this provision. Again, the elimination of the unrelated income business tax from an S corp has allowed significant deferral, and that ability to defer income on business income has been marketed substantially as a tax shelter.

There have been several articles in the literature. Marty Ginsburg, Professor Ginsburg, at Georgetown wrote an article.

Senator BREAUX. That is about the potential. Do we have any examples of it?

Mr. TALISMAN. We do have examples which I am happy to share.

Senator BREAUX. I would like to see the example.

Do you disagree that the proposal that you have is a broad-brush proposal that is going to eliminate S corporations from participating in ESOP programs?

Mr. TALISMAN. What we attempted to, and whether we did so successfully—we certainly want to work with your staff to address your concerns. What we attempted to do is ensure that there was only one level of tax ever paid. However, that tax would be imposed at the time the business earned the income, rather than allowing the deferral that the current law allows.

What we did was we provided a basis mechanism for the ESOP that allowed the ESOP to avoid paying tax when it distributed the earnings out to its participants. There still is only one level of tax under our proposal. However, it is the back-ended tax that is eliminated, rather than the front-loaded tax.

Mr. LUBICK. Which is the same and true of every other shareholder.

Senator BREAUX. You allow the ESOP to get a deduction when they distribute the proceeds?

Mr. LUBICK. Yes.

Senator BREAUX. Suppose they do not do it for 10 or 15 years, and it is a retirement plan for the employees.

Mr. LUBICK. But that is true of every shareholder.

Mr. TALISMAN. That puts them in the same status as every other shareholder. They pay the one level of tax. When they came forward, the ESOP industry asked for this proposal. They just were concerned about paying only one level of tax.

Senator BREAUX. We are going to work on this. Otherwise, I do not think it is going to happen.

I am willing to go after the abuses on the thing, but I certainly do not want to create a situation where S corporations cannot use legitimately this program to encourage participation in the companies, to encourage more productivity, to help retirement savings accounts for employees.

I can see if you get only a handful of people who are involved in controlling the bulk of a company participating. That is not right.

If you have everybody participating, available to everybody, that is, I think, good public policy, but we are going to work together on this?

Mr. TALISMAN. We are happy to work with you.

Senator BREAUX. The other thing is I am on the Commerce Committee, and we deal with communications. One of the proposals that has been brought to my attention in your business plan is sales commissions to obtain new customers, which is a mechanism that companies use in the sale of mobile cellular phones.

I am concerned that the proposal that you have does not really fit into this particular business proposition and how it has been handled. What is your timing on that one? Do you know the one I am talking about?

Mr. TALISMAN. We do not have a proposal. What we do have is an item on our business plan to address the treatment of cellular commissions under the INDOPCO case and the treatment of whether you capitalize or expense cellular commissions.

Senator BREAUX. But INDOPCO was not anything like the cellular telephone business. Didn't it deal with banks?

Mr. TALISMAN. However, INDOPCO raises issues regarding capitalization and whether these commissions relate to future periods as well as the current period.

Senator BREAUX. Here, we are talking about a corporation acquisition. That was a totally different case from the sale of cellular telephones, right?

Mr. TALISMAN. I understand. Yes.

Senator BREAUX. There is a huge difference.

Mr. TALISMAN. Yes.

Senator BREAUX. They both would be treated the same, which I do not think it makes a great deal of sense.

Mr. TALISMAN. Again, it is a business plan project. I do not believe we have determined where we are with respect to our position on that.

We are looking at the issue. We have met with the industry and have reviewed their comments, and there are significant issues involved in the treatment of cellular commissions.

Senator BREAUX. Again, on this, we are going to work together on this before anything goes through?

Mr. TALISMAN. We will keep you informed of the progress, yes.

Senator BREAUX. I do not want to just be informed. I want to be part of it.

Mr. TALISMAN. Okay. [Laughter.]

Senator BREAUX. Informing me of an answer I do not agree with is not really participating in the process. There is a big difference.

Thank you, Mr. Chairman.

The CHAIRMAN. I would emphasize the importance of working with the Senator. [Laughter.]

Senator BREAUX. Thank you.

Mr. TALISMAN. We are well aware of the importance of working with the Senator, Mr. Chairman.

Senator BREAUX. I love Don's new terminology. Maybe it is not used. This is the first time I had heard it. We were talking about loopholes, and you have also added a new phrase, a new level, "leaks." We want to close loopholes and also plug the leaks in the system.

Mr. LUBICK. I did not want to use the pejorative. That is why I avoided the term "loophole."

Senator BREAUX. Legal loopholes, leaks.

The CHAIRMAN. Gentlemen, thank you for being here today. We will, of course, be working with you as we proceed, and I appreciate your help today.

Mr. LUBICK. Thank you.

The CHAIRMAN. We will now call forward our second panel, which includes Mr. Harold R. Handler, who is Chair of the Tax Section of the New York State Bar Association; Mr. David A. Lifson, who is the Chair of the Tax Executive Committee of the American Institute of Certified Public Accountants. He also provided testimony at our recent hearing on tax law complexity. Finally, I welcome Mr. Stefan F. Tucker, who is Chair of the Section of Taxation of the American Bar Association. Mr. Tucker testified before the Finance Committee as we considered restructuring of the IRS, and we welcome you back, Mr. Tucker.

Gentlemen, it is a pleasure to welcome you, and we will begin, if we may, with Mr. Handler.

STATEMENT OF HAROLD R. HANDLER, CHAIR, TAX SECTION, NEW YORK STATE BAR ASSOCIATION, NEW YORK, NY

Mr. HANDLER. Mr. Chairman, my name is Harold Handler, and I appear in my capacity as Chair of the Tax Section of the New York State Bar Association.

The Section has 3,000 tax professionals as members and, through its Executive Committee, prepares and disseminates between 25 and 40 analytic reports each year on various topics relating to State, Federal, and local taxation.

This year, in addition to other projects, we have undertaken a study of a number of the proposals contained in the President's fiscal year 2000 budget proposals, which were submitted on February

1st. I expect that our internal review process will produce a series of reports in May and June with respect to these proposals, but we have accelerated our report on aspects of a significant element of the President's proposals, those relating to the phenomenon known as corporate tax shelters.

This week, we have delivered a report analyzing what we consider to be the two most important of these tax shelter proposals, a more stringent penalty requirement, coupled with incentives for increased disclosure, and the proposal for a new substantive provision intended to deny the tax benefits arising from tax avoidance transactions, this 269 proposal that you referred to. I am prepared to discuss our comments today.

We believe there are serious and growing problems with aggressive, sophisticated, and, we believe in some cases, artificial transactions designed principally to achieve a particular tax advantage. A good example is the transaction recently the subject of a Tax Court and Third Circuit decision in the ACM case, but this is not the only example, and our report attempts to detail a number of abusive corporate tax shelter transactions.

The problem with these transactions is two-fold. There is obviously an effect on revenue. While we are unable to estimate the amount of this revenue loss, anecdotal evidence and personal experience leads us to believe that it is likely to be quite significant, but there is a second corrosive effect. The constant promotion of these frequently artificial transactions breeds significant disrespect for the tax system, encouraging responsible corporate taxpayers to expect this type of activity to be the norm and to follow the lead of other taxpayers who have engaged in tax-advantaged transactions.

The overriding theme that emerges from our analysis of the administration's proposal is the obvious one: there are no simple solutions to the problems posed by corporate tax shelter phenomenon. We believe, however, that there are several related steps. First, the Service must increase its audit efforts and intensify the scrutiny of these transactions. As an example, the recent Government success in the ACM case, we believe, has had a perceptible impact on the willingness of corporate taxpayers to engage in these transactions, but audit scrutiny and diligent litigation alone will not, in our opinion, be sufficient to deter these transactions.

There must be further steps taken to change the risk/reward ratio. In our view, even if substantially greater resources were devoted to attacking corporate tax shelters under current law, the structure of our current penalty system ultimately would not provide adequate deterrence for corporate tax shelter activity. For this reason, we strongly support the approach of the administration's proposal to increase accuracy-related penalties for defined corporate tax shelter transactions to encourage disclosure and deter risk-taking by taxpayers.

Disclosure will be helpful on several accounts. First, proper disclosure will change the odds of the audit lottery, and the need to disclose will itself act as a deterrent. In addition, to the extent taxpayers actually report, a disclosure regime will acts as an early warning system to allow the Treasury and the Service to respond

quickly to new developments on this front, but more than disclosure is required.

To address the insufficient deterrent effect of current law, we believe it important for Congress to adopt, as proposed by the administration, a strict liability approach to the accuracy-related tax shelter penalties by eliminating the reasonable cause exception to the imposition of the accuracy-related penalties for certain tax-motivated transactions.

Under a strict liability regime, a taxpayer's reliance on professional tax opinions would no longer have the effect of eliminating the penalty imposed on corporate taxpayers engaged in corporate tax shelter transactions.

Consequently, corporate taxpayers would be forced to assume a real risk in entering into these transactions, and advisors would be induced to supply balanced and reasoned analysis rather than merely supplying reasonable cause, as under current law.

The current equation is all too simple. Even responsible corporate financial officials, when faced with the choice of paying tax on some item of gain or other income, may choose to engage in somewhat artificial transactions to eliminate the tax they would otherwise pay. The only downside risk at present, given the availability of reasonable cause opinion, is some additional interest, which is likely to be at a higher rate. The possibility for the benefit far exceeds the potential risk.

We believe this equation must be changed, and that the administration's approach is correct. If a taxpayer is considering a tax shelter transaction, the elements to be considered must include the likelihood of a significant penalty.

We acknowledge that strict liability to accuracy-related penalties will put considerable pressure on defining the appropriate cases and may increase significantly the leverage of the IRS in some audits. Because we believe it is crucial to increase the risk associated, we have concluded that on balance it is acceptable to live with the effects of these proposals.

As a second matter, we do not believe that a Super 269 provision, as you discussed, is appropriate at this time to address the illegal treatment of these transactions. We agree that a substantial amount of discretion must be granted to the Government under generally worded statutory and regulation or provisions to deal substantively with aggressive motivated tax transactions.

In addition, we believe it is appropriate on occasion for the Treasury Department's regulatory authority to be exercised with retroactive effect. We do not, however, support the general substantive anti-abuse provision because we believe that in most cases the proposed provision would not prove as effective a tool as currently exists with the existing body of judicial authorities. Nonetheless, some of our members believe that the tax shelter problem cannot be significantly alleviated without enactment of substantive provisions of the type proposed, and we are aware that it may eventually prove to be necessary to enact this type of provision.

We intend, therefore, to continue to work with the administration and Congress to develop these substantive tools.

We also have included in our report a revised definition of a tax shelter, which we are prepared to work with the administration

and Congress in developing an appropriate approach to tax shelters.

Thank you, Mr. Chairman, for the opportunity to appear, and I am prepared to answer any questions.

[The prepared statement of Mr. Handler appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Handler.

Mr. Lifson?

STATEMENT OF DAVID A. LIFSON, CHAIR, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, NEW YORK, NY

Mr. LIFSON. Mr. Chairman and members of this distinguished committee, my name is David Lifson, and I am the Chair of the Tax Executive Committee of the American Institute of CPAs.

I am pleased to present to you today our comments on selected revenue proposals in the President's fiscal year 2000 budget. The AICPA is the professional association of certified public accountants, with more than 330,000 members, many of whom provide comprehensive tax services to all types of taxpayers, including businesses and individuals in various financial situations.

Our members work daily with the tax provisions you enact, and we are committed to helping make our tax system as simple and fair as possible.

Many of our comments provided in our written statement for the record urge simpler solutions, particularly in the area of individual alternative minimum tax and the proliferation of individual credits with complex income phase-out rules for families.

We urge you to place a high tax policy value on tax simplification and would be pleased to work with you to try to make your tax legislative proposals as simple, yet effective, as possible.

I commend our tax simplification recommendations to your attention, but today I want to focus my testimony on an issue that is extremely difficult and extremely important to our tax system, the sections of the administration's proposals referred to as corporate tax shelters.

We oppose abuses in our tax system by improper activities and believe that their restriction makes the system fairer for all. However, changes in this area must be made with great care in order to avoid overreaching that would curtail entirely appropriate business behavior.

The President's proposals grant overly broad power to the IRS to impose extraordinary sanctions on corporate taxpayers by applying standards that are far from clear, and that could give examining revenue agents a virtual hunting license to go after corporate taxpayers and their advisors. In our view, the debate concerning the sanctions for improper corporate tax behavior must begin with a clear understanding of the standards that distinguish abusive transactions from legitimate tax planning.

Extraordinary sanctions should not apply in areas that are difficult to distinguish from the normal exercise of a taxpayer's right to manage their tax cost.

The difficulty is in distinguishing between legitimate tax planning, which we believe is the right of the taxpayer, and overly ag-

gressive abusive behavior which we believe should be curtailed whenever and wherever it occurs.

Unless this distinction can be clearly drawn, you run the risk of making the business of tax payment and tax collection far less efficient.

In the Treasury's proposals, for instance, the multiple and punitive sanctions, some or all of which could be asserted on transactions that the IRS agent determines fall within loosely defined parameters of tax avoidance transactions, can approach the civil fraud penalty level of 75 percent.

The broad grant of authority to the IRS, the vague definitions, and the harsh sanctions would have a chilling effect on our tax system and could reverse recently enacted system improvements.

While it is at least difficult and maybe impossible to develop clear and comprehensive guidelines, at a minimum, we believe that any legislation of this type must include a safe harbor that would rule out the application of these extraordinary sanctions when a transaction is either undertaken for reasons germane to the conduct of the corporation's business, expected to produce a pre-tax return that is reasonable in relation to the costs that are being incurred, or reasonably consistent with the legislative purpose for which the tax provision is enacted.

We also strongly report an effective disclosure mechanism to advise the Government, as the transactions are occurring, generally reported on the return, but there must be an incentive to disclosure, and we believe the elimination of a penalty would be the only effective incentive.

While we also believe that disclosure must be in a form and at a time when it can be used effectively by the Government so we could support a prefiling disclosure, but only if it replaces or significantly revises the registration requirement enacted only 2 years ago, and the standards for advanced disclosure must be clear.

With respect to promoters and advisors, we do not support a disallowance or excise tax approach. Instead, we favor direct penalties for well-defined improper activities, but with due process safeguards so that, for example, sanctions conceded by a taxpayer as part of an overall settlement with the IRS do not create automatic liability for a promoter or an advisor.

We thank you for the opportunity to speak. We would be pleased to work with Congress and the administration and with our friends in the ABA and New York State Bar Tax Section to help develop a solution to the corporate tax shelter issue, if the issues still exist, and a solution that would sufficiently deter undesirable conduct, while protecting legitimate taxpayer rights and business planning.

[The prepared statement of Mr. Lifson appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Lifson.

Mr. Tucker?

STATEMENT OF STEFAN F. TUCKER, CHAIR, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, WASHINGTON, DC

Mr. TUCKER. Mr. Chairman, Mr. Breaux, and Mr. Mack, my name is Stefan Tucker. I am the Chair of the American Bar Association's Section of Taxation. My testimony is presented on behalf of the ABA's Section of Taxation.

The ABA's Section of Taxation consists of about 20,000 tax lawyers, and we are, we believe, the national representative of the legal profession with regard to the tax system.

We are really only talking today about two items within the multitude of items presented by the budget proposals. One is the range of corporate tax shelter provisions, and secondly the taxation investment income of trade associations, to some extent.

I would like to start by noting that the Tax Section is very much attuned to simplification and the lack of complexity, and in your April 15th hearings, we testified as to simplification even as we talked about a number of the provisions that were there.

We are not moving away from that. We believe strongly in simplification. We would urge that you do not make things worse with any legislation, and we would urge that, to the extent possible, you rectify what occurred in the past. We recognize simplification may not garner political capital or headlines, but it is crucial. The more complex, the more non-compliance. Simplification both enhances understanding and compliance, and we think the Senate Finance Committee needs to endorse simplification overall.

Now let me move to the tax shelter provisions of the budget proposals, the so-called corporate tax shelter provisions, recognizing that these do not apply just to corporations, but to limited liability companies, to partnerships, to trusts and the like. They are broad-ranging.

The administration has proposed 16 provisions, a number of which are overly complex and too broad, and we believe that is a concern, but we do believe that the corporate tax shelter regime as it exists today is a concern. We would urge that you not heed those who say that there are no problems or that corporate taxes are high enough. The corporate tax shelter problem is here. It is not self-correcting. It is secretive. It is insidious. It needs to be placed under the microscope like other viruses, analyzed and eradicated before everyone is affected all the way down the economic ladder.

We know that not everybody is involved with this. We recognize that lawyers are involved with this, and along that line, we in the ABA Tax Section and the ABA itself are reviewing ABA Opinion 346 which deals with opinions of tax lawyers, and we know that Treasury is looking at Circular 230, and we agree with that effort as well.

The hallmark of these shelters is the use of tax benefits which are consciously granted by Congress—excuse me. It is not the use of tax benefits. It is the use of transactions to achieve economic results that would not otherwise occur, often feeding off of glitches in the tax law.

I would like to point out that without the presence of a sufficient business purpose—note business purpose—the tax benefit claim would not be available under the existing law, and I would repeat that. Most, if not all, of these tax shelter transactions that concern us depend upon the avoidance of well-established judicial principles, such as the Business Purpose Doctrine, the step transaction rule, substance over form, or the clear reflection of income.

We are concerned generally about 269. We do not think it works today. We do not think it ought to be broadened by Congress.

We suggest instead a Code provision applicable to transactions to which the Economic Substance Doctrine now applies, and we think the Code should make it clear that the expected economic benefits of a transaction must—I underscore the word "must"—be meaningful. That is, they must be more than de minimis or nominal in relation to the expected tax benefits.

We have specific proposals. We have six of them in our written testimony. First, require specific clear reporting for large tax shelters by adding a question to a return and requiring that if the answer is yes that certain things be noted, and yes, we are one party that said a statement ought to be signed by a responsible corporate officer with detailed knowledge of the business or economic purposes and the facts underlying that. These questions should elicit clear and accurate responses, not voluminous material.

Second, we believe you ought to broaden the understatement penalties to cover outside advisors, promoters, and the tax in different parties that were noted.

Third, we think you ought to have a new definition of a large tax shelter within the tax shelter definitions under Section 6662.

Fourth, you need to provide new penalties in the case of tax shelters that fail to disclosure the required information, whether or not the tax shelter is ultimately sustained or rejected by the courts. Maybe that means you have less of a penalty if somebody discloses something, even if it does not work in the courts.

Fifth, and importantly, clarify that where the Economic Substance Doctrine applies, the non-tax considerations must be substantially in relation to the potential tax benefits. There must be an economic substance test.

Lastly, articulate a clear Congressional policy that the existing enforcement tools must be used to stop the proliferation of large tax shelters and, if need be, to add resources to the Revenue Service in focussing on these large tax shelters.

We would simply note the trojan horse is already inside the walls, except the promoters are coming out at night, and by disclosure, you make them come out during the day. You make them show their faces. You make their wares show up in the sunshine, and that way is when we are going to see if the emperor actually has any clothes.

With that, I will thank you.

[The prepared statement of Mr. Tucker appears in the appendix.]

The CHAIRMAN. Thank you.

Mr. Handler testified that a strict liability standard would be appropriate in connection with the substantial understatement penalty for tax shelters. Do you agree with that, Mr. Lifson?

Mr. LIFSON. That is not consistent with our thinking. No.

The CHAIRMAN. You do not agree, then.

Mr. Tucker?

Mr. TUCKER. Strict liability is a two-edged sword, and we are not quite sure how you would define "strict liability" and in what manner you would apply it and how you would set up the criteria for strict liability.

I think just as Mr. Lubick noted, we do not want the CID coming after everybody. We do not want strict liability there where you might have a number of circumstances where it ought not apply.

The CHAIRMAN. Mr. Handler, did you want to comment?

Mr. HANDLER. I think the critical issue is how do you define the transactions which would be subject to strict liability. With a proper definition, strict liability would change the equation, whereby today CFOs have no significant risk in entering into these transactions, other than slightly additional interest.

We believe that the way to deter taking these transactions on is to make corporate taxpayers aware that if they try a transaction and lose, the cost will not just be the tax they were otherwise seeking to avoid, but also a penalty. That will act, I think, more than any other way, we think, to deter the transactions which are undertaken, but, again, the key issue is to define the transactions that you are going to subject the strict liability standard to in a very critically precise manner.

The CHAIRMAN. This panel has raised, of course, a question of a high-level corporate officer being required to investigate and disclose the underlying facts of the transaction as a means of chilling the use of corporate tax shelters.

Can you be a little more precise what you believe should be disclosed and in what format? I know one of you said it should not be substantial. It could be fairly simple.

I guess that was you, Mr. Tucker.

Mr. TUCKER. One of the things that we have found, and we know this applies to attorneys as well, is very often the opinions that are given and the tax benefits that are taken are dependent upon an assumption of facts. That means there is no due diligence done as to the actual facts underlying the transaction, and very often, the assumption is there is a "business purpose" or if we assume X, Y, or Z.

We think somebody needs to be responsible not just to say these are assumed facts, but these are the actual facts that went into this transaction, and I think that there has to be some officer responsible, just as the person giving the opinion cannot assume the facts, but has to base them on the actual facts.

We know that we are working on that on the attorney side in the ABA. We think somebody needs to work that on the corporate side.

The CHAIRMAN. Mr. Handler, you also supported the administration's proposal to increase accuracy-related penalties for defined corporate tax shelter transactions to encourage disclosure and deter risk taken by taxpayers.

I think Mr. Lifson and Mr. Tucker disagree, but how do you respond to Mr. Handler's position?

Mr. Lifson?

Mr. LIFSON. I think the biggest problem is Mr. Handler's, I could only call it, "euphemism" that a standard could be designed that would define this activity that is then going to be punished or penalized.

We have spent hundreds of hours trying to offer a standard ourselves and find it a little more difficult than pornography to describe, and we have not gotten anywhere with coming up with a standard that would be able to be understood by not only Fortune 500 companies, but the chief executive officer of a little 1-, $2-million shrimp boat company that would be held to the same standard of care here. And I am not sure that they would completely under-

stand all these rules. We think it would give revenue agents a complete hunting license.

So, by the time it filters down to the small business community, these broad concepts are very hard to apply to those kinds of business transactions.

The CHAIRMAN. Mr. Tucker?

Mr. TUCKER. Again, our focus is to go into a large tax shelter concept, which is $10 million or more, number one.

Number two, based on experience and practice, I would agree with Mr. Lifson that very often a revenue agent comes in, the first thing they do is assert penalties on the theory that if you will at least concede the basic tax consequence, they will give up the penalty. So it is a negotiating tool.

I think to us as practitioners, the penalties ought to be something there if something is misused. It ought not to be simply a negotiating tool, but we would focus on not the everyday business, but the large tax shelter and then add penalties in that line.

The CHAIRMAN. Any comment, Mr. Hander?

Mr. HANDLER. We also would have a limit below with there would be no penalties applied. Where that limit is to be set is obviously your province.

As far as disclosure is concerned, we think there are two kinds of disclosure that would be required. One would be within so many days of entering into a transaction as defined. There would be an obliged reporting to the Treasury and IRS in order to allow the ads that Senator Breaux referred to, to be alerted in advance of them being published in the newspaper, but also we think that there needs to be disclosure on the tax returns of the individual corporate taxpayer, so that there is less risk that on audit the transactions will go undisclosed or undiscovered.

As far as the penalties with respect to corporate activity is concerned, the element that we are most concerned about is at the moment, as I said earlier, there is no serious risk to engaging in these kinds of transactions. The only additional cost that a corporate taxpayer currently is subject to is some additional interest cost because, in most cases, in virtually all cases as a matter of fact, attorneys and other advisors have provided opinions that are reasonable cause for the taxpayer to rely on in order to avoid the current penalties.

We believe that that reasonable-cause exception allows taxpayers to take risk without subjecting themselves to any additional cost.

If there is an accurately defined tax shelter which, if the taxpayer were to lose an ultimate audit or litigation, there were to be a penalty imposed, it would deter significantly many, if not most, of these artificial transactions, and we think that it is possible to create a definition which would distinguish between legitimate corporate tax planning, which, of course, we support, from those transactions which are marketed and are artificial and which do not really bear any relationship to the overall business of the company.

The CHAIRMAN. My last question involves the administration's proposal concerning the issuance of tracking stock.

In the Treasury's view, the use of tracking stock permits a corporation to sell an economic interest in the corporation without rec-

ognizing any gain. It also views tracking stock as a way to avoid the spinoff rules.

We have heard, however, that there are valid business reasons for issuing tracking stock. I would like to ask each of you briefly what are your views.

Mr. Handler?

Mr. HANDLER. As I said earlier, we have a number of reports underway, and one of them involves tracking stock. We expect that it will be ready in the middle of May. So the comments that I now make are my own.

Tracking stock is a legitimate corporate security. The definition, once again, of tracking stock is what is difficult.

Many of the tracking stocks that were issued and have been issued are well within the bounds of legitimate corporate transactions. There may be cases where the type of security has been pushed to an extreme which creates concerns exactly as you are expressing, Mr. Chairman, such as the avoidance of the spinoff rules, and those have to be looked at and examined more carefully.

The CHAIRMAN. Mr. Lifson?

Mr. LIFSON. While have no official position on this, in my view, it would be my own as well, it seems to me in an increasingly complex global world that tracking stock does serve a useful purpose of concentrating corporate assets in a single business enterprise, but allowing it to engage in the multiple types of business that are important to keep American corporations competitive globally.

I think it was invented or first designed by General Motors to deal with its aerospace operations, an obvious example where a tracking type of stock might be a good policy decision, but this comes under the rubric of policy and not practice.

The CHAIRMAN. Mr. Tucker?

Mr. TUCKER. Again, our Committee on Corporate Tax is focussing on tracking stock. So I, too, would give a personal opinion, but somebody originally from the State of Michigan and who knows about GM, which was an auto company with divisions that then acquired both Hughes and EDS and used tracking stock to trace those particular entities, I think it is something that is beneficial, and in a global economy, which we must focus on, it is useful retaining the control without need for a spinoff or something like that.

The CHAIRMAN. Senator Breaux?

Senator BREAUX. Thank you, Mr. Chairman.

I thank the panelists for their presentations.

Mr. Lifson, what does your button say? I cannot see it.

Mr. LIFSON. "Simplify."

Senator BREAUX. "Simplify." If we simplify too much, we are going to put all of you out of business.

Mr. LIFSON. Not worried. [Laughter.]

Senator BREAUX. Not worried that that is going to happen or it will not be that simple?

Mr. Hander, in your testimony, you point out the fact that more than disclosure is required. My question that really concerns me, it seems that you are suggesting that there be a greater penalty or a risk assigned to certain type of transactions that are designed to avoid tax liabilities, and, of course, my concern with that is that

presumably, these things that have been passed by Congress are legitimate mechanisms to reduce a taxpayer's liability; that Congress has said this is something that is legal.

I do not understand why we would then assign a greater penalty for someone attempting to do something that is legal than for other people that attempt to do something else that is legal.

Mr. HANDLER. That is a very good question, and it is a very difficult one.

Our definition, which is appended to the report which we have delivered, establishes an exception for any advantage contemplated by law, by the statute, by regulations, or by administrative authority.

For example, there is a long practice of leverage leasing, which has been a standard financial transaction for many, many years. There are revenue procedures that govern the basis upon which leverage leasing transactions could be effected. They are clearly tax-motivated transactions. They are not ones that we think should be included within any of these definitions.

Senator BREAUX. Wouldn't all of these efforts—I mean, every corporate tax attorney is going to tell you every time they do this, it is for a tax purpose.

Mr. HANDLER. The issue is whether or not an advantage which is built into the law has been engrafted on an otherwise appropriate business transaction to achieve artificial benefit, and the process whereby the difficult definition will have to be developed is to identify elements of those transactions which identify the artificiality or the overwhelming tax benefit motive as opposed to, as Mr. Tucker talked about, the economic substance of the transaction.

We believe it is possible to do that, and without doing that, I do not think you can come up with an effective program.

Senator BREAUX. The thing that bothers me, and I will ask the other two gentlemen to comment on it, is that it is almost like you are asking for some divine wisdom here in Washington to look into someone's head to determine why they did something. I mean, if they did it improperly or incorrectly, well, then it should be disallowed, but to say that you had some other reason for doing it that we determined we therefore are going to have a super penalty assigned to you is a very difficult thing for Government to do.

Mr. HANDLER. There are a number of elements of these transactions, such as the shifting of income beyond economic income from a taxable party to a tax-indifferent party, which we believe is important and which is an element of a corporate tax shelter.

Similarly, transactions which the economic deductions or income reported differed very substantially from the taxable income or loss that is being reported, in our report we have attempted to identify transactions such as loss-generating transactions, such as the ACM transaction and others, where it is fairly apparent that the transaction has no purpose other than to take advantage of an existing tax provision. Those are the kinds of transactions we would seek to identify.

Senator BREAUX. Can Mr. Lifson and Mr. Tucker comment on my basic question?

Mr. LIFSON. We have also offered a series of transactions in our prepared testimony that we think clearly would not be subject to the penalty.

Senator BREAUX. The safe-haven type of thing you suggested?

Mr. LIFSON. The safe harbor, correct.

Senator BREAUX. Safe harbor, safe haven.

Mr. LIFSON. And another series of transactions that we have identified as being clearly, in our view, potential targets for this type of legislation.

Our concern is everything in the middle; that the proposal would create extraordinary sanctions and apply them to vague standards of a whole mass of transactions that sit in between the two obvious problems and not problems.

Ultimate simplification is creating a law that is less likely to cause a dispute between the IRS and the taxpayer. This proposal is much more likely to cause a dispute between taxpayers and the IRS. The IRS's view of simplification, the way Mr. Lubick described it earlier, might be considered that a law is simpler if it is easier to collect a tax because no one knows for sure what the law is.

We go for the first brand of simplification, not the second.

Senator BREAUX. Mr. Tucker, do you have a comment?

Mr. TUCKER. Mr. Breaux, perhaps I have been working in the tax law too long. I started in 1963, and I was taught when I was in law school before that, that Section 61 of the Code says everything is gross income unless there is an exception. My problem is that in the corporate tax shelter world, everything is not income unless you are caught. I think within that gray area, I recognize there are fine lines that people might trip over, one place or the other.

I think a clearly articulated concept coming out of Congress in which there are penalties, where there is no economic substance to the transaction, and you are violating what the courts have recognized over the years, but, unfortunately, it is only if, as, and when a particular revenue agents is bright enough or articulate enough to take that forward, and I think we need to come up with some rules focussing on that economic substance and say you must compare those with the tax benefits.

If they really are so de minimis and so nominal and it is not something like low-income housing or other areas where Congress has specifically said we want this as a matter of policy, then we ought to have something that keeps people on that line or inside the line and they do not step over it.

Senator BREAUX. I appreciate it, but everything they are attempting to do apparently has been generated by Congress, whatever exemption it is or whatever shelter that exists. It seemed that Congress has established that as something that is a legal transaction, whether they do it legally or illegally in how they do it.

I am just concerned about saying is this some sort of a super penalty for someone attempting to do something that is a shelter as opposed to somebody attempting to do something that is not.

Mr. TUCKER. No, sir. I think that Congress has not said all of this is legitimate.

What happens is we are often taking mismatched provisions. Liquidating REIT is a good example of taking the REIT provisions and

taking Section 332 of the Code and mismatching them to put them together.

Another way is using the offshore partnership with a tax-indifferent party to put together the loss inside the U.S. and the income outside the U.S. for the tax-indifferent party.

I think there are lines that can be drawn, and it is not simply these people are using what Congress has authorized. It is people are extending beyond or basing it on facts that do not fit within what Congress thought about or would have thought about if they had thought about the area at the time to fit within that.

Senator BREAUX. I have another question, but I will come back later.

The CHAIRMAN. Senator Mack?

Senator MACK. Thank you, Mr. Chairman, and I, too, want to welcome the panel. I am sorry I was unable to attend the earlier portion of the hearing.

It is pretty obvious that in listening to you all that it is a very complicated area, and one that is difficult to define. I do not think that there is any question that there are abuses out there where people take advantage of the way tax laws are written.

The Congress, 2 years ago, tried to give some direction to the Treasury with respect to this issue. It does not seem to me that Treasury really has given those approaches an opportunity to work, but let's set that aside for a moment. Treasury has come forward with some proposals.

First, I am not an attorney. I am not a CPA. I am not a tax expert. But it seems to me that what Treasury has done, A, they have recognized this is a very complicated area, very difficult to define. So they have put out some very vague language, and then proposed some incredibly draconian penalties. The only conclusion that I can draw from this is they just decided to scare the hell out of everybody and that will take care of the problem, and I do not think we can allow that to take place.

I would be interested, Mr. Lifson, if you would identify for me, first of all, what the penalties are because I think one of the penalties is going to be increased to 40 percent, and there are a couple of additional 25-percent penalties. I think if you would briefly lay those out for me.

Mr. LIFSON. It is easier to give you the bottom line. The bottom line is the penalties run between 75 and 80 percent by the time you are done with all the layering of penalty on penalty on penalty.

Senator MACK. The problem that I have with that is I suspect that there could be someone who, because of the vague definition, pursued a particular line of planning and then found themselves to have been judged by the IRS and Treasury to have violated these rules.

Can you give me some examples of where that might be the case, or am I just dreaming that up?

Mr. Tucker or any of you can hop in here at any moment you would like to.

Mr. TUCKER. Before I get to what the case may be, Mr. Mack, I think that one of the items that we are all focussed on here is that if people adequately disclose the facts, if they adequately dis-

close the conclusions they based it on, they ought not be assessed the penalties in as draconian a method.

Senator MACK. Does everybody agree with that?

Mr. HANDLER. Our report, Senator, indicates support for a step down of the penalties for proper disclosure.

The problem is that you need to have some incentive to disclose. So you have to have something that would require taxpayers to distinguish. The easiest way to get people's attention is to penalize them if they do not.

Mr. LIFSON. My practice clearly indicates that the reduction of penalties for disclosure and disclosure itself has a very chilling effect on aggressive tax planning, and that many, many, many people will rethink what they have to do and what positions they might take when they are told that they have to actually explain it to the IRS.

Mr. HANDLER. We agree with that.

Senator MACK. All right. It might be helpful, at least for me, anyway, to try to understand what might be a proper transaction that could be thwarted by this vague language and these draconian penalties.

Mr. Lifson, could you give an example or two?

Mr. LIFSON. Sure. Without being specific, I can explain it just as a non-lawyer, non-CPA. There are all kinds of provisions that relate to corporate reorganizations. Some of them utilize aggressive tactics, like this step-down REIT which was mentioned earlier, and others use other perfectly legitimate tax-planning methodologies in reorganizing a business.

Unfortunately, when you are reorganizing a business, you are not really sure you are always within the rules. The rules are complex and subjective, and need to be complex and subjective to handle an infinite number of types of transactions.

So that would be an area where certainly disclosure would be up front and would give the IRS sufficient time to study the transaction you were engaging in and decide whether you are engaging in bad behavior, good behavior, or debatable behavior.

Mr. HANDLER. If I may, there is a very well-known case that came out of a transaction in the late 1980's in which the ESMAR Company sold an oil subsidiary to Mobil in a very highly tax-structured transaction. The transaction ultimately was decided by the Tax Court and ultimately by a Court of Appeals in favor of the taxpayer, but it was a clearly tax-motivated structure of a perfectly legitimate business transaction.

In the last 3 years——

Senator MACK. Can I just hop in there for a second?

Mr. HANDLER. Sure.

Senator MACK. There is something that strikes me that there should not be something that is illegal about structuring an organization because of tax laws.

Mr. HANDLER. That is the point I was trying to make, Senator.

Senator MACK. Okay.

Mr. HANDLER. That transaction, which was approved by the courts, is one that our group, for example, believes would not be subject to penalty. It is a perfectly legitimate tax-planning exercise.

On the other hand, in the last 3 to 4 years, there have been a number of similar transactions structured in which artificially the transactions pass through the hands temporarily of a tax-exempt entity, allowing the buyer to get a stepped-up basis for the assets which the Code prohibits under normal circumstances.

The transaction through the tax-exempt party was totally artificial, and yet, there were a number of opinions of tax advisors that would justify the relying on those opinions to avoid any penalty for a transaction that was clearly, totally artificial. Those kinds of transactions, we believe can be defined to be caught by an appropriate structured penalty procedure, which in addition to the disclosure, which Mr. Lifson indicated and which I agree, would deter taxpayers from taking the risk. It would also deter taxpayers from taking the risk if they were ultimately determined to be wrong and to be within the defined transactions that would be subject to penalty.

Mr. LIFSON. But you won in court. What happens when you lose 2 to 1 on appeal? Is that going to be subject the penalty because you lost?

Certainly, if you win the point in court, then you are not going to be subject to a penalty.

Mr. HANDLER. It is a very good example, Mr. Lifson.

I think if you asked a number of tax professionals about the ACM transaction, which was recently decided, and the ASA transaction, which was recently decided, both by the Tax Court and by various circuit courts in favor of the Government, most people would say the transaction really had principally, if not entirely, tax benefit and very little business motivation, and yet, it was a 2-to-1 decision in the Third Circuit for the ACM transaction.

I certainly and our group certainly does not believe that that transaction, were you to have a situation in which penalties were imposed on a strict liability basis, without reasonable cause exception, would be one of the prime examples of transactions subject to penalty.

Senator MACK. Mr. Chairman, thank you.

The CHAIRMAN. Well, gentlemen, thank you for being here today. Senator Breaux?

Senator BREAUX. Mr. Lifson, I appreciate your extensive discussion and your documentation. I think it is set out very well about the specifics of the administration's proposal. I am particularly intrigued by your discussion on the treatment of an S corporation investing in ESOPs.

It seems to me that what the Treasury is doing—we do not even have the regulations on this proposal yet, and we are already talking about changing the law, even before the regs have been introduced. Your discussion says that, well, Ginsburg pointed out there is some potential opportunities for abuse, but I take it that you would agree with me, I guess, that perhaps these potentials for abuses could be corrected either through the regulatory process and issue tight regulations dealing with this. Or, do you think it is necessary to have legislation? The ink is not dry on the last bill we did. The regulations have not been produced yet, and we are already talking about changing the law.

Can you give me some more comments on this?

Mr. LIFSON. I was particularly impressed with the earlier discussion that you had that clearly to me show that there are two intentional tax benefits working in tandem, and I was trying to figure out what was wrong with that.

Senator BREAUX. Yes.

Mr. LIFSON. What is wrong with passing through the benefits to an ESOP, and yet not taxing the ESOP which is a pension plan until the ESOP distributes the pension to the participants?

So I listened to the colloquy and tried to find where is the abuse.

Senator BREAUX. I do not want to defend their position because I disagree with it, but I would take it, I guess, that a potential could exist if it was just a couple of shareholders in an S corporation which distributed the income to a very small number of employees. I would think that regulation could govern something like that.

Mr. LIFSON. I agree completely that both the ESOP regulations and the use of the S corp in the ESOP environment should be able to handle that type of problem.

Senator BREAUX. I appreciate your comments.

You also offered and said in your statement, if Congress is concerned about these transactions, the appropriate response is to craft narrow solutions targeting these particular transactions, rather than to reject wholesale the decision made in the 1997 Act and that your organization would be happy to work with this committee in devising such solutions.

I want to take you up on that offer, and if you all have any ideas about how we may correct the potential for abuse, I want to do it, but not kill the program, which I happen to think has a great deal of merit to encourage retirement savings and have people feel that they are part of a cooperation and want to make it more productive, so message delivered.

Thank you very much.

Mr. LIFSON. Thank you.

The CHAIRMAN. Thank you, gentlemen, for being here. We will undoubtedly call on you in the future.

At this stage, I would like to call the third panel. We are pleased to have Mr. Lester Ezrati, who is the International President of the Tax Executive Institute. He is also General Tax Counsel for Hewlett-Packard. We have Ms. Jeanne Hoenicke, who is a Vice President and Deputy General Counsel for the American Council of Life Insurance. We have Edward Kleinbard of the law form of Cleary, Gottlieb, Steen & Hamilton who is representing the Securities Industry Association, and finally, we have Ms. Nancy H. Worman, who is the Chair of the Tax Committee of the American Bankers Association.

We will start with Mr. Ezrati.

STATEMENT OF LESTER D. EZRATI, INTERNATIONAL PRESIDENT, TAX EXECUTIVE INSTITUTE, AND GENERAL TAX COUNSEL, HEWLETT-PACKARD COMPANY, PALO ALTO, CA

Mr. EZRATI. Thank you, Mr. Chairman.

I am General Tax Counsel for Hewlett-Packard Company in Palo Alto, California. Although HP is very much interested in the subject of today's hearing, I am here today as President of Tax Execu-

tive Institute, the preeminent group of in-house tax professionals in North America.

TEI is dedicated to working with Congress, the administration, and our colleagues in the tax community to craft an appropriate response to so-called corporate tax shelters.

As an organization of taxpayers, TEI's perspective differs from that of other organizations that have commented on the administration's proposals. We do not represent the so-called tax shelter promoters and developers who either sell or facilitate the transactions. The Institute does not represent the professional advisors who opine on the legitimacy of the arrangements. Rather, TEI's members work directly for the corporations that regularly enter into business transactions that require an analysis of their tax benefits and burdens.

To this end, these companies evaluate particular transactions, decide whether they pass muster not only in terms of the substantive requirements for the tax law, but importantly in terms of their own business needs and corporate culture, and if they proceed, they report the transactions on their tax returns and defend them on audit.

Mr. Chairman, let me assure you that TEI is not among those who believe that no problem exists, but the challenge in confronting the tax system is not simple and care must be taken to ensure that the solutions are measured and balanced.

Ultimately, it is the corporation that is responsible for what is reported on its tax return, but in our view, it is wrong to suggest that the problem lies only with the taxpayers themselves and that the solution should be directed only at them.

Accordingly, TEI is pleased that the administration has suggested that attention be paid to promoters and outside advisors.

TEI also believes it is necessary to recognize that Congress, the Treasury Department, and the IRS play in this matter as well. Thus, we are disappointed that the administration has not addressed the complexity that characterizes the tax law.

We also think a legitimate question can be raised whether the Treasury and the IRS have effectively utilized its current tools to address the perceived growth of tax shelters. Experience teaches that notices, rulings, regulations, and litigation can be and have been successfully used to halt questionable transactions. We suggest that before deciding that a new 40-percent strict liability penalty should be enacted, the IRS and Treasury should be asked why they had not promulgated regulations defining tax shelter under rules enacted in 1997.

As Senator Mack said, why promote a 40-percent penalty when the necessary steps to vivify the current 20-percent penalty have not been taken?

Even assuming that current law is inadequate to the task of impeding corporate tax shelters, TEI has serious misgivings about the administration's proposals.

First, the administration's proposals contain several subject terms that currently remain undefined. Among the undefined terms are "corporate tax shelter," "tax avoidance transaction," "tax benefit clearly contemplated by the applicable provision of the tax law, taking into account the Congressional purpose," and "improper

elimination or significant reduction of tax on economic income," whatever that is.

We believe that the cumulative effect of this vagueness is a set of proposals so fraught with ambiguity that they will inhibit the ability of corporate taxpayers to conduct, in your words, Senator Roth, legitimate business transactions.

Second, the proposals lack proportionality. As others have pointed out in the aggregate, the various penalties can approach or potentially exceed the penalty for fraud. This constitutes overkill.

Third, the proposals would grant too much discretion to IRS field agents. Some have suggested that the unclear definition of "corporate tax shelters" is acceptable because such issues are frequently left to the courts. TEI believes, however, that such an approach is a recipe for wasteful litigation and inconsistency, not good tax administration. Indeed, we suggest that the proposed delegation of authority, especially under Super Section 269, threatens to transform the U.S. tax system from Tax Code by Congress to Tax Code by revenue agent.

As Mr. Lubick said, he does not think Congress is up to the task of fixing this, and he is going to let the revenue agent do it for you.

Fourth, the administration's desire to impose a strict liability penalty is misguided. TEI strongly opposes the proposed elimination of the reasonable cause and good-faith exception of current law.

TEI appreciates the Treasury's desire to increase the stakes, but the enactment of a no-fault penalty is wholly inappropriate. Indeed, the less clear the applicable standard, the more important it is to include safety valves to guard against patent unfairness.

In our view, imposing a penalty with a standard is unclear, especially where the taxpayers either sought professional advice or undertaken to inform the IRS of the possible dispute is to breach the trust that Congress sought to create in enacting the IRS Restructuring and Reform Act.

Finally, the proposals provide an inadequate incentive to disclose. In TEI's view, current law has the perverse effect of discouraging disclosure because disclosure of a potentially questionable transaction has no effect on the applicability of the current shelter penalty.

The administration recognizes this shortcoming, but would address it by doubling the current penalty and then reducing it to only 20 percent, when the taxpayer makes a timely and adequate disclosure. In our view, the reviewed structure would still be so excessive when applied on a strict liability basis, it would not have its intended effect. TEI believes that the IRS should not penalize taxpayers that adequately disclose their activities.

We also believe that such disclosure should not be required before the filing of the tax return. In the event it is concluded that earlier disclosure should be required, we recommend that the burden of such disclosure be properly placed on the promoter or advisor.

Mr. Chairman, Tax Executive Institute appreciates this opportunity to provide its comments on proposals relating to tax shelters. I would be pleased to respond to any questions you may have.

Thank you.

[The prepared statement of Mr. Ezrati appears in the appendix.]

The CHAIRMAN. Thank you.

Ms. Hoenicke?

STATEMENT OF JEANNE E. HOENICKE, VICE PRESIDENT AND DEPUTY GENERAL COUNSEL, AMERICAN COUNCIL OF LIFE INSURANCE, WASHINGTON, DC

Ms. HOENICKE. Thank you, Mr. Chairman.

I am representing the American Council of Life Insurance. The nearly 500 company members of the ACLI offer life insurance, annuities, pensions, long-term care, disability income insurance, and other retirement and protection products.

The ACLI is strongly opposed to the nearly $7-billion tax increase on life insurance products and companies in the administration's budget. I am especially pleased to be here today because a large bipartisan majority of this committee have joined Senator Nickles and Senator Baucus in signing a letter opposing these proposals. They have recognized that the proposals would seriously threaten the hopes of millions of Americans for a secure retirement and would jeopardize the protection of family businesses and family farms.

The Council is pleased to provide this testimony representing, for the first time in 20 years, a life industry fully united on all tax issues. For many years, the industry's voice has been weakened by disagreements among the stock and mutual segments of this industry. This year brought an historic change, the end of the longstanding feud between stocks and mutuals. With one voice now, the Council declares that there is no justification for provisions of the Code that separately tax stock and mutual life companies.

With one voice now, the Council opposes tax increases on any segment of this industry, and with one voice now, the Council shows that our industry already pays more than its fair share of taxes. And the administration's proposals are unjustified.

The National Association of Life Underwriters and its conference, the Association of Advanced Life Underwriters, also endorse these remarks.

Why all this unanimity? Because the administration's proposals are seriously wide of the mark. Two of the proposals would make annuities and life insurance more expensive for individuals. Annuities are the only financial product that provides guarantees against outliving one's income. Life insurance is the only product that gives security to families should a bread-winner die.

Another of the proposals could wipe out a product that protects businesses and allows them to provide employee benefits, including retiree health benefits.

In addition, contrary to the administration's apparent perception, life companies already pay a large amount of Federal taxes, and pay at a rate significantly higher than the rate for all U.S. corporations.

A study recently completed by Coopers & Lybrand shows that the life insurance industry paid $54 billion of taxes from 1986 to 1995. In 1995 alone, the industry paid over $10 billion in taxes. Most importantly, the average effective tax rate for U.S. life insurers over those 10 years was 32 percent, significantly higher than

the average rate for all U.S. corporations of approximately 25 percent.

Let me turn now to the three specific proposals that concern us; first, the so-called DAC tax on life insurance and annuities. In addition to paying regular corporate income tax, life insurers must pay a tax based on gross premiums from the sales of their products, including life insurance and annuities. This is known as the DAC tax.

Under the DAC tax, selling expenses are not fully deductible in the year paid. Rather, the deduction is spread over 10 years. The DAC tax is calculated as an arbitrary percentage of net premiums for each type of policy.

The administration proposes to triple this tax on annuities, nearly double it on whole life, and raise the tax on group whole life sixfold. This type of tax increase is an indirect tax on owners of annuities and whole life insurance. It is bad public policy at a time when Americans are living longer than ever before. Congress sensibly rejected similar proposals on annuities and life insurance last year. We urge you to do so again.

An increase DAC tax is entirely unnecessary because the Tax Code already defers life insurer's deductions for selling expenses by the mechanism of reducing deductions for the reserves life insurers hold for policyholders. No insurance accounting system, including GAAP, requires both the use of reduced reserves and the deferral of selling expenses.

Treasury specifically cites the GAAP system as a model for requiring deferred deductions of selling expenses, but if GAAP is the right model, then tax reserve deductions for life insurers must be drastically increased. For some reason, Treasury left out that part of the story.

As to their proposal to tax policyholder's surplus accounts, under the tax law in place before 1984, shareholder-owned life companies subtracted from their taxable income a portion of their operating gains. These amounts were recorded in an account called a policyholder surplus account, or PSA. The amount recorded in these accounts were part of a carefully crafted balance of the effective tax rates of stock and mutually companies under the tax framework for life insurers at that time.

The administration now proposes to force life companies to include these tax accounts in income over a 10-year period. To reach back for tax revenues on long past operating results, some from nearly 40 years ago is wrong.

Nothing has happened to day that should cause Congress to go back and undo or redo this old cold tax framework. It is important to understand that the policyholder surplus account is only an accounting record. There are no assets set aside in a vault to pay this unanticipated tax. There is no reason to do so now, especially given the high level of taxes paid by life insurers.

Let me just touch briefly on the rerun of their proposal to tax business life insurance.

The CHAIRMAN. I would ask you to summarize quickly, please.

Ms. HOENICKE. I will summarize.

I will just say here that Congress fully treated corporate-owned life insurance in 1996 and 1997, and there is no reason to undo what they did in 1996 and 1997.

In conclusion, the life insurance and annuity proposals would add over a billion dollars a year to the taxes on life insurance products and companies. The study provided by Coopers & Lybrand reveals that these additional taxes would be unreasonable and unfair, and indeed, many provisions such as Subpart F, under consideration by this committee, to reduce life company taxes would be appropriate.

Mr. Chairman and distinguished members, I thank you for this opportunity to speak to you, and I respectfully request that our entire prepared statement and the Coopers & Lybrand study be included in the record of this hearing.

Thank you.

[The prepared statement of Ms. Hoenicke appears in the appendix.]

The CHAIRMAN. Without objection, and all the full statements that goes before us will be included, as if read.

Mr. Kleinbard?

STATEMENT OF EDWARD D. KLEINBARD, CLEARY, GOTTLIEB, STEEN & HAMILTON ON BEHALF OF SECURITIES INDUSTRY ASSOCIATION, NEW YORK, NY

Mr. KLEINBARD. Mr. Chairman and members of the committee, I am appearing today on behalf of the Securities Industry Association. We thank you for this opportunity to summarize our concerns with several of the administration's budget proposals that would raise revenues by targeting capital markets transactions.

We believe that many of the administration's capital markets proposals would increase the cost of capital for U.S. companies, reduce financing alternatives, and create new economic dislocations in our capital markets, all without furthering any tax policy objective.

We have two broad policy objections to the administration's capital markets proposals. First, the administration would pepper the Tax Code with a variety of new economic distortions. Second, the administration proposes to trample over the substantive legal rights and obligations created by financial instruments. This second point is not an issue of fine-print lawyering. In fact, the tax classification of the capital structure of a corporation turns principally on the analysis of just such legal rights and obligations.

The administration's proposals regarding the dividends-received deduction illustrate both of my themes. Corporate earnings today are subjected to double tax, once when earned by the corporation and then again when paid out as dividends.

To mitigate the potential triple taxation of corporate earnings, corporate shareholders receive a 70-percent dividends-received deduction. Yet, the administration now proposes to increase this multiple taxation of the same economic income.

First, the administration proposals to scale back the dividends-received deduction for any corporate shareholder that has also borrowed money, even for entirely unrelated purposes. In practical ef-

fect, this proposal is simply a back-door reduction in the 70-percent dividends-received deduction.

Second, Treasury proposes to treat certain preferred stock as too similar to debt for the holder to qualify for the dividends-received deduction, but at the same time, Treasury proposes to deny the issuer an interest deduction on those same dividend payments. This inconsistent treatment of holders and issuers introduces another economic distortion into the code, which no doubt explains why this idea has been rejected by this very committee in the past.

Another administration proposal would impute interest income to a company that agrees today to sell its own stock in the future. In effect, the proposal would treat the issuing company as if it had sold it stock today and then lent the money it received back to the forward buyer. The issuer would be charged with fictional interest income, but the buyer would not obtain an interest deduction.

An agreement to sell stock in the future is not the same as selling the stock today. A forward buyer has none of the current rights of a shareholder, such as the right to dividends or the right to vote at stock.

Moreover, by treating the forward buyer as if it paid interest to the seller, but not permitting the buyer an interest deduction, the forward sale proposal would introduce still another economic distortion into the Code. The administration's tracking-stock proposal suffers from precisely the same flaw of ignoring the substantive differences between issuing stock and actually selling the assets of the business underlying the stock.

I would like to turn now to a notable omission from the administration's tax proposals, the extension of Subpart F's international tax reforms for financial services firms.

Leveling the tax playing field with our foreign-based competitors is crucial to the long-term global success of U.S.-based financial services firms. The 1998 Act's 1-year extension of the Subpart F reforms was the culmination of a great deal of hard work by many people under the leadership of this committee. We urge the committee to extend this important provision.

Finally, I would like to address the administration's corporate tax shelter proposals. We understand the Treasury's concerns with strictly tax-motivated transactions. Nonetheless, we find the broad reach of Treasury's corporate tax shelter proposals to be truly alarming.

These proposals represent a radical departure for our tax system which in general encourages accurate self-assessment through the development of clear tax rules. Treasury's proposals, by contrast, threaten to introduce a set of rules that are substantively vague in scope and application, and yet impose punitive penalties with mathematical precision.

The result in practical application is that taxpayers will always be uncertain of what the law is and will only know for certain what the penalty will be if an IRS agent were later to disagree.

Treasury's White Paper on this topic undoubtedly will bring into sharper focus Treasury's views in the area. We are committed to working with this committee, the House Ways and Means Committee, and Treasury following the White Paper's release to address

any issues that this committee may identify in a fashion that is consistent with a sound administration of our complex Tax Code.

Mr. Chairman, I have been mindful of your injunction to limit my remarks to 5 minutes. The brevity of our remarks on corporate tax shelters is not intended to imply that we think that the issues are simple or trivial.

I appreciate this opportunity to speak. Thank you.

[The prepared statement of Mr. Kleinbard appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Kleinbard.

Ms. Worman?

STATEMENT OF NANCY H. WORMAN, CHAIR, TAXATION COMMITTEE, AMERICAN BANKERS ASSOCIATION, AND EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, KEYCORP, CLEVELAND, OH

Ms. WORMAN. Thank you.

Mr. Chairman and members of the committee, I am Nancy Worman, Executive Vice President of Finance of KeyCorp. I am pleased to appear before you to present the American Bankers Association's views on the administration's revenue-raising provisions.

At the outset, I would like to commend you, Chairman Roth, for holding these hearings. We are particularly appreciative of your continued efforts with respect to expanding IRAs and promoting retirement savings. We recognize that your job here is not easy. Noncontroversial revenue-raisers are scarce, while the list of needed and tax cuts is long. However, it is simply wrong to label many of the administration's proposals as corporate loopholes. In fact, some of the items could actually ensnare the innocent by creating new taxes on activities that may not have been contemplated or targeted.

I will summarize four of the issues we believe fit this description. Generally, the budget revenue-raising proposals are very troubling in that they overkill the narrow transactions the administration claims to target. They can best be summarized by a paraphrase of the legal adage, "You do not need a legislative sledgehammer to crack tax walnuts."

The provisions we find most offensive share certain common characteristics. They are actually thinly disguised corporate tax increases or significant tax policy changes, rather than loophole-closers. They will cause harm to the corporate community and its stockholders. They are overly broad and penalize banks' customary and ordinary business transactions that are not in fact abusive.

The better course would be to equalize the business playing field by closing genuine loopholes. For example, limiting the proliferation of multiple common bond credit unions that have expanded their membership customer base far beyond the parameters of the original common bond is a sorely needed loophole-closer, which we would respectfully offer for your consideration.

We did note that the administration's revenue proposals did not include the taxation of credit unions.

There are four items I wish to cover this morning. First of all, I will address corporate-owned life insurance. The administration's

proposed COLI change, which was rejected by both tax-writing committees during the 105th Congress, will effectively eliminate the use of COLI to offset escalating employee and retirement benefits. It would also penalize, retroactively, businesses that reasonably relied on existing tax law. We urge you once again to reject this proposal.

Our second issue is information reporting and substantial understatement penalties. The information reporting penalty change will not improve compliance. Penalties typically are intended to discourage bad behavior and encourage good behavior, not to serve as revenue-raisers.

The banking industry files an enormous number of information returns annually in good faith for the sole benefit of the IRS. We take particular umbrage with the suggestion that this proposal closes a corporate loophole that in fact presumes noncompliance, a conclusion for which there is no substantiating evidence.

Also, the proposals to modify the substantial understatement penalties would create an inflexible standard that could penalize innocent mistakes and inadvertent errors.

The next issue, is Subchapter S. As you know, the 104th Congress first allowed banks and thrifts to elect S corporation status, a change for which we are greatly appreciative. However, the administration's proposal would accelerate net unrealized build in gains and create an immediate corporate and shareholder-level tax, effectively making the cost of conversion prohibitively expansive.

This seems particularly unfair since the institutions have only had a short period of time to elect S corporation status. Such a change is also contrary to the apparent Congressional intent of removing unreasonable burdens placed on S corporations.

Instead, legislation is needed to assist community banks in qualifying under current rules. We understand that such legislation will soon be introduced which we would urge you to include in any tax package that you enact.

Our final issue for this hearing is structured settlements. The administration's structured settlement proposal to impose excise taxes on the purchase of structured settlements may seem to be a simple solution, but it could have unintended repercussions.

Unknowingly, banking institutions could be ensnared in a punitive tax trap simply by making loans to borrowers under a blanket security agreement. It would also force lenders to rewrite their outstanding lending agreements in the attempt to avoid the excise tax, imposing new and unduly burdensome administration costs.

We suggest that pledges for bank loans in the normal course of business should be excluded from any legislation on structured settlements.

In conclusion, I appreciate the opportunity to present the ABA's views. I would be pleased to answer any of your questions.

[The prepared statement of Ms. Worman appears in the appendix.]

The CHAIRMAN. Thank you.

Basically, I only have two questions at this time. I would like to ask you, Mr. Ezrati, what are your views with respect to the American Bar Association's suggestion that we require a high-level corporate officer to investigate and disclose the facts of a deal?

Mr. EZRATI. I think it has some merit. I think you have to be cognizant of the fact that in a company the size of most of our members I know at HP, probably our tax return has contained within it millions of transactions. So I think if you have a clear definition of what you want disclosed, maybe by size, and the facts you want to have a high-level review, then it is a proposal that could be considered, but if you are going to ask for disclosure and a representation from that officer about those millions of transactions, it is just not going to happen. Keep it narrow. Get it to a critical mass where the size is appropriate, and I think it is a proposal we could consider.

The CHAIRMAN. This is a question I would ask of either Mr. Kleinbard or Ms. Worman.

Ms. Worman, in your testimony, you mentioned your opposition to modifying the standard for determining whether a portfolio stock is debt-finance. As I recall Section 246A was enacted to prevent double deduction for interest and dividends for stock required by debt. The theory was that the corporation should not be able to double-dip.

We have heard, however, that this rule is easily avoided by not incurring debt that is directly attributable to the purchase of portfolio stock.

Would you comment on this, Ms. Worman, or do you have any suggestions how we can strengthen the provision?

Ms. WORMAN. I am not sure that it is directly attributable if there has been direct borrowing associated with acquiring portfolio stock. However, the bank's balance sheet, half of it is borrowing in this form of deposits of outside borrowings for it. So, on that particular level, it is not, but the level of equity securities is fairly closely regulated by the OCC and other regulatory bodies that are there. I do not perceive this to be an abuse.

The CHAIRMAN. Mr. Kleinbard, do you have any comment?

Mr. KLEINBARD. Yes. I think you have raised a very good question, and I think it is important to go back to what the purpose of 246A was when it was in fact enacted in 1984.

The purpose of 246A was not to catch all corporate investors in the stock of other corporations. At the time, the transactions that were identified by this committee as troublesome were transactions in which corporate investors using typically a trust vehicle would incur non-recourse debt to debts which they were not personally liable to acquire a stock of another company in a transaction that was typically treated as off balance sheet, so that the debt financing did not appear on the investor's balance sheet and claimed both an interest deduction with respect to the non-recourse debt and the dividends-received reduction in respect of the income from the security, thereby turning a very small spread into a large after-tax return. This committee appropriately concluded that those sorts of transactions ought to be addressed.

It is a long way from that to conclude that every corporation in America should have its dividends-received deductions scaled back because every corporation in America in fact has debt somewhere on their balance sheet. Corporations borrow money for a thousand purposes.

The Treasury believes that all debt is completely fungible across the corporate sector. That is not in fact true. If I borrow money to build a plant, that money is not available to finance a preferred stock.

I think that this committee and this Congress came to the right conclusion in 1984 as to where the boundaries should be in this area. What the administration's proposal in fact represents is simply a back-door way of scaling back the DRD because it will apply to every corporation.

The CHAIRMAN. Thank you.

Senator Breaux?

Senator BREAUX. I thank the panel for the testimony. I think it has all been very, very helpful. I will not go into any of the details. I think that your suggestions and things that you are pointing out as potential problem areas are well taken.

I would only encourage everyone that I am not sure what form a tax bill is going to take. It may be something that is part, Mr. Chairman, of a reconciliation process that may go down this track speeding like a locomotive, and it is not going to be a lot of time to look at a freestanding tax bill. It may be that you are going to see it all wrapped up into a budget reconciliation process, and everybody will be holding their breath as to find out what is happening and why it is happening and what is in it. So stay tuned for an interesting next couple of months. Your recommendations have been very helpful, and I think have great merit.

Thank you.

The CHAIRMAN. We will keep the record open for additional questions. We would ask you to reply in writing.

Thank you very much for being here today. It has been very helpful.

The committee is in recess.

[Whereupon, at 12:24 p.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Lester D. Ezrati

Good morning. I am Lester D. Ezrati, General Tax Counsel for Hewlett-Packard Company in Palo Alto, California. I appear before you today as the president of Tax Executives Institute, the largest group of in-house tax professionals in North America. The Institute is pleased to provide the following comments on the corporate tax shelter provisions of the Clinton Administration's Fiscal Year 2000 Budget.[1]

BACKGROUND

Tax Executives Institute is the preeminent association of corporate tax executives in North America. Our 5,000 members are accountants, attorneys, and other business professionals who work for the largest 2,800 companies in the United States and Canada; they are responsible for conducting the tax affairs of their companies and ensuring their compliance with the tax laws. Hence, TEI members deal with the tax code in all its complexity, as well as with the Internal Revenue Service, on almost a daily a basis. (Most of the companies represented by our members are part of the IRS's Coordinated Examination Program, pursuant to which they are audited on an ongoing basis.) TEI is dedicated to the development and effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. Our background and experience enable us to bring a unique and, we believe, balanced perspective to the subject of corporate tax shelters.

Because of the importance of the Administration's proposals and their potential long-term effect on the fair and efficient administration of the tax system Tax Executives Institute has established a special task force to study the proposals and to develop alternatives that address the Administration's legitimate concerns without imperiling lawful tax minimization efforts. Although the task force's preliminary views are reflected in this testimony, its principal work awaits the issuance of the Department of the Treasury's forthcoming "white paper" on corporate tax shelters. It is our understanding that the Treasury paper will elaborate on the Administration's still inchoate proposals. Our hope is that, in doing so, the Treasury will allay the concerns that TEI and other commentators have identified with the proposals.[2] Because the Administration's proposals themselves remain a "work in progress," TEI stands ready to supplement this testimony at the appropriate time.

OVERVIEW OF THE ADMINISTRATION'S PROPOSALS

The Administration's Fiscal Year 2000 Budget contains 16 provisions related to so-called corporate tax shelters. In this testimony, TEI does not address each of these proposals, but rather sets forth its general reactions to and questions about the proposals. In particular, we seek to explain our concerns about the proposals' lack of clarity (e.g., in defining the term "corporate tax shelter"), their overall lack of proportionality, their possible interference with normal business transactions, and their potentially detrimental effect on tax administration. We also comment on our disappointment that the Administration has proposed a series of new provisions without having fully utilized the tools currently at its disposal. Finally, we set forth our preliminary suggestions on how the Administration's proposals can be refined to address our concerns.

Under the general corporate tax shelter proposals in the Administration's budget, a corporate tax shelter would be any entity, plan, or arrangement in which a direct

or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction. A tax benefit would include any reduction, avoidance, or deferral of tax, but would not include any tax benefit clearly contemplated by Congress; a tax avoidance transaction would be any transaction in which the reasonably expected pre-tax profit of the transaction is insignificant relative to the reasonably expected net tax benefits of the transaction. In addition, a tax avoidance transaction would include certain transactions involving the improper elimination or significant reduction of tax on economic income.

If a corporation received an improper tax benefit from a corporate tax shelter, it would suffer a number of adverse consequences. First, the corporation would be subject to a 40-percent penalty, even if it acted with reasonable cause and in good faith. (The penalty would be reduced to 20 percent if the transaction were adequately disclosed.) Second, the taxpayer could not deduct any fees paid for advice concerning the corporate tax shelter. Third, a 25-percent excise tax would be imposed on investment banking and other fees relating to the shelter. Fourth, if the seller of the corporate tax shelter agreed to rebate any fees paid if the shelter were not successfully implemented, a 25-percent excise tax would be imposed on such "unwind" payments. Fifth, the income received by tax-indifferent parties (including tax-exempt organizations, foreign entities, Native American tribes, and taxpayers having expiring loss or credit carryforwards) from the corporate tax shelter would be subject to tax. In addition, taxpayers would be prohibited from taking tax positions inconsistent with the form of their transactions, and the IRS would be given broader authority to deny tax benefits under section 269 of the Internal Revenue Code in respect of tax avoidance transactions.

THE NATURE OF THE PROBLEM

Tax Executives Institute's perspective differs from that of other organizations that have commented on the Administration's proposals. TEI does not represent the so-called tax shelter promoters and developers who either sell or facilitate the transactions (including investment bankers). The Institute does not represent the professional advisers (be they attorneys or accountants) who opine on the legitimacy of the arrangements. Rather, TEI's members work directly for the corporations that regularly enter into business transactions that require an analysis of their tax benefits and burdens. These companies have professional staffs dedicated to minimizing their tax liability while ensuring compliance with the law.[3] To this end, these companies evaluate particular transactions (whether developed by their own staffs or brought to the companies by outside advisers or promoters), decide whether or not these offerings pass muster not only in terms of the substantive requirements of the tax law but, importantly, in terms of their own business needs and corporate culture and, if they proceed, report the transactions on their tax returns and defend them on audit. Ultimately, of course, these companies face potential exposure to sanctions (and public opprobrium) should their analysis of a transaction not be sustained.

In other words, TEI's members are in the thick of it. We along with the government have the most at stake in trying to craft an equitable tax system that is administrable.

TEI is not among those who believe no problem exists. But the problem confronting the tax system is not simple, and care must be taken to ensure that the solutions are measured and balanced and, further, that they do not add even more complexity to the already overburdened tax law. For this reason, the Institute has significant reservations about the scope and efficacy of some of the Administration's proposals, especially in light of (1) the IRS's and Treasury's failure to use the tools currently at their disposal and (2) the absence of a clear definition of the term "corporate tax shelter." In addition, we join others in wondering whether the bleak picture painted by the Administration is accurate and, further, whether the highly charged rhetoric that has accompanied the proposals is either justified or helpful.

But these concerns notwithstanding, TEI agrees that the situation cannot be ignored. As tax executives, we see the challenge to the tax system every day. We respond to the challenge by adhering to the Institute's Standards of Conduct and exercising our best professional judgment. TEI members are routinely called on to analyze various proposed transactions, and upon doing so, we say "yes" when "yes" is both proper and in the best interests of our companies, and "no" when the line is crossed. It is important to realize, however, that reasonable people can legitimately differ on when "yes" is a proper answer and when "no" needs to be said. That is the inconvenient but inevitable truth given the current, complicated state of the tax law. That the Administration does not fully acknowledge this that it seemingly declines to recognize that not every taxpayer who says "yes" when the appropriate an-

swer is "no" should automatically be subject to sanction may be our biggest concern with its overall package of proposals.

THE NEED FOR BALANCE

There is no simple, easy solution to the corporate tax shelter "problem." The key is realistically assessing the causes of the problems and then designing measured, balanced approaches to dealing with them. In the final analysis, rules must be developed that encourage all participants to exercise self-restraint.[4] Ultimately, it is the corporation that is responsible for what is reported on its tax return, but in our view it is wrong to suggest that the problem lies only with taxpayers themselves and that the solutions should be directed only at them. Accordingly, TEI is pleased that the Administration and others have suggested that attention be paid to both the promoters of tax- advantaged products and to the outside advisers whose opinions facilitate the marketing of such products, and that the rules of professional conduct possibly be revised to reach their activities. We are certainly not claiming that sophisticated taxpayers are "victims," but in our view the solutions must reach the organizations and advisers who put unduly aggressive "products" into play.

Equally important, TEI believes it is necessary to recognize the part that Congress, the Treasury Department, and the IRS each play in creating an environment in which so-called corporate tax shelters can flourish. Each of the government players, too, bears responsibility for how the law reads (warts, "discontinuities," and all), how it is interpreted, and how it applies. Thus, TEI must acknowledge its frustration that the Administration has not sought to address either the complexity that characterizes the tax law or the unfair, one-sided provisions that, while crafted for a "pro-government" purpose, are often turned on their head by taxpayers in what is later deemed to be a tax shelter. For example, the contingent payment regulations that the taxpayer invoked in the ACM case were drafted by the government in a manner to be used against taxpayers; the taxpayers in that case simply tried to utilize the rules for their own benefit. In the aftermath of the Tax Court's decision, TEI does not contend that the taxpayers' position was justified. We do note, however, that an evenhanded rule would not have presented even the opportunity for abuse. That the Administration does not address this issue in its budget proposals is disappointing.

TEI also questions whether the Administration has adequately addressed why the provisions of the current tax code are inadequate to staunch the perceived growth of tax shelters. The IRS and Treasury have a powerful array of tools available from substantive provisions already in the tax code to the authority to issue notices and regulations to halt specific abuses to the ability to target transactions for litigation using one or more common-law anti-abuse doctrines. Moreover, experience teaches that these tools can be and have been successfully invoked to curb several questionable transactions. It may well be that current law is insufficient to stop all abuses, but we submit that the effectiveness of current law should be fully assessed before a series of new provisions are layered on top of them. More specifically, before deciding that a new 40-percent strict liability penalty should be enacted, we believe it is appropriate to ask why the IRS and Treasury have failed to promulgate regulations defining "tax shelter" under current law and thereby trigger the shelter registration provisions that were enacted in 1997. Why promote a 40-percent penalty when the necessary steps to vivify the current 20-percent one have not been taken? The Treasury's failure in this regard is especially disappointing inasmuch as both it and the staff of the Joint Committee on Taxation have studies of the Internal Revenue Code's entire penalty regime underway perhaps the legislative equivalent of "ready, fire, aim!"

Similarly, before enacting a greatly expanded section 269 to disallow deductions, credits, exclusions, or other allowances obtained in a "tax avoidance transaction," we believe the Administration should be called into account for its current use or disuse of section 269. If revenue agents are not using it effectively, why not? Such an approach will ensure that any new provisions are necessary, targeted, and properly nuanced.

Even assuming that current law is inadequate to the task of impeding corporate tax shelters, TEI has serious misgivings about the overall thrust of the Administration's proposals. Our concerns can be summarized, as follows:

The Administration's Proposals Are Unacceptably Vague. The overall scope of the Administration's proposals is impossible to determine because they depend upon the meaning of several subjective terms that currently remain undefined. The result of this vagueness is that legitimate tax planning planning that supports valid and unassailable business purposes are at risk. Consider the panoply of terms. What is a corporate tax shelter? It is a transaction where a direct or indirect participant at-

tempts to obtain a tax benefit in a tax avoidance transaction. What is a tax benefit? It includes a reduction, exclusion, avoidance or deferral of tax or an increase of a refund, but would not include a tax benefit clearly contemplated by the applicable provision of the tax law (taking into account the congressional purpose). What is a tax avoidance transaction? It is a transaction in which the reasonably expected pre-tax profit is insignificant relative to the reasonably expected net tax benefits. It is also a transaction involving the improper elimination or significant reduction of tax on economic income.

TEI recognizes that the tax law is replete with provisions containing such terms as "insignificant" or "reasonably expected." We suggest, however, that the cumulative effect of including all these terms are proposals so fraught with ambiguity and uncertainty that they should fall for this reason alone.[5] Indeed, the lack of specificity in the proposals means that the proposals may inhibit the ability of corporate taxpayers to conduct routine, non-abusive transactions. This, in turn, may undermine their competitiveness.

The Administration's Proposals Lack Proportionality. The Administration has proposed several overlapping penalties including most notably (1) the loss of expected tax benefits under its so-called super section 269, (2) the 40-percent strict liability penalty, (3) the denial of a deduction for fees paid in a tax shelter transaction, and (4) the imposition of an excise tax on a "tax benefit arrangement." In the aggregate, these penalties could exceed the 75-percent civil fraud penalty. This constitutes overkill, especially given the proposals' lack of clarity. Indeed, the Draconian, shotgun nature of the proposals might well discourage their effective use.[6] In other words, a measured penalty would be more likely to be asserted by a revenue agent and sustained by the courts.

The Administration's Proposals Would Grant Too Much Discretion to IRS Field Agents. Some commentators have suggested that the unclear definition of corporate tax shelters (or the scope of super section 269) is acceptable (or, at least, tolerable) because such issues are frequently left to the discretion of the courts. TEI respectfully submits, however, that such an approach is a recipe for wasteful litigation (and high attorneys' fees), not good tax administration. More fundamentally, we are concerned that the exercise of discretion would not in the first instance be the courts', but rather the IRS field agent's. In the absence of clear guidance on the scope of the various provisions, the agents (especially in light of the pitched rhetoric surrounding the current debate) may be emboldened to assert the penalties in a broad array of cases (including those involving routine business transactions). At a minimum, the vague standards will inevitably lead to inconsistent results, with similarly situated taxpayers potentially being treated differently. Although our concern about possible IRS abuses might be mitigated by the establishment of a national penalty coordinating committee (which would review a case before any penalty could be asserted), we are not convinced that such an approach would be sufficient. Indeed, the proposed delegation of authority (especially under super section 269) threatens to transform the U.S. tax system from "tax code by Congress" to "tax code by revenue agent." In our view, this runs counter to the overall purpose of the taxpayer rights provisions of the IRS Restructuring and Reform Act as well as the IRS's new mission statement.

The Administration's Desire to Impose a No-Fault, Strict Liability Penalty Is Misguided. The Administration proposes to eliminate the reasonable cause exception of current law and hence to convert section 6662 into a strict liability 40-percent penalty. TEI has grave reservations about the Administration's proposal to eliminate the reasonable cause exception to the imposition of the tax shelter penalty. Under current law, no penalty will be imposed if the taxpayer acted with reasonable cause and in good faith. Because some taxpayers have apparently escaped penalties by relying on professional opinions that the Treasury Department regards as suspect (e.g., because they are based on facts that, in reality, do not exist in the taxpayer's case), the Administration proposes eliminating the exception.

Although TEI appreciates the Treasury's desire to "increase the stakes" in respect of tax shelter transactions, the Institute believes the enactment of a strict liability penalty is wholly inappropriate given the complex nature of the tax laws. Indeed, the less clear the substantive standard to be applied and the more amorphous the definitions of what is and what is not a tax shelter, then in our view, the more objectionable a strict liability regime becomes. Penalties should be designed either to punish purposeful misbehavior or to provide an incentive to behave properly. To impose a strict liability penalty where the law is unclear, where the standard is protean especially where the taxpayer had either sought professional assistance in analyzing its obligations under the tax law or undertaken to inform the IRS of the possible dispute (by making adequate disclosure) is to breach the trust that Congress sought to create (or restore) in enacting the IRS Restructuring and Reform Act.

TEI recognizes that some commentators have argued that the courts have been too lenient with taxpayers and that they have blocked the IRS's efforts to stop abuses by interpreting the reasonable cause exception too liberally. If this is true, the answer lies not in abandoning the reasonable cause provision in its entirety but in clarifying what can or cannot constitute reasonable cause.[7] Although TEI is not in a position to make a formal recommendation at this time, we suggest that among the alternatives that should be explored is the adoption of a rule that obtaining a favorable ("more likely than not") opinion from an adviser will not by itself constitute reasonable cause where one or more of the following exist:

- a confidentiality agreement between the taxpayer and the developer/promoter of the tax shelter;
- a contingency fee arrangement or unwind clause; and
- an opinion issued by a practitioner who has been subject to sanction under Circular 230.[8]

Finally, TEI questions whether the doubling of the current penalty (from 20 to 40 percent) has been justified, especially given the Treasury's failure to issue regulations under the current provision. If the current provision has not been given a chance to work, why rachet it up (especially in view of the proposed elimination of the reasonable cause exception)?

The Administration's Proposals Provide an Inadequate Incentive to Disclose. Under current law, a taxpayer's disclosure of a putative tax shelter has no effect on the applicability of the section 6662 penalty. Hence, current law has the perverse effect of discouraging disclosure. While recognizing this shortcoming, we regret that the Administration's proposals do not go far enough to reverse the disincentive. To be sure, the Administration recommends that the heightened 40- percent penalty be reduced to "only" 20 percent when the taxpayer makes a timely and adequate disclosure, but in TEI's view the "reduced" penalty is still so excessive that when applied on a strict liability basis it will not have its intended effect. TEI believes that the adequate disclosure of a tax shelter item should insulate the taxpayer from penalties. Moreover, although the Administration's proposals would require that the taxpayer disclose the tax shelter within 30 days of the closing of the transaction, TEI believes that taxpayers should only be required to disclose the designated transactions on their tax returns. In the event it is concluded that earlier disclosure should be required, we recommend that the burden of such disclosure be properly placed on the promoter or adviser; the timing of the disclosure could be tied to the receipt of fees associated with the transaction.

The Administration's Proposals Do Not Apply Consistently to All Taxpayers. Finally, we note that, by their terms, certain of the Administration's proposals apply exclusively to corporations and not to enterprises conducting business in a different form (such as a partnership or a limited liability company). Clearly, the applicability of the rules should not depend on the form of the enterprise. Indeed, if the anti-shelter provisions applied only to corporations, their enactment could well trigger business restructuring (where possible) in order to avoid the proposals' reach.

CONCLUSION

Tax Executives Institute appreciates this opportunity to present its views on the Administration's corporate tax shelter proposals. As our comments make clear, we believe the task confronting Congress is monumental: developing measured legislative proposals that safeguard the integrity of the tax system without interfering with legitimate tax planning and without unfairly penalizing taxpayers that strive in good faith to comply. If the job were easy, of course, it would have been completed long ago. That it is hard, however, does not mean that it should not be undertaken. TEI looks forward to working with the Committee, Treasury Department, and other interested parties to ensure that the final legislation is balanced and that the cure is not worse than the disease.

ENDNOTES

[1] TEI has previously submitted comments to the tax-writing committees opposing the proposal in the President's budget to tax the investment income of organizations qualified under section 501(c)(6) of the Internal Revenue Code, and the Institute is giving consideration to commenting on other budget proposals as well. At this time, however, the Institute is limiting its comments to the corporate tax shelter proposals.

[2] TEI welcomes the Treasury's recognition both in congressional testimony and in other public statements that its proposals need refinement.

[3] Corporations, operating through their officers, directors, and employees, have a fiduciary obligation to their shareholders to lawfully minimize expenses, including federal, state and local, and foreign taxes.
[4] Deputy Treasury Secretary Summers has analogized the situation to fans at a sporting event. If everyone stays seated, he noted, all will be able to see; but if one or more fans decide to stand if one or more taxpayers choose to engage in conduct that is arguably "at the margin" others may be tempted to do so as well. We agree that the analogy has some validity, but emphasize the need for everyone most especially the fans who prefer to sit to be assured that the operating rules will be clear and applied in an consistent, evenhanded manner.
[5] The vague nature of the Administration's proposals calls to mind the Supreme Court's "void for vagueness" principle, under which criminals law are invalidated where they do not provide constitutionally sufficient notice of what acceptable and unacceptable behavior is. Although the doctrine has no formal application in respect of civil tax rules, we suggest that the notions of fair play and due process should equally inform what Congress does in this area, especially in light of last year's IRS Restructuring and Reform Act.
[6] Witness the need to enact intermediate sanctions for violation of the rules relating to tax-exempt organizations because the alternative revocation of their exempt status was uniformly considered too harsh.
[7] For example, the Treasury could provide that a taxpayer may not rely on the opinion of a professional adviser that fails to contain a complete and accurate description of the facts underlying the transaction
[8] TEI believes there is merit in exploring the expansion of Circular 230 to cover other participants in tax shelter transactions. We further believe that the Administration is correct in seeking to address the role (and affect the behavior) of all parties to tax shelter transactions, including the promoters and practitioners whose opinions play an integral role in the marketing of the questionable transactions.

PREPARED STATEMENT OF HON. JOHN H. CHAFEE

Mr. Chairman, I want to thank you for holding this hearing. I think it is appropriate for the Committee to review the proposals put forward by the Administration. The testimony we will hear today is an important part of that review.

I want to concentrate my remarks on the Administration's proposal to impose an excise tax on the purchase of structured settlement payments. This is similar to legislation that I introduced last year with Senator Baucus. Senators Rockefeller, Kerrey and Grassley joined us as cosponsors of that legislation. It is my intent to reintroduce that legislation soon.

Ms. Worman will testify this morning on behalf of the American Bankers Association. In her prepared testimony she expresses concern that our proposal will have the unintended and harmful consequences for banking institutions that make loans, pursuant to blanket security agreements, to consumers who receive structured settlement payments. I want to assure the members of the American Bankers Association, and the members of this Committee, that it certainly is not my intent—nor do I believe is it the result—that this legislation affect banks' normal lending practices.

Over the years Congress has adopted special tax rules to encourage the use of structured settlements in physical injury cases. By encouraging the use of structured settlements, Congress sought to shield victims and their families from pressures to prematurely dissipate their recoveries. Structured settlement payments are non-assignable. They cannot be pledged as collateral for loans. This is done to preserve the injured person's long-term financial security.

In recent years, however, factoring companies have been more aggressive in inducing injured victims to sell off future structured settlement payments, often at steeply discounted prices. These transactions directly contravene the intent and policy of Congress in enacting the structured settlement tax rules. The Structured Settlement Protection Act attempts to end these transactions.

The point I would like to make to the American Bankers Association is that this legislation will not affect the normal course of their business of lending money. The fear that so-called "blanket security agreements" will trigger the excise tax on the purchase of structured settlement payments is unfounded. Under current law, structured settlement payments cannot be used as security for a loan. Thus, the excise tax cannot be triggered.

Furthermore, I believe our proposal will protect banks that lend money to injury victims. I can envision a member of the ABA lending money to an injury victim,

using as a basis for making that loan the fact that the borrower is receiving periodic payments under a structured settlement. As I mentioned earlier, the bank cannot receive a security interest in those payments, but it is reasonable for the bank to assume that the payments would serve as the source of funds for repayment of the debt.

Along comes a factoring company who entices an injured victim to sell his or her rights to future settlement payments. Because the bank has no security interest in the payments, it is likely that the bank will suffer a loss as a result of this transaction because the payments that the borrower was counting on to repay the loan are now gone. It is the factoring transaction, not the loan, that the Structured Settlement Protection Act is designed to address.

I look forward to working with the American Bankers Association to help them better understand our proposal. I believe that they will come to see that it is in their best interest to support this legislation.

PREPARED STATEMENT OF HAROLD R. HANDLER

Mr. Chairman and Members of the Committee: My name is Harold R. Handler and I appear in my capacity as Chair of the Tax Section of the New York State Bar Association. The Section has 3,000 tax professionals as members, and through its Executive Committee, prepares and disseminates between 25 and 40 analytic reports a year on various topics relating to Federal, State and Local taxation.

This year, in addition to other projects, we have undertaken a study of a number of proposals contained in the President's Fiscal Year 2000 Budget Proposal, submitted to the Congress on February 1, 1999. I expect that our internal review process will produce a series of reports in May and June with respect to these proposals. But we have accelerated our report on aspects of a significant element of the President's proposals, those relating to the phenomenon known as corporate tax shelters. This week we have delivered a report analyzing what we consider to be the two most important of these tax shelter proposals, a more stringent penalty requirement coupled with incentives for increased disclosure, and the proposal for a new substantive provision intended to deny the tax benefits arising from tax avoidance transactions. I am prepared to discuss our comments, today.

We believe that there are serious, and growing, problems with aggressive, sophisticated and, we believe in some cases, artificial transactions designed principally to achieve a particular tax advantage. A good example is the transaction recently the subject of a Tax Court, and a 3rd Circuit decision in ACM Partnership vs. Commissioner. But this is not the only example and our report attempts to detail a number of abusive corporate tax shelter transactions.

The problem with these transactions is two-fold. There is obviously an effect on revenue. While we are unable to estimate the amount of this revenue loss, anecdotal evidence and personal experience leads us to believe that it is likely to be quite significant. But there is a second corrosive effect. The constant promotion of these frequently artificial transactions breeds significant disrespect for the tax system, encouraging responsible corporate taxpayers to expect this type of activity to be the norm, and to follow the lead of other taxpayers who have engaged in tax advantaged transactions.

The overriding theme that emerges from our analysis of the Administration's proposals is the obvious one: there are no simple solutions to the problems posed by the corporate tax shelter phenomenon. We believe there are several related steps to dealing with this phenomenon. First, the Service must increase its audit efforts and intensify the scrutiny of these transactions. As an example, the recent government success in the ACM case has had a perceptible impact on the willingness of corporate taxpayers to engage in these transactions.

But audit scrutiny and diligent litigation alone will not, in our opinion, be sufficient to deter these transactions. There must be further steps taken to change the risk/reward ratio. In our view, even if substantially greater resources were devoted to attacking corporate tax shelters under current law, the structure of our current penalty system ultimately would not provide adequate deterrence of corporate tax shelter activity. For this reason, we strongly support the approach of the Administration's proposal to increase accuracy related penalties for defined corporate tax shelter transactions to encourage disclosure and deter risk taking by taxpayers.

Disclosure will be helpful on several counts. First, proper disclosure will change the odds of the audit lottery, and the need to disclose will itself act as a deterrent. In addition, to the extent taxpayers actually report, a disclosure regime will act as an early warning system to allow the Treasury and the Service to respond quickly to new developments on this front.

But more than disclosure is required. To address the insufficient deterrent effect of current law, we believe it important for Congress to adopt, as proposed by the Administration, a "strict liability" approach to the accuracy-related tax-shelter penalties by eliminating the reasonable cause exception to the imposition of the accuracy-related penalties for certain tax-motivated transactions. Under a strict-liability regime, a taxpayer's reliance on professional tax opinions would no longer have the effect of eliminating the penalty imposed on corporate taxpayers engaging in corporate tax shelter transactions. Consequently, corporate taxpayers would be forced to assume a real risk in entering into these transactions, and advisers would be induced to supply balanced and reasoned analysis rather than supplying "reasonable cause" as under current law.

The current equation is all too simple. Even responsible corporate financial officers, when faced with the choice of paying tax on some item of gain or other income may choose to engage in somewhat artificial transactions designed to eliminate the tax they would otherwise pay. The only downside risk at present, given the availability of "reasonable cause" opinions today, is some additional interest, which is likely to be at a somewhat higher rate than they would otherwise pay. But the possibility for benefit by avoiding the tax completely is substantial, and far greater than the risk of somewhat greater interest cost.

We believe this equation must be changed, and that the Administration's approach is correct. If a taxpayer is considering a tax-shelter transaction, the elements to be considered must include the likelihood of a significant penalty if the claimed tax treatment is disallowed.

We acknowledge that a strict-liability approach to accuracy-related penalties will put considerable pressure on defining appropriate cases subject to the provision, and may increase significantly the leverage of Internal Revenue Service agents in some audits of corporate taxpayers. Because we believe it is crucial to increase the risk associated with entering into corporate tax shelters, we have concluded that, on balance, it is acceptable to live with these effects of the Administration's proposal when the imposition of the penalty (i) depends on the taxpayer's position ultimately not being sustained as a matter of current law, (ii) the amount of the penalty is reduced if the transaction is disclosed on the taxpayer's return, and (iii) the penalties are targeted at corporate tax shelters, as appropriately defined.

The critical element is therefore to define these suspect transactions in a manner that distinguishes artificial transactions designed to produce a tax benefit only, from legitimate corporate tax planning which we believe is clearly appropriate. Our report includes a definition of the type of transaction we believe should be subject to these penalties. We would be pleased to work with the Administration and Congress to clarify this approach.

Second, although we agree it is also important to address the legal treatment of corporate tax shelter transactions, we do not believe the Administration's proposed general substantive provision denying tax benefits from corporate shelter transactions should be adopted at this time. We agree that a substantial amount of discretion must be granted to the government under generally worded statutory and regulation provisions to deal substantively with aggressive tax-motivated transactions. In addition, we believe it is appropriate, on occasion, for the Treasury Department's regulatory authority to be exercised with retroactive effect. We do not, however, support the general substantive anti-avoidance provision proposed by the Administration at this time, because we believe that in most cases the proposed provision would not prove to be as effective a tool for distinguishing between legitimate tax planning and unwarranted tax-motivated transactions as the existing body of judicial authorities and statutory and regulatory provisions potentially applicable to those transactions.

Nonetheless, some of our members believe the corporate tax shelter problem cannot be significantly alleviated without enactment of substantive provisions of the type proposed by the Administration in addition to the changes to the penalty structure that we support, and we are aware that it may eventually prove necessary to enact a general substantive anti-avoidance provision of the type proposed by the Administration. We intend, therefore, to continue to work with the Administration and Congress to develop additional substantive tools to deal with corporate tax shelter transactions, including both provisions of the type proposed by the Administration and more targeted provisions. In our full Report we suggest possible approaches to formulating those additional substantive provisions.

Mr. Chairman, thank you for the opportunity to appear before the Committee today. I will be pleased to answer your questions.

Prepared Statement of Jeanne Hoenicke

Thank you, Mr Chairman. I am Jeanne Hoenicke, Vice President and Deputy General Counsel of the American Council of Life Insurance. The American Council of Life Insurance (ACLI) is strongly opposed to the totally unwarranted $7 billion tax increase on life insurance companies and products in the Administration's Fiscal Year 2000 Budget Proposal. I am especially pleased to be here today because a large bi-partisan majority of this Committee has joined Senator Nickles and Senator Baucus in signing a letter opposing the Administration's proposals. The Senators have recognized that these proposals would seriously threaten the hopes of millions of Americans for a financially secure retirement and jeopardize the financial protection of families, businesses and family farms.

The nearly 500 company members of the ACLI offer life insurance, annuities, pensions, long term care insurance, disability income insurance and other retirement and financial protection products.

The Council is pleased to provide this testimony representing, for the first time in twenty years, a life insurance industry fully united on all tax issues. For many years the industry's voice, has been weakened by the disagreements among the stock and mutual segments. This year brought about an historic change—the end of the long-standing stock and mutual tax differences. With one voice now, the Council declares that there is no justification for provisions of the Code that separately tax stock and mutual life companies. With one voice now, the Council opposes any increase in taxes on any industry segment. With one voice now, the Council shows that our industry already pays more than its fair share of taxes, and the Administration's proposals are totally unjustified.

Finally, I am pleased to state that the National Association of Life Underwriters endorses these remarks.

Two of the proposals in the Fiscal Year 2000 Budget Proposal would make annuities and life insurance more expensive for individuals and families struggling to save for retirement and protect against premature deaths. Annuities are the only financial product that provides guarantees against outliving one's income. Life insurance is the only product that gives security to families should a breadwinner die prematurely. Another proposal could wipe out a financial product that protects businesses and allows them to provide employee benefits, including retiree health benefits.

The proposals do not make sense, and represent a retreat by the Administration from its stated goal of encouraging all Americans to take more personal responsibility for their income needs in retirement and at times of unexpected loss. They also seem to reflect a failure to understand the important role life insurance products play in the retirement and protection plans of middle-income Americans. ACLI member companies strongly support fixing Social Security first, but they are convinced that it will be impossible to reach this goal in the absence of a strong and vital private retirement and financial security system. Tax proposals that weaken that system are misguided and contradictory.

Contrary to the Administration's perception, life insurance companies already pay federal taxes at a rate which is significantly higher than the rate for all U.S. corporations. Additional federal taxes would unfairly increase that already high tax burden. A recently completed study by Coopers & Lybrand shows that life insurers paid $54.4 billion in Federal corporate income taxes from 1986-1995. The average effective tax rate for U.S. life insurers over that ten year period was 31.9%, significantly higher than the 25.3% average effective rate for all U.S. corporations. Moreover, the effective rate rose sharply during the ten-year study period, from 23.9% between 1986 and 1990, to 37.1% between 1991 and 1995, with the imposition of the DAC tax in 1990 (described below).

The Administration Budget Proposal for Fiscal 2000 contains many unwarranted tax increases on life insurance products, policyholders and companies. The major increases include:

PROPOSAL TO INCREASE DAC TAX ON ANNUITIES AND LIFE INSURANCE

In addition to paying regular corporate income taxes, life insurers must pay a tax based on gross premiums from the sales of their products, including life insurance and annuities. This tax is known as the DAC tax. This new tax was imposed in 1990 to serve as a proxy for the expenses life companies incur when they sell life and annuity policies. Under the DAC tax, these selling expenses are no longer tax deductible in the year paid; rather the deduction is spread over a ten year period. (The acronym DAC stands for deferred acquisition costs.) The DAC tax is an arbitrary addition to corporate income tax calculated as a percentage of the net premiums attributable to each type of policy. It was not logically defensible in 1990, and is not

now. The Administration proposes to triple the DAC tax on annuities, nearly double the tax on individual whole life insurance, raise the tax on group whole life six-fold and also increase other DAC taxes.

ACLI RESPONSE:

- An Increase in the DAC Tax on Annuities and Life Insurance Would Make Important Protection and Retirement Savings Products More Expensive. Today Americans are living longer than ever before and our aging population is putting more pressure on already-strained government entitlement programs. Consequently, individuals must take more responsibility for their own retirement income and protection needs. Adding taxes based on the premiums companies receive for retirement and protection products will lead directly to higher prices and undermine Americans' private retirement and protection efforts.
- The Administration Proposal Represents a Thinly Disguised Tax Increase on Policyholders and an Attack on Inside Build-up. The proposed DAC tax increase falls principally on annuities and whole life insurance, both individual and group. These are the products that allow policyholders to accumulate earnings to fund the costs of insurance in the later, more expensive years of the policy. The inside build-up is taxed if cash is withdrawn from the policy. This tax treatment represents sound social and tax policy designed to encourage individuals to purchase these important retirement and protection products. The increase in the DAC tax on annuities and whole life insurance is an attempt to tax indirectly the policyholders' inside build-up on these products, contrary to sound tax policy. The tax will certainly have that effect on policyholders through increased costs and lower returns.
- The Tax System Prior to Enactment of the 1990 DAC Tax Already Deferred Life Insurers' Deductions for Acquisition Costs through Reduced Reserve Deductions. It is Inappropriate to Further Extend this Unfair "Double Deferral" Scheme. In 1984, Congress reduced companies' reserve deductions by a formula that effectively defers deductions for policy acquisition costs. Thus, the DAC tax was unnecessary in 1990 and should not be increased in the 21st century. No insurance accounting system (GAAP or state regulatory) requires both the use of low reserves and deferral of deductions for policy acquisition expenses. Treasury specifically cites the GAAP system as a model for requiring deferred deductions for acquisition costs, but ignores the fact that GAAP does not also require reduced reserve deductions.

PROPOSAL TO TAX POLICYHOLDERS SURPLUS ACCOUNTS

Prior to the Tax Reform Act of 1984, shareholder-owned life insurance companies recorded accounting entries called policyholders surplus accounts (PSAs), which reflected a portion of their operating gains that were not subject to tax. PSA amounts would be taxed only if deemed distributed to shareholders or the company ceased being a life insurance company. In 1984, Congress completely rewrote the structure of taxation of life insurance companies to tax them on a comprehensive income basis. As part of that thorough rewrite, Congress decided to eliminate further additions to PSAs. Congress also concluded that the shareholder distribution trigger for taxing PSAs would be maintained. The Administration now proposes to force life companies to include these tax accounts in income and pay tax on the PSA over a ten year period.

ACLI RESPONSE:

- The Administration Proposal Is a Retroactive Tax and a Violation of Fair Tax Treatment. To reach back for tax revenues on long-past operating results, some from nearly 40 years ago, is wrong. Congress addressed the tax treatment of policyholders surplus accounts 15 years ago. In fact, the Committee Reports to the 1984 Tax Reform Act specifically provide that life insurance companies "will not be taxed on previously deferred amounts unless they are treated as distributed to shareholders or subtracted from the policyholders surplus account under rules comparable to those provided under the 1959 Act." Such arbitrary efforts to retroactively change the tax rules applicable to old operations reveals a desperate revenue grab by Treasury.
- The Administration Proposal Inappropriately Resurrects Tax Code Deadwood. The policyholders surplus account (Section 815 of the tax code) is merely a tax accounting mechanism or record in the practical operations of life insurance companies. There are no special untaxed assets set aside in a vault available to pay this unanticipated tax. In fact, the accountants have concluded that under state statutory and GAAP accounting rules that govern shareholder-owned life insurance companies, Section 815 accounts would very rarely, if ever,

be triggered, and, if so, would be triggered only by activities under the control of the taxpayer. Thus, statutory and GAAP accounting conclude that the potential tax liability under Section 815 should be disregarded for accounting purposes. No one could conceive that Treasury would resurrect this deadwood. Only now, when Treasury needs to fill out its budget, is the deadwood brought to life.

- The Administration Proposal Creates Immediate Full Loss of Shareholder Value, in Addition to Tax Hit. Should this proposal become law, shareholder-owned life insurance companies would be hit first when forced to pay tax over a ten-year period out of the earnings and assets that would otherwise be used to do business and protect policyholders. The companies would also be forced to record immediately the new, full tax liability on their public accounting reports to shareholders. This creates an immediate loss to shareholders of the entire amount of the new tax, not just the first year payment.
- The Administration Reasoning Relating the PSAs to Specific Policies is Specious. There is not now, and never has been, any relationship between liabilities under specific policies and additions to PSAs that took place prior to 1984. Thus, Treasury is disingenuous when it suggests that taxing PSAs now would cause no harm to policyholders from a past era. What the new tax will do is affect the return to current policyholders since this is a tax that must be paid from current operations.

PROPOSAL TO TAX BUSINESS LIFE INSURANCE

In 1996, Congress eliminated the deductibility of interest paid on loans borrowed directly against business life insurance (policy loans), except in very limited circumstances involving grandfathered policies and policies covering key individuals. In 1997, Congress further limited deductions for interest on unrelated business borrowing if the business owns life insurance. This most recent tax penalty does not apply to contracts covering employees, officers, directors and 20-percent owners. The Administration now proposes to place an additional tax on companies that borrow for any purpose if those companies also own life insurance, including key employee insurance. The proposal would also increase taxes on companies that borrow directly against life insurance policies covering key employees. This proposal would destroy the carefully crafted limitations created in the 1996 and 1997 legislation by eliminating most key persons as defined in the 1996 Act and eliminating employees, officers and directors from the 1997 Act provisions.

ACLI RESPONSE:

Further changes in the tax treatment of business life insurance are unnecessary and would unfairly disrupt the fundamental protection and benefit plans of many businesses. Far from a "tax shelter" as Treasury contends, business life insurance is a product that protects businesses, especially small businesses, and allows all businesses to provide employee benefits, including retiree health benefits. The proposal would eliminate the use of business life insurance in providing those protections and benefits.

- The Proposal Is Anti-Business Expansion. Under the proposal, the mere ownership of a whole life insurance policy on the president of a company could result in additional tax to that company. This additional tax would be imposed against loans that bear no relation to any borrowing from the life insurance policy, but rather would result from normal business borrowing for expansion and similar fundamental purposes. There is no good reason why the mere ownership of a policy on the employees, directors or officers of the firm should result in a tax penalty on unrelated borrowing. The businesses affected by this proposal will have to choose between protecting themselves against the premature death of a valued employee, officer or director, and borrowing to increase their business. This forced choice between valid, unrelated business needs is bad tax and economic policy.
- Key Person Direct Borrowing Exception Is Important. In 1996, Congress reviewed the taxation of policy loans borrowed directly from life insurance policies. As a result of this review, substantial restrictions were placed on this borrowing, limiting it to coverage on a small number of key employees. The present proposal ignores this review and crafts new and more draconian limitations. There is no rationale for changing from the 1996 legislation to the current proposal. The key person exception is especially important to allow small businesses access to their limited assets.
- Mere Ownership Of A Policy On An Employee, Officer Or Director Should Not Result In A Tax Penalty. In 1997, Congress reviewed the taxation of borrowing unrelated to life insurance policies where the business also happened to own life insurance. As a result of this review, a tax penalty was imposed on companies

that have loans unrelated to the life insurance policy if the policy covers customers, debtors and other similar insureds. Coverage of employees, officers, directors and 20-percent owners was specifically exempt from this penalty. There is no rationale for changing from the 1997 legislation to the current proposal under which policies on employees, officers and directors can result in a tax penalty. Protection of valuable workplace human capital assets is crucial to business and should not be penalized.

- Protecting Against Loss Of Valuable Employees Is Fundamental To Business Operations. Just as businesses rely on insurance to protect against the loss of property, they need life insurance to minimize the economic costs of losing other valuable assets, such as employees. This is especially important with respect to small businesses, the survival and success of which often rest with their key employees. Without access to permanent life insurance at a reasonable cost, companies may not have the capital necessary to keep operations afloat after the loss of such assets. The proposal can well make that cost in excess of what a business can afford.
- Businesses Need Employee Coverage To Fund Retiree Benefits. Corporations frequently use life insurance as a source of funds for various employee benefits, such as retiree health care. Permanent life insurance helps make these benefits affordable. Loss of interest deductions on unrelated borrowing is an inappropriate tax penalty that will force these companies to reduce employee and retiree benefits funded through business life insurance.
- The Administration "Arbitrage" Reasoning is Specious and Masks an Unwarranted Attempt to Tax Inside Build-Up. Any further tax changes to business life insurance target the current treatment of inside build-up on permanent life insurance. The effect of denying general interest deductions by reference to the cash value of life insurance is to tax the cash value build-up in the permanent policy. Allowing general business interest deductions to accompany mere ownership of life insurance cash values does not represent tax arbitrage and is fully consistent with general tax and social policy. For example, a business that uses commercial real estate as collateral for a loan does not lose the deduction of loan interest even though the property's value consists of appreciation and even though the tax on that appreciation is deferred until the property is sold. Additionally, the rate of tax on any gain is the lower capital gains rate. Similarly, other business tax benefits, such as the research and development tax credit, do not result in a loss of interest deductions when a firm borrows for normal business purposes. The

Administration's arbitrage reasoning is plainly inappropriate because if applied to an individual it would cause the loss of home mortgage interest deductions when a taxpayer also owns permanent life insurance.

CONCLUSION

These proposals would add over a billion dollars a year to the tax payments of the life insurance industry. The study provided by Coopers & Lybrand reveals that, not only would additional taxes be unreasonable and unfair, our members' high level of taxation offers further reason for several forms of tax relief already under consideration by this Committee, reason beyond the sound tax policy underlying those proposals. For example, this Committee has led in the development of new tax rules under Subpart F for active financing income that will allow U.S. global financial services industries to be more competitive. Other outdated restrictions on life companies to consolidate tax returns when they merge with other insurance companies, banks, securities firms or anyone else should be reviewed by this Committee. And certainly, the important protection and retirement products provided by life insurance companies should continue to receive the support of public policymakers such as Senator Grassley and Senator Graham's proposed above-the-line deduction for long term-care insurance.

Mr. Chairman and distinguished members, I thank you again for this opportunity to speak to you today, and I respectfully request that our entire statement and the Coopers & Lybrand study on Federal Income Taxes Paid by Life Insurance Companies 1986-1995 be included in the record of this hearing.

PREPARED STATEMENT OF EDWARD D. KLEINBARD

I. INTRODUCTION

The Securities Industry Association ("SIA") appreciates the opportunity to testify before the Committee on Finance regarding the revenue-raising proposals in the Ad-

ministration's FY 2000 budget which deal with financial instruments and transactions. SIA brings together the shared interests of more than 740 securities firms. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift, and pension plans. The industry generates more than $300 billion of revenues yearly in the U.S. economy and employs more than 600,000 individuals.

We are concerned about the effects that the revenue proposals in the Administration's fiscal year 2000 budget that are discussed below would have on the functioning of capital markets if they were enacted. Our comments are both technical and practical, and we draw upon our substantial experience in helping businesses raise capital and reorganize ownership structures to meet business needs, as well as in standing ready to both buy and sell stocks, securities, and derivative products in order to accommodate the free flow of capital to its most productive uses.

Before turning to the provisions included in the budget, we would like to express disappointment at a significant omission. The budget does not contain a provision extending the reforms of the international tax rules on behalf of financial services firms that were enacted last year and that are due to expire at the end of this year. Under last year's legislation, U.S. financial services firms generally are not taxed by the U.S. on profits from the active overseas operations of their foreign subsidiaries until those profits are distributed to the U.S. parent company. This legislation allows the subsidiaries of U.S.-based firms to face current taxation in the jurisdictions in which they operate under the same local tax rules that apply to their foreign-based competitors. In passing this important legislation, Congress recognized its importance to the long-term competitiveness of U.S.-based financial services firms. The tax systems of our major trading partners, such as the United Kingdom, Germany, Switzerland, France and Japan, provide similar or even more favorable tax rules to financial services firms based in their countries. Financial services companies also should be entitled to the benefits of an international tax regime similar to that which has long governed U.S.-based manufacturers and other businesses. We urge Congress to make permanent, or extend, last year's international reforms for financial services firms before they expire at the end of 1999.

In broad summary of what is set out below, we think the capital market budget proposals that are discussed below have the following flaws: First, they are founded on notions of economic equivalence that are factually inaccurate and in any case inconsistent with current tax policy and practice. Second, their adoption would needlessly impede the free flow of capital and the functioning of capital markets. Third, their adoption would effectively increase the tax on investment capital—particularly the corporate-level tax—thereby discouraging savings and investment. We note that the U.S. already imposes one of the world's highest effective rates of tax on investment capital and that it is one of the few first-world countries which has not yet "integrated" its corporate-level tax. Finally, their adoption would disadvantage U.S. financial institutions in their efforts to compete with foreign financial institutions.

II. REQUIRE ACCRUAL OF TIME VALUE ELEMENT ON FORWARD SALE OF CORPORATE STOCK

The Administration's FY 2000 budget includes a proposal to effectively treat a corporation which agrees to issue shares of its stock in the future (a so-called "forward sale" of its own stock) as if it had (a) issued its stock on the date of the agreement in exchange for a smaller amount of cash, and (b) lent this smaller amount of cash back to the deemed purchaser of the stock for the period between the date of the agreement and the date of actual issuance of the stock. The excess of the amount which the company actually received in the future over the amount which the company was deemed to receive today would be taxable interest income, rather than a nontaxable receipt of property in exchange for the issuance of stock.

The basis for this proposal, according to the Administration, is that a corporation's agreement to sell its own stock in the future is economically equivalent to selling its stock today and lending the proceeds of the sale back to the purchaser of the stock. SIA believes, however, that there are several problems with the Administration's logic.

First, our system imposes tax by reference to the transactions which taxpayers actually enter into, not by reference to alternative transactions which taxpayers might have entered into, but didn't, to reach economically similar results. There are an infinite number of transactions which give rise to different tax results notwithstanding that they give rise to economic results that are arguably equivalent. The continued ownership of appreciated property is economically equivalent, for exam-

ple, to selling it and buying it back again, and holding debt is economically equivalent, for example, to holding stock, selling an at-the-money call on that stock and buying an at-the-money put on that stock. We therefore do not think it desirable to seek to tax financial transactions on the basis of their economic similarity to other financial transactions.

Second, an agreement to issue stock in the future is not economically similar to an issuance of stock today. A taxpayer who merely agrees to purchase stock in the future lacks (a) the right to dividends on the stock, (b) the right to vote the stock and (c) the ability to dispose of, or pledge, the stock. In short, the taxpayer lacks all of the current benefits and indicia of ownership.[1] Such a taxpayer is not ever exposed to the risk of the issuer's bankruptcy, because a forward contract to acquire issuer stock is generally void in the event of the issuer's bankruptcy.

Third, there is no economic similarity, as posited by the Administration, in the case of a stock which pays dividends. If the relevant stock pays dividends equal to the market rate of interest, for example, the "forward price" of the stock generally equals the current price of the stock, and treating as interest a portion of the amount received in the future for the stock would be theoretically incorrect. Put differently, under the more typical circumstance in which the relevant stock pays dividends, the Administration's proposal would in effect treat a forward issuer as making deemed nondeductible dividend payments on deemed currently issued stock and immediately receiving those payments back again as includable interest income.

Fourth, far from increasing tax equivalence and consistency, adoption of this proposal would create inconsistency by deeming certain events to occur for purposes of determining the tax treatment of a forward issuer of stock but not for purposes of determining the tax treatment of the forward purchaser of stock. Thus, the proposal would require an issuing corporation to recognize income from a deemed receipt of interest from the purchaser, but it would not permit the purchaser to deduct deemed payments of interest to the issuing corporation. We think that such inconsistent and one-sided treatment violates the basic fairness principles underlying sound tax administration.

Finally, the harsh treatment accorded future sales of a corporation's stock would effectively prevent corporations from agreeing to issue their stock in the future. Yet there are legitimate business reasons for agreeing to issue stock in the future. For example, an issuer may believe that its stock is temporarily overpriced but not yet have any use for the cash proceeds of a current stock issuance. We see no reason to interfere with capital markets in this manner.

III. MODIFY RULES FOR DEBT-FINANCED PORTFOLIO STOCK

Section 246A of current law[2] disallows the dividends-received deduction to the extent that relevant portfolio stock is debt financed. Portfolio stock has generally been treated as debt-financed where (a) it is acquired with the proceeds of indebtedness, or (b) it secures the repayment of indebtedness. The Administration's FY 2000 budget includes a proposal to attribute general corporate indebtedness pro-rata to a corporation's assets for purposes of treating the corporation's portfolio stock as debt-financed, regardless of how or why the indebtedness is incurred. This means that the dividends-received deduction would be partially disallowed for most corporations. Enactment of this proposal would therefore be equivalent to substantially reducing the dividends-received deduction. The effective reduction would depend on the leverage of the relevant corporation, however, and the deductions of highly leveraged corporations, such as most financial institutions, would be greatly reduced.

SIA objects to this proposal. The dividends-received deduction is designed to prevent multiple levels of corporate taxation from being imposed on the same dollar of earnings when corporations invest equity capital in other corporations. SIA believes that this deduction plays an essential role in the economy and should be increased, rather than reduced. The deduction permits the free flow of equity capital from "mature" corporations with limited economic opportunities to "growth" corporations which can employ the capital to expand the economy. Absent the deduction, the government would be imposing multiple-level corporate taxation on capital seeking its most productive use.

Congress recognized the essential role of the dividends-received deduction when it first enacted Section 246A of the Code in 1984. The provision was enacted to deal with a relatively narrow concern. The relevant "blue book" contains the following language, for example: "Specifically, under prior law, corporate taxpayers were borrowing money and using the proceeds to acquire dividend-paying portfolio stock . . .. If the indebtedness was non-recourse, the transaction may have involved little risk and, if properly structured, may not even have had to be fully reflected on the investing corporation's balance sheet."[3] Congress made it quite clear, however, that

it did not intend a broad disallowance. The relevant House Report contains the following language:

> "The bill contemplates that the directly attributable requirement will be satisfied if there is a direct relationship between the debt and an investment in stock. The bill does not contemplate the use of any allocation or apportionment formula or fungibility concept. Thus, for example, the bill does not apply merely as a result of (i) the existence of outstanding commercial paper that is issued by a corporation as part of an ongoing cash management program or (ii) deposits received by a depositary institution as a part of the ordinary course of its business. However, if indebtedness is clearly incurred for the purpose of acquiring dividend-paying stock or otherwise is directly traceable to such an acquisition, the indebtedness would constitute portfolio indebtedness. Thus, if stock is held in a margin account with a securities broker, the margin borrowing constitutes portfolio indebtedness. The same result would follow with respect to any nonrecourse loan secured, in whole or in part, by dividend-paying stock.[4]

The Administration has not pointed out any change in circumstance which might lead Congress to change its mind.

We are also troubled by the inequity of the Administration's proposal. We do not see why the dividends-received deduction should be effectively disallowed for securities dealers or disallowed in proportion to corporate leverage. Securities dealers, which are almost always highly leveraged, maintain equity portfolios in the ordinary course of business for reasons that are wholly unrelated to tax.

In any case, we think this proposal would have several undesirable collateral consequences. First, it would encourage corporations to lend capital to other corporations, rather than make equity investments. The resulting increase in corporate leverage would weaken the stability of the corporate sector and result in needless and costly bankruptcies in the event of an economic downturn. Second, it would reduce the international competitiveness of U.S. corporations by effectively increasing the rate of U.S. corporate-level taxation, a rate which is already much higher than the rate imposed on foreign competitors by many of our trading partners, most of which have already integrated their corporate-level taxes. Third, it would disrupt capital markets by leading to sudden and unanticipated drops in the secondary market values of preferred and other yield-oriented equities that were issued assuming no "haircut" for corporate leverage. Finally, for the reasons set out above, it would impede securities dealers from holding significant inventories in such equities in order to stand ready to buy or sell them (i.e., to "make a market" in those equities), thereby diminishing the liquidity of such equities and further exacerbating the problems set out above.

IV. DENY THE DIVIDENDS-RECEIVED DEDUCTION FOR CERTAIN PREFERRED STOCK

The Administration's FY 2000 budget also includes a proposal to disallow the dividends-received deduction all together for dividends received on term preferred stock (i.e., stock that will likely be redeemed within 20 years) and floating-rate preferred stock (i.e., stock with dividend rates which vary with interest rates, commodity rates or similar indices). For reasons similar to those set out in III. above, SIA objects to this proposal. Indeed, Congress considered and rejected this proposal last year.

According to the Administration, the rationale for this proposal is that such stock has debt-like characteristics. This is not an argument, however, for disallowing the dividends-received deduction. Under current law an issuer of preferred stock does not get any interest deduction, and the issuance of preferred stock rather than debt therefore generally increases, rather than decreases, aggregate corporate-level tax by introducing an additional 10.5% tax on dividends (i.e., a 35% tax on the 30% of the dividend that is taxable).

The Administration also maintains that the proposal is justified because current law denies the dividends-received deduction where holders are protected from risk of loss. Congress has already concluded, however, that the dividends-received deduction should not be disallowed merely because the terms of the preferred stock are designed to insulate a holder from market risks such as changes in interest rates.[5] Such terms do not protect the holder from the key risk which distinguishes equity from debt for tax purposes: the risk that the issuer will not pay dividends if its business performs poorly. Neither is a holder of preferred stock protected from this risk merely because the stock is scheduled for ultimate redemption. The stock is never redeemed if the issuer becomes insolvent prior to redemption, in which case the holder has no creditor's claim. The holder may receive neither dividends nor the redemption price if the issuer lacks sufficient earnings, and in such a case the holder cannot sue the issuer to enforce payment.

In any case, we see no basis for selectively eliminating the dividends-received deduction for particular classes of preferred stocks. The Administration's proposal is unfair and one-sided, because it would deny a dividends-received deduction on the theory that the security is "debt," but it would not grant an interest deduction instead. The result would make it impossible to issue the relevant securities, because the securities would fall into a noneconomic "no man's land" for tax purposes. There are important and legitimate business reasons, however, why some corporations investing equity capital in other corporations receive term preferred stock rather than perpetual preferred stock, or floating preferred stock rather than fixed preferred stock. We do not see any reason to force capital markets to limit the means by which domestic corporations can provide each other with equity capital.

V. DEFER INTEREST AND OID DEDUCTIONS ON CERTAIN CONVERTIBLE DEBT

The Administration's FY 2000 budget contains a proposal to defer deductions for interest accruing on zero-coupon debt that is convertible into the stock of the issuing corporation until the interest is actually paid. If the holder exchanged the right to receive such accrued but unpaid interest for stock before the instrument matured, the interest deduction would effectively be disallowed all together. This proposal has been repeatedly considered and rejected by Congress since 1995.

We oppose this provision as lacking a coherent policy rationale. The only possible rationale for the proposed disallowance is that an issuance of convertible discount debt is economically similar to an issuance of equity, and an issuer should therefore not be entitled to deduct interest accruing on discount debt that is ultimately converted into equity. We assume that the Administration would not propose, however, to disallow deductions for interest paid on conventional current-pay convertible debt. As an empirical matter, current-pay convertible debt is far more likely to be converted into equity than is zero-coupon convertible debt. A converting holder of zero-coupon debt must give up the right to receive accrued but unpaid interest; a converting holder of current-pay debt does not give up this right, because the interest has already been received. This is borne out by the fact that most current-pay convertible debt instruments are ultimately converted into stock prior to maturity, whereas most zero-coupon convertible debt instruments are ultimately not converted. In other words, it is generally the zero-coupon instruments, not the current-pay instruments, which in fact pay principal at maturity.

Moreover, this provision would result in inconsistent treatment of issuers and holders. Issuers would be denied any deductions for accrued but unpaid original issue discount, yet holders would still be required to include such discount in income. We think this would be unfair as a matter of policy.

VI. TAX ISSUANCE OF TRACKING STOCK

"Tracking stock" is an economic interest (e.g., stock) which "tracks" the economic performance of one or more divisions or subsidiaries of the issuing corporation. The Administration's FY 2000 budget includes a proposal which would require a corporation to recognize gain upon the issuance of tracking stock in an amount equal to the excess of the fair market value of the tracked assets over their adjusted basis. According to the Administration, the rationale for this proposal is that issuing corporations are avoiding the gain which they would otherwise recognize if they sold stock in the tracked subsidiary or division.

We disagree with the assumptions underlying this proposal. In many cases, the proceeds of an issuance of tracking stock are contributed to the relevant tracked subsidiary or division. Thus, the overall transaction is economically equivalent (and could be replicated by) a primary issuance of stock to new investors by the relevant subsidiary or division. Such a primary issuance would "dilute" the parent's interest in the subsidiary but would not cause the parent to recognize gain. We therefore do not agree that the issuance of tracking stock is primarily designed to avoid recognition of gain.

Admittedly an issuance of tracking stock is sometimes chosen over the alternative of a primary issuance partly to prevent the relevant subsidiary from being "deconsolidated" from the parent. There are many legitimate business reasons, however, for choosing an issuance of tracking stock over a primary issuance, including (a) the issuer's desire to retain full economic control over (but not full economic participation in) the relevant subsidiary, (b) the desire to permit both parent and subsidiary to achieve the lower financing costs associated with a higher credit rating based on a stronger, unified credit, (c) the desire to obtain or avoid desirable or onerous accounting or regulatory objectives or consequences, and (d) the desire to maximize synergies and cooperation. Further, enactment of this proposal would leave corporations which have already issued tracking stock in an untenable posi-

tion. Such corporations must issue new equity on an ongoing basis to grow, make acquisitions and meet other business requirements. If this new equity cannot be issued in proportion to existing equity (i.e., cannot include issuances of new tracking stock on a pro-rata basis), the balance in the corporation's capital structure will be undermined.

As discussed above in connection with the Administration's proposal to treat a forward issuance of stock like an "economically equivalent" current issuance, SIA does not believe that taxpayers should be taxed by reference to economically similar transactions which they might have undertaken to reach their economic objectives but didn't. Moreover, an issuance of tracking stock is clearly not economically equivalent to a sale of stock in the tracked subsidiary. Among other things, such an issuance (a) leaves investors fully exposed to loss from the bankruptcy of the issuing corporation, (b) generally gives investors voting control over the issuing, rather than the tracked, corporation and (c) subjects investors to substantial limitations on the receipt of dividends or profits which relate to the performance of the issuing, rather than the tracked, corporation.[6]

VII. APPLY SECTION 265(B) TO SECURITIES DEALERS

Section 265(a)(2) generally disallows deductions for interest on indebtedness incurred or continued to purchase or carry tax-exempt debt. Under relevant case law and IRS regulatory authority, securities dealers are generally required to allocate their indebtedness pro-rata among their assets for this purpose, with certain exceptions where indebtedness proceeds are clearly traceable to purposes other than the acquisition of tax-exempt debt. Section 265(b) applies a blanket pro-rata allocation rule to banks and other financial institutions.

The Administration's FY 2000 budget includes a proposal to apply Section 265(b) to securities dealers. The stated purpose of this proposal is to deny securities dealers the right to trace the proceeds of certain borrowings to specified taxable investments. This proposal, if adopted, would effectively overturn 30 years of guidance concerning what portion of a securities dealer's indebtedness is deemed effectively incurred to carry inventories of tax-exempt securities.

More specifically, when Congress first enacted Section 265(a)(2) of the Code in 1917, it clearly did not desire a pro-rata disallowance of interest expense for general business purposes.[7] In fact, Congress considered whether to amend the predecessor to section 265(a)(2) to enact a pro-rata disallowance rule in 1918, 1924, 1926 and 1934, and each time explicitly refused to do so.[8] Thereafter, the Second Circuit, in *Leslie v. Commissioner*,[9] concluded that securities dealers must allocate general subordinated indebtedness pro-rata among their business assets for purposes of applying Section 265(a)(2) but conceded that Section 265(a)(2) is not properly applied to disallow interest deductions where "business reasons not related to purchase of tax-exempt securities dominate the incurring of indebtedness." It allowed the Commissioner to allocate the taxpayer's indebtedness pro-rata among its business assets only because the proceeds of the indebtedness could not be traced to the acquisition of taxable assets. Likewise, under Rev. Proc. 72-18,[10] the Internal Revenue Service generally requires securities dealers to allocate their indebtedness pro-rata among their business assets but recognizes that such allocation is inappropriate where indebtedness is incurred for certain specified purposes.[11] Similarly, in Rev. Rul. 74-294,[12] the Service concluded that indebtedness incurred to make margin loans to customers was not allocable to tax-exempt debt because the indebtedness proceeds had to be segregated in a separate account.

The objective of all of these authorities has been to carry out the will of Congress as regards the application of Section 265 to securities dealers. In pursuance of this goal, these authorities have generally required pro-rata allocation, but they have also recognized the fact that some indebtedness is clearly not incurred to carry tax-exempt debt. The only rationale advanced by the Administration for reversing all of this guidance is that specific identification is not available to banks. Yet banks do not, like securities dealers, generally hold inventories of tax-exempt debt securities for sale to customers in the ordinary course of business. To the extent that they do, they also should be entitled to specific identification. Uniformity of treatment should not be sought by extension of a flawed rule.

In fact, the rule proposed by the Administration would be exceedingly harsh on securities dealers. Consider, for example, a securities dealer maintaining a "matched book" of repo transactions whereby the dealer effectively borrows and onlends large amounts of cash (which borrowings and onloans are fully collateralized by Treasury securities) and earns a thin "spread" for its corresponding role as a "middleman" in the efficient flow of capital. Under the Administration's proposal, such a dealer would be required to allocate the "borrowings" pro-rata among its assets, including

its inventory of tax-exempt securities, and a portion of its deductions for interest paid on the borrowings (but not its income from the onloans) would be disallowed accordingly. In effect, the net taxable income from the transactions would substantially exceed the economic income. Similarly, where a securities dealer borrowed money and onlent the proceeds to a customer in connection with a customer margin account, the resulting taxable income would substantially exceed the net economic income. Such treatment would hamper the ability of U.S. securities dealers to compete effectively with foreign securities dealers. If and to the extent that current rules have a similar effect on banks (i.e., to the extent that banks make markets in tax-exempt debt), we think the rules for banks should be changed.

The Administration maintains that "it is difficult to trace funds within an institution and nearly impossible to assess the taxpayer's purpose in accepting deposits or making other borrowings." To the contrary, however, the IRS has successfully audited securities dealers under an allocation methodology which includes both pro-rata allocation and specific tracing since the introduction of its 1972 revenue procedure on the subject.

VIII. REQUIRE CURRENT ACCRUAL OF MARKET DISCOUNT BY ACCRUAL METHOD TAXPAYERS

The Administration's FY 2000 budget includes a proposal which would require accrual-basis taxpayers to include the difference between the purchase price of a debt obligation and the issue price of the obligation—i.e., the "market discount" on the obligation—in income as it accrues. The accrual rate would be limited to 5 percentage points above (a) the original yield of the debt or (b) the applicable federal rate of interest at the time the debt was acquired. The basis for this proposal, according to the Administration, is that the failure of current law to require current accrual of market discount "creates asymmetries between similarly situated holders."

Congress has provided for the deferral of market discount in light of its simplicity and its consistency with the treatment of the issuer. Like the issuer, all holders continue to accrue interest at a rate equal to the initial yield of the debt instrument, regardless of subsequent changes in the value of the debt arising from changes in circumstance (e.g., changes in the market rate of interest or credit worthiness). Congress has also provided for the deferral of market discount partly in consideration of the administrative difficulties associated with requiring cash-basis holders to measure and accrue such discount currently.[13]

In light of the above, we believe that it is this proposal, rather than current law, which would create asymmetries. The proposed treatment of accrual-basis holders would not be consistent with the treatment of cash-basis holders, who would still (for the reasons set out above) be permitted to defer the inclusion in income of market discount to maturity. We do not think it fair or advisable to impose a substantially less desirable tax treatment on a category of investors based solely on their accounting method.

We are also concerned about the policy implications of this proposal. Current market discount rules generally encourage investors to acquire distressed debt in the secondary markets. The resulting increase in the liquidity of such debt helps to stabilize the financial positions of troubled corporations. Similarly, current market discount rules help increase the liquidity of Treasury and other government securities in rising interest-rate environments. We believe the Administration should set out in greater detail the likely economic impact of this proposal.

IX. MODIFY AND CLARIFY STRADDLE RULES

The Administration's FY 2000 budget includes a proposal designed to "clarify" that taxpayers cannot currently deduct certain expenses and losses that are attributable to structured financial transactions that are part of a straddle. We think this proposal is too broad. The proposal would disallow current deductions for all expenses incurred in connection with a straddle, even though the expenses are not incurred to purchase or carry the straddle and even though the expenses are not related to increases or decreases in the value of the underlying property.[14] In the case of a typical 5-year exchangeable debt instrument, for example, the proposal would disallow deductions for fixed conventional market-rate interest payments (e.g., 7% per annum), even though the proceeds of the borrowing were used for wholly unrelated purposes and the relevant growth stock did not serve as collateral for the borrowing.

If the straddle rules are modified, moreover, we think the modifications should also deal with rules which currently work against taxpayers in an unfair manner. For example, under current straddle rules, a small loss can be deferred even though larger amounts of gain have been recognized on the offsetting position, because

there is still some unrecognized gain left in the offsetting position (e.g., unrealized gain which antedated the straddle). Likewise, losses can be deferred to the extent of unrealized offsetting gains, but gains are never deferred to the extent of unrealized offsetting losses. Partly in recognition of these facts, the Administration last year proposed to permit taxpayers to elect to treat straddles as hedging transactions and account for the timing of gains and losses on a unified basis. The Administration did not include this proposal among its proposals for hedging transactions this year, however. We think this proposal should be included as part of any current plan to change the straddle rules.

X. THE ADMINISTRATION'S CORPORATE TAX SHELTER PROPOSALS

The Administration's FY 2000 budget includes a group of proposals which respond to a perceived increase in corporate tax shelter transactions. These proposals would introduce a variety of penalties for attempting to obtain a "tax benefit" by entering into a "tax avoidance transaction." A "tax avoidance transaction" is generally defined to include (a) any transaction where the expected pre-tax profit is insignificant relative to the expected tax benefit, and (b) certain transactions involving "the improper elimination or significant reduction of tax on economic income." A tax benefit would include any reduction, exclusion, avoidance or deferral of tax that was not "clearly contemplated by the applicable provision."

The penalties would generally include all of the following: (a) automatic disallowance of the relevant tax benefits, regardless of what would otherwise be the outcome under current law, (b) automatic imposition of a substantial understatement penalty, (c) increase in the amount of the understatement penalty from 20% to 40%, (d) disallowance of all deductions for fees, including underwriting fees, paid to enter into the transaction, (e) imposition of a 25% excise tax on such fees, (f) imposition of an immediate 25% excise tax on the maximum amount which the taxpayer could conceivably collect from insurance, gross-up provisions, make-whole provisions or other mechanisms designed to compensate the taxpayer for loss of tax benefits and associated penalties, and (g) imposition of tax on otherwise tax-exempt or foreign persons who invest in, or otherwise participate in, the relevant transactions.

One of the principal tasks of the securities industry is to help corporations structure and implement financial transactions. SIA recognizes that the Administration is concerned about strictly tax-motivated transactions. Such transactions must be distinguished, however, from the much broader group of financial transactions that are not motivated primarily by tax considerations but are legitimately structured to minimize their tax consequences. The latter are often novel and complex, and the application of existing tax rules to them is often a matter of first impression. There are, moreover, numerous "gray areas" where the application of existing legal concepts is not entirely clear. The objective rules that are set out in statutes, regulations, case law and other official guidance are mostly "good" rules that have been carefully thought out and work well in most cases. SIA agrees that taxpayers should not be allowed to abuse these rules to avoid paying tax. The system as we know it will not work, however, if taxpayers cannot rely on these rules to determine the tax consequences of new financial transactions without fearing that their good faith efforts will be second guessed with drastic consequences. Moreover, a taxpayer's efforts to structure legitimate business transactions in the most tax-advantageous manner in light of these rules should not make them or their advisors the targets of legislation that is intended to deal with corporate tax shelter activity.

It is not easy (indeed it may be impossible) to define "tax avoidance transaction" in a way which effectively catches strictly tax-motivated transactions without catching the tax-motivated aspects of legitimate business transactions. The Administration's penalty proposals would place enormous pressure on this definition, however, by automatically imposing severe and redundant penalties on taxpayers purporting to derive tax benefits from tax avoidance transactions.

We note, moreover, that efforts to define "tax avoidance transaction" using such concepts as whether a transaction "improperly eliminates tax on economic income" or "creates a tax benefit which is not clearly contemplated by the applicable provision" introduces a "normative" concept which cannot be found in objective rules. The objective rules set out in our statutes and regulations are not necessarily economic. For example, some rules do not impose tax on economic gains, and other rules impose tax on noneconomic gains (e.g., impose tax on dividends). There is no "natural law" of federal income taxation. Thus, no statute or regulation can serve to determine whether a taxpayer has used objective rules to "improperly eliminate tax on economic income" or "create a tax benefit which has not been contemplated by the applicable provision." That is something which must be decided by individuals.

It follows that the efficacy of proposals based on such definitions must depend on the judgement and discretion of IRS agents. The additional steps required to structure a merger, acquisition, spinoff or other business transaction to be tax-free or tax-deferred, rather than fully taxable, can often be described as transactions entered into solely to avoid taxes. The same can be said of steps undertaken to structure financings in the most tax-advantageous manner while still addressing various accounting, regulatory, rating agency, foreign and domestic law concerns. If IRS agents were to treat such additional steps as tax-avoidance transactions, taxpayers might be forced to concede disputed technical issues to avoid the risk of onerous penalties. In any case, the IRS would have to substantially increase its resources to permit it to work through a large volume of complex financial transactions, analyze the underlying intent of the relevant objective rules and do so on a basis that was timely enough to permit business to proceed without serious interruption.

[1] See Staff of Joint Comm. on Taxation, 106th Cong., Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal 179 (Comm. Print JCS-1-99) (hereafter, the "Joint Committee Description").

[2] All section references are to the Internal Revenue Code.

[3] 1984 Blue Book at 128.

[4] H.R. Rep. No. 98-432, pt. 2, at 1184 (1984). The relevant Senate report contains almost identical language. See S. Rep. No. 98-169, at 165-66 (1984).

[5] See e.g., H.R. Conf. Rep. No. 98-861, at 818-19 (1984), dealing with the enactment of Section 246(c) of the Code: "The substantially similar standard is not satisfied merely because the taxpayer (1) holds a single instrument that is designed to insulate the holder from market risks (e.g., adjustable rate preferred stock that is indexed to the Treasury Bill rate). . . ."

[6] See the Joint Committee Description at 224-225:

"While it generally is anticipated that the issuing corporation will pay dividends linked to the tracked assets, in many instances holders of tracking stock may not actually be entitled to the dividends, even though the tracked assets are profitable, if the parent corporation does not declare dividends. The tracked assets may be subject to liabilities of the parent corporation that may diminish the tracking stock shareholders' interests in the values of such assets. Under such circumstances, it might be questioned whether the issuance of such stock is economically equivalent to a direct ownership of the underlying assets. If tracking stock has a value that differs from the value of the underlying assets, it could be questioned whether the issuing corporation is properly treated as having distributed the entire value of the attributable portion of the tracked asset."

[7] Revenue Act of 1917, ch. 63, §§1201(1) & 1207(2), 40 Stat. 300, 330, 335 (1917).

[8] See J.S. Seidman, Seidman's Legislative History of Federal Income Tax Laws 1938-1961 301, 597, 727-28, 910 (1938).

[9] 413 F.2d 636, 639 (2d Cir., 1969), cert. den. 396 U.S. 1007 (1970).

[10] 1971-1 C.B. 740.

[11] Id. at Section 5.04: Indebtedness incurred to acquire or improve physical facilities is not allocated partly to tax-exempt debt.

[12] 1974-1 C.B. 71.

[13] See the Joint Committee Description at 207, and Staff of Joint Comm. on Taxation, 98th Cong., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 93 (Comm. Print 1984) (hereafter, "1984 Blue Book").

[14] See the Joint Committee Description at 217.

Prepared Statement of David A. Lifson

I. Individual Income Tax Proposals Generally

The Administration's revenue proposals contain numerous provisions affecting individuals, such as: a new long-term care credit, a new disabled workers tax credit, the child and dependent care tax credit expansion, the employer-provided educational assistance exclusion extension, a new energy efficient new homes credit, the electric vehicles credit extension, AMT relief extension, a new D.C. homebuyers credit, optional self-employment contributions computations, a new severance pay exemption, a new rental income inclusion, etc. While we are not commenting on the policy need for these provisions, we note that Congress must consider the general administrability of these provisions.

We are very concerned about the increasing complexity of the tax law as a result of targeted individual tax cuts. The 1997 Taxpayer Relief Act contained several targeted individual tax cuts that were first effective for 1998 individual income tax re-

turns. As discussed in the Wall Street Journal of February 17, 1999, these provisions, while providing tax relief to certain individuals, have greatly increased the complexity of the preparation of individual income tax returns. This increased compliance burden is born mostly by lower income taxpayers who can least afford the cost of hiring a professional income tax return preparer.

IRS National Taxpayer Advocate W. Val Oveson, in his first report to Congress, stated that increasing tax law complexity is imposing significant compliance and administrative burdens on the IRS and taxpayers. The report also cited the increasing complexity caused by the targeted individual tax cuts contained in the 1997 Taxpayer Relief Act.

The Administration's tax proposals contain 28 new targeted tax cuts. Many of these provisions have limited applicability; none are available to high-income taxpayers. Unfortunately, the way these provisions are drafted with different income limits for each provision, taxpayers need to make many additional tax calculations just to determine if they are eligible for the tax benefit. The Administration's tax proposals will add several additional income limits to the Internal Revenue Code.

Below are a few examples of provisions in the Administration's tax proposals that have different phase-out limits:

- The long-term care credit and disabled workers tax credit would be phased out "by $50 for each $1,000 (or fraction thereof) by which the taxpayer's modified AGI exceeds" $110,000 (married filing a joint return taxpayers), $75,000 (single/head of household), or $55,000 married filing separate.
- The first-time D.C. homebuyers credit phases out for individuals with AGI between $70,000 and $90,000 ($110,000 to $130,000 for joint filers).
- The severance pay exemption would not apply if the total severance payments received exceed $75,000.
- The expanded child and dependent care credit proposal would allow taxpayers the 50 percent credit rate if their AGI is $300,000 or less, then the credit rate would be reduced by one percentage point for each additional $1,000 of AGI in excess of $300,000, and taxpayers with AGI over $59,000 would be eligible for a 20 percent credit rate.
- The student loan interest deduction (to which the President's proposal would eliminate the current 60-month limit) phases out ratably for single taxpayers with AGI between $40,000 and $55,000 and between $60,000 and $75,000 for married filing a joint return taxpayers.

This type of law, with so many different phase-out limits, provides incredible challenges for middle-income taxpayers, in determining how much of what benefit they are entitled to. We suggest common phase-out limits among all individual tax provisions in order to target benefits to one of three uniform groups and simplify the law. Our phase-out simplification proposal is attached.

Another problem with these targeted tax cuts is that the impact of the alternative minimum tax (AMT) on these cuts is not adequately addressed. This is evidenced by the provision in the 1998 IRS Restructuring and Return Act and the provision in the Administration's tax proposals that provide temporary relief from the AMT for individuals qualifying for some of the targeted tax credits. We believe that the individual alternative minimum tax needs to be simplified; our proposal is attached.

Finally, much of the complexity in the individual income tax system is the result of recent efforts to provide meaningful tax relief to medium and low-income taxpayers. In order to aid simplification, we believe that Congress should consider alternatives to targeted tax cuts, including the new ones proposed by the Administration, with provisions such as the following:

- Increased standard deduction.
- Increased amount for personal exemptions.
- Increasing the taxable income level where the 28 percent tax and the 31 percent tax rate begins.
- Marriage penalty relief.

The AICPA would like to further study the complexity caused by the proliferation of credits with their complex provisions, and hopes to provide further specific comments as this legislation progresses.

Phase-Outs Based on Income Level

Present Law

Numerous sections in the tax law provide for the phase-out of benefits from certain deductions or credits over various ranges of income based on various measures of the taxpayer's income. There is currently no consistency among these phase-outs in either the measure of income, the range of income over which the phase-outs apply, or the method of applying the phase-outs. Furthermore, the ranges for a par-

ticular phase-out often differ depending on filing status, but even these differences are not consistent. For example, the traditional IRA deduction phases out over a different range of income for single filers than it does for married-joint filers; whereas the $25,000 allowance for passive losses from rental activities for active participants phases out over the same range of income for both single and married-joint filers. Consequently, these phase-outs cause inordinate complexity, particularly for taxpayers attempting to prepare their tax returns by hand; and the instructions for applying the phase-outs are of relatively little help. See the attached Exhibit for a listing of most current phase-outs, including their respective income measurements, phase-out ranges (for 1998) and phase-out methods.

Note that currently many the phase-out ranges for married-filing-separate (MFS) taxpayers are 50 percent of the range for married-filing-joint (MFJ), while many of the phase-out ranges for single and head of household (HOH) taxpayers are 75 percent of married-joint. That causes a marriage penalty when the spouses' incomes are relatively equal.

Recommended Change

True simplification could easily be accomplished by eliminating phase-outs altogether. However, if that is considered either unfair (simplicity is often at odds with equity) or bad tax policy, significant simplification can be achieved by creating consistency in the measure of income, the range of phase-out (including as between filing statuses) and the method of phase-out.

Instead of the approximately 20 different phase-out ranges (shown in attached Exhibit A), there should only be three—at levels representing low, middle, and high income taxpayers.

If there are revenue concerns, the ranges and percentages could be adjusted, as long as the phase-outs for each income level group (i.e., low, middle, high income) stayed consistent across all relevant provisions. In addition, marriage penalty impact should be considered in adjusting phase-out ranges for revenue needs. We propose that, in an effort to eliminate the marriage

penalty and simplify the Code, all phase-out ranges for married-filing-separate (MFS) taxpayers should be the same as those for single and head of household (HOH) taxpayers, which would be 50 percent of the range for married-filing-joint (MFJ) range.

The benefits that are specifically targeted to low-income taxpayers, such as the earned income credit, elderly credit, and dependent care credit, would phase-out under the low-income taxpayer phase-out range. The benefits that are targeted to low and middle income taxpayers, such as the traditional IRA deduction and education loan interest expense deduction, would phase-out under the middle-income taxpayer phase-out range. Likewise, those benefits that are targeted not to exceed high income levels, such as the new child credit, the new education credits and Education IRA, and the new Roth IRA, as well as the existing law AMT exemption, itemized deductions, personal exemptions, adoption credit and exclusion, series EE bond exclusion, and section 469 $25,000 rental exclusion and credit, would phase-out under the high-income taxpayer phase-out range. See the chart below.

Additionally, instead of the differing methods of phase-outs (shown in attached Exhibit B), the phase-out methodology for all phase-outs would be the same, such that the benefit phases out evenly over the phase-out range. Every phase-out should be based on adjusted gross income (AGI).

PROPOSED ADJUSTED GROSS INCOME LEVEL RANGE FOR BEGINNING TO END OF PHASE-OUT FOR EACH FILING STATUS

Category of Taxpayer	Married Filing Joint	Single & HOH & MFS
Low-income	$15,000-$37,500	$7,500-$ 18,750
Middle-income	$60,000-$75,000	$30,000-$ 37,500
High-income	$225,000-$450,000	$112,500-$225,000

Contribution to Simplification

The current law phase-outs complicate tax returns immensely and impose marriage penalties. The instructions related to these phase-outs are difficult to understand and the computations often cannot be done by the average taxpayer by hand. The differences among the various phase-out income levels are tremendous. Either we should eliminate phase-outs and accomplish the same goal with a lot less complexity by adjusting rates, or at least make the phase-outs applicable at consistent

income levels (only three) and apply them to consistent ranges and use a consistent methodology. This would ease the compliance burden on many individuals. If there were only three ranges to know and only one methodology, it would be easier to recognize when and how a phase-out applies. Portions of numerous Internal Revenue Code sections could be eliminated. By making the MFJ phase-out ranges double the ranges applicable to single individuals, and by making the MFS ranges the same as single individuals, the marriage penalty associated with phase-out ranges would be eliminated.

Alternative Minimum Tax Proposal

Background on AMT

The budget proposals would extend, for two years, the availability of refundable credits against the individual alternative minimum tax. Thus, this issue has now joined the list of "extenders" or "expiring provisions" which Congress must address every few years, searching for the revenues to prevent some tax inequity (as here) or maintain some tax incentive.

We are clearly pleased to support this proposal, but we would caution the Congress (as we have in the past) that there are many more issues with the individual AMT that need to be addressed. Some of these issues are discussed below.

Complexity of AMT

The AMT is one of the most complex parts of the tax system. Each of the adjustments of Internal Revenue Code (IRC) section 56, and preferences of IRC section 57, requires computation of the income or expense item under the separate AMT system. The supplementary schedules used to compute many of the necessary adjustments and preferences must be maintained for many years to allow the computation of future AMT as items turn around.

Generally, the fact that AMT cannot always be calculated directly from information on the tax return makes the computation extremely difficult for taxpayers preparing their own returns. This complexity also calls into question the ability of the Internal Revenue Service (IRS) to audit compliance with the AMT. The inclusion of adjustments and preferences from pass-through entities also contributes to the complexity of the AMT system.

Effects of the Taxpayer Relief Act of 1997 and AMT on Individual Taxpayers

If the Administration's budget proposal on temporary AMT relief expansion is not enacted, several tax credits included in the Taxpayer Relief Act of 1997 will have a dramatic impact on the number of individuals who will find themselves subject to the alternative minimum tax (AMT). For many, this will come as a real surprise and, in all likelihood, will cause substantial problems for the IRS, which will have to redirect significant resources to this area in the future to ensure compliance, educate taxpayers, and handle taxpayer questions. We believe the Administration's proposal should be for permanent AMT relief rather than just temporary two-year relief.

Most sophisticated taxpayers understand that there is an alternative tax system, and that they may sometimes wind up in its clutches; unsophisticated taxpayers, however, may never have even heard of the AMT, certainly do not understand it, and do not expect to ever have to worry about it. Unfortunately, that is changing—and fairly rapidly—since a number of the more popular items, such as the education and child credits that were recently enacted, offset only regular tax and not AMT. Due to these changes, we believe it is most important that Congress obtain information (from Treasury, the Joint Committee on Taxation staff, or OMB) not only as to the revenue impact of the interaction of all these recent tax changes with the AMT, but also of the likely number of families or individuals that will be paying AMT as a result of the 1997 tax legislation.

Indexing the AMT Brackets and Exemption

While the AICPA has not undertaken detailed studies, we have all seen, during the past year, anecdotal examples indicating the likelihood that taxpayers with adjusted gross incomes in the $60,000-$70,000 range (or below) will be subject to AMT. Aside from the fairness issues involved—this is not the group that the AMT has ever been targeted to hit—we see some potentially serious compliance and administration problems. Many of these taxpayers have no idea that they may be subject to the AMT (if, indeed, they are even aware that there is an AMT). Thus, we anticipate large numbers of taxpayers not filling out a Form 6251 or paying the AMT who

may be required to do so, thus requiring extra enforcement efforts on the part of the IRS to make these individuals (most of whom will be filing in absolute good faith) aware of their added tax obligations. Further, IRS notices to these taxpayers assessing the proper AMT may well be perceived as unfair, subjecting the IRS to unfair criticism that should be directed elsewhere.

Individual AMT Recommendations

We recognize that there is no simple solution to the AMT problem given the likely revenue loss to the government. As a start, however, Congress should consider:

1. Increasing and/or indexing the AMT brackets and exemption amounts.
2. Eliminating itemized deductions and personal exemptions as adjustments to regular taxable income in arriving at alternative minimum taxable income (AMTI) (e.g., all—or possibly a percentage of—itemized deductions would be deductible for AMTI purposes).
3. Eliminating many of the AMT preferences by reducing for all taxpayers the regular tax benefits of AMT preferences (e.g., require longer lives for regular tax depreciation).
4. Allowing certain regular tax credits against AMT (e.g., low-income tax credit, tuition tax credits)—permanently, rather than just for the next two years.
5. Providing an exemption from AMT for low and middle-income taxpayers with regular tax AGI of less than $100,000.
6. Considering AMT impact in all future tax legislation.

Due to the increasing complexity, compliance problems, and a perceived lack of fairness towards the intended target, an additional alternative Congress might also want to consider is eliminating the individual AMT altogether.

Contribution to Simplification of AMT

The goal of fairness that is the basis for AMT has created hardship and complexity for many taxpayers who have not used preferences to lower their taxes but have been caught up in the system's attempt to bring fairness. Many of these individuals are not aware of these rules and complete their return themselves, causing confusion and errors. The 1997 law and the impact of inflation on indexed tax brackets and the AMT exemption are causing more lower income taxpayers to be inadvertently subject to AMT. Increasing and/or indexing the AMT brackets and exemption (recommendation 1) would solve this problem.

Under recommendation 2, those individuals who are affected only by itemized deductions and personal exemption adjustments would no longer have to compute the AMT. Itemized deductions are already reduced by the 3 percent AGI adjustment, 2 percent AGI miscellaneous itemized deduction disallowance, 7.5 percent AGI medical expense disallowance, $100 and 10 percent AGI casualty loss disallowance, and the 50 percent disallowance for meals and entertainment. Similarly, the phase out of exemptions already affects high-income taxpayers. It is also worth noting that because state income taxes vary, taxpayers in high income tax states may incur AMT solely based on the state in which they live, while other taxpayers with the same adjusted gross income (AGI), but who live in states with lower or no state income taxes, would not pay AMT. This results in Federal tax discrimination against residents of high tax states.

In addition, under recommendation 3, many of the AMT preferences could be eliminated by reducing for all taxpayers the regular tax benefits of present law AMT preferences (e.g., require longer lives for regular tax depreciation). This would add substantial simplification to the Code, recordkeeping and tax returns.

Under recommendation 4, those who are allowed regular tax credits, such as the low income or tuition tax credits, would be allowed to decrease their AMT liability by the credits. This would increase simplicity and create fairness. Compliance would be improved.

Under recommendation 5, fewer taxpayers will be subject to AMT and the associated problems. By increasing the AMT exemption to exclude low and middle income taxpayers, the AMT will again be aimed at its original target—the high-income taxpayer.

By eliminating AMT altogether, all the individual AMT problems would be solved.

Conclusion on AMT

In conclusion, we see the AMT as becoming more prevalent and causing considerable disillusion to many taxpayers whom do not see themselves as wealthy and who will believe they are being punished unfairly. The AMT will apply to many tax-

payers it was not originally intended to affect. We believe our proposals offer a wide range of ways to help address this problem.

I.B.2—Exclusion FOR Employer-Provided Educational Assistance

Section 127 allows workers to exclude up to $5,250 a year in employer reimbursements or direct payments for tuition, fees, and books for certain courses. This exclusion expires on June 1, 2000. The President's proposal would extend the Section 127 exclusion for eighteen months for both undergraduate and graduate courses.

We support extension of the Section 127 exclusion and encourage Congress to consider making it a permanent part of the tax code. We also support re-inclusion of graduate-level courses as expenses qualifying for the exclusion. Expanding and making Section 127 a permanent part of the tax code would remove the uncertainty and ambiguity that employees and employers now regularly face.

Evidence indicates that Section 127 has met the broad policy goals for which it was designed. It has provided incentive for upward mobility of employees who might not otherwise choose or be able to afford to return to school to improve their skills and educational qualifications. It has reduced complexity in the tax law because it does not require a distinction between job-related and non-job related educational assistance. Further, it has also reduced possible inequities among taxpayers by allowing lower-skilled employees, on a nondiscriminatory basis, eligibility for the exclusion without worry about the job-related test.

Complexity could be further reduced by making Section 127 permanent thereby eliminating the periodic rolling forward of the expiration date and the need for retroactive reinstatement. This is particularly troublesome to students who are planning a multi-year education program and cannot plan on consistent after-tax costs throughout their education. These students are often on a tight budget and find it difficult to plan for and implement full-degree programs.

The continued education and increased competence of the U.S. worker are critical to surpassing the challenges of an international marketplace.

I.F.13-17—Promote Expanded Retirement Savings, Security, and Portability

The President's budget contains five provisions to increase pension portability, the ability to roll over retirement savings between pension plans. The AICPA supports these provisions and commends the Administration for addressing a complex area of the tax law that is becoming increasingly utilized given our mobile workforce. These provisions would simplify planning and reduce the pitfalls and penalties that taxpayers run afoul of in attempting to comply with the current rules.

Under the budget proposal:

An eligible rollover distribution from a qualified retirement plan could be rolled over to a qualified retirement plan, a Code section 403 (b) annuity, or a traditional IRA. Likewise, an eligible rollover distribution from a Section 403 (b) annuity could be rolled over to another Section 403 (b) annuity, a qualified retirement plan, or a traditional IRA. The conduit IRA rules would be modified similarly.

Individuals who have a traditional IRA and whose IRA contributions have been tax deductible would be allowed to transfer funds from their traditional IRA into their qualified defined benefit retirement plan or Section 403(b) annuity, provided that the retirement plan trustee meets the same standards as an IRA trustee.

After-tax employee contributions to a qualified retirement plan could be included in a rollover contribution to a traditional IRA or another qualified retirement plan, provided that the plan or IRA provider agrees to track and report the after- tax portion of the rollover for the individual. Distributions of the after-tax contributions would continue to be nontaxable.

Individuals would be permitted to roll over distributions from a governmental Section 457 plan to a traditional IRA.

State and local employees would be able to use funds from their Section 403 (b) annuities or government Section 457 plans to purchase service credits through a direct transfer without first having to take a taxable distribution of these amounts.

In addition, there are numerous other pension provisions from previous budget proposals which the AICPA supports. These provisions would: Make it easier for workers to contribute to IRAs through payroll deduction at work; provide a three-year small business tax credit to encourage them to start up retirement programs; create a new simplified defined benefit pension plan (The SMART Plan-Secure Money Annuity or Retirement Trust Plan); provide faster vesting of employer matching contributions; improve pension disclosure; improve benefits of non-highly compensated employees under Section 401 (k) safe harbor plans; simplify the definition of highly compensated employee; simplify full-funding limitations and Section 415 benefit limits for multi-employer plans, and eliminate partial termination rules

for multi-employer plans. All of these provisions would assist taxpayers in setting up retirement plans and improve the overall rate of savings in the U.S.

The AICPA supports these recommendations and believes that Congress should consider further efforts to encourage retirement savings and investment, including making personal financial planning more available to employees through employee benefits plans.

I.H.4—Simplify the Foreign Tax Credit Limitation for Dividends from 10/50 Companies

The underlying simplification provision was included in the 1997 Act, but with a delayed effective date. The Tax Division supported this provision in 1997, as part of its tax simplification recommendations, and supports the proposed accelerated effective date of this simplification.

This measure brings simplicity to the area. Prior to 1997, each investment of a U.S. corporate shareholder in a so-called "10/50 company" fell into a separate basket for purposes of the foreign tax credit limitation rules. (A "10/50 company" is a foreign corporation that is not more than 50% owned by U.S. shareholders [i.e., not a controlled foreign corporation] but which has at least one 10% or more U.S. shareholder.) This segregation into separate baskets had the effect of precluding the averaging of high- and low-taxed foreign earnings. The effect of the 1997 simplification provision was to apply a look-through rule to determine the foreign tax credit baskets for dividends paid by a 10/50 company.

We are concerned about the proposed grant of broad authority to Treasury to determine the pre-acquisition earnings and profits of a foreign corporation. Treasury is empowered to rule that pre-acquisition earnings and profits and foreign taxes could be disregarded "in appropriate circumstances." While this could achieve some simplification, it could result in inequities and is inconsistent with the general treatment of distributions from acquired corporations for foreign tax credit purposes. We believe this authority should be more carefully defined, and would be happy to work with your staff to develop appropriate limitations.

I.H.5—INTEREST TREATMENT FOR DIVIDENDS PAID BY CERTAIN REGULATED INVESTMENT COMPANIES TO FOREIGN PERSONS

The AICPA supports the Administration's proposal that would eliminate U.S. withholding tax on dividends paid to foreign investors in certain bond mutual funds. This would eliminate the disparate treatment based solely on whether a foreign investor purchases U.S. debt through a U.S. regulated investment company (RIC),through a foreign fund, or directly from the U.S. issuer.

Background

When the "portfolio interest" exception was enacted in The Tax Reform Act of 1984, domestic corporations faced a situation in which they were limited in their ability to obtain foreign debt financing because of the 30% tax on interest paid to nonresident alien lenders. Such companies would have had to use offshore financing subsidiaries to offer competitive returns. Congress viewed this situation as not only a costly inconvenience, but as a limiting factor on the ability to raise capital, potentially driving up borrowing costs. As a result, payments of "portfolio interest" were exempted from the tax imposed on nonresident alien individuals under IRC section 871.

Distributions paid by a U.S. RIC from portfolio interest earned by the RIC, however, were not included in this exception. As a result, foreign investment in U.S. RICs has been historically low. With the growth of mutual funds as a major financing intermediary and the build-up of significant investment capital by less sophisticated foreign investors, the Administration's proposal is needed to fully achieve Congress's original intent. It is also clear that the focus of the 1984 legislation was not the structural differences between mutual funds and direct investments in U.S. securities.

An added benefit of using RICs as a vehicle to obtain offshore financing is that RICs permit the raising of foreign capital without diluting the ownership of U.S. operating concerns.

U.S. mutual funds are at a competitive disadvantage relative to non-U.S. funds. Under the current situation, a U.K. investor would be better off investing in U.S. interest-bearing obligations through a U.K. fund than through a U.S. fund, since the latter would impose a withholding tax. This disincentive to purchase U.S. mutual funds deprives the foreign investor of access to the most knowledgeable financial experts in the U.S. markets.

The Administration's proposal also is consistent with the development of RIC taxation. RICs provide an opportunity for smaller investors to benefit from the expertise and market presence of large investors. To accomplish this result, Congress has continually provided conduit tax treatment for certain items, which, if realized through direct ownership, would have similarly received special tax treatment. Examples include long-term capital gains, tax-exempt interest and foreign tax credits. The current proposal is consistent with, and a necessary continuation of, this legislative history.

Comments

The proposal permits qualifying RICs to treat all dividends paid to its foreign shareholders as interest that qualifies for the "portfolio interest" exception from U.S. tax. The language of the proposal, however, refers to this change as an exception from withholding tax. Although the practical effect may be to eliminate a withholding tax, this statutory revision should be enacted within IRC section 871(h)(2). A change under section 871(h) will flow through as an exception from withholding under IRC section 1441(c)(9). Enactment under section 871(h) is suggested so as to ensure that the full benefits of portfolio interest treatment will flow through to foreign shareholders.

The proposal treats the RIC dividend paid as portfolio interest providing the fund invests "substantially all" of its assets in qualifying debt obligations. If this proposal is enacted, the AICPA recommends that care be taken in designing the limitation on investment in foreign debt securities. With the globalization of the financial services industry, foreign debt is an important part of U.S. income-oriented mutual funds. This limitation should not prohibit existing mutual funds from qualifying for this exemption or impair their ability to reallocate their portfolios between domestic and foreign assets.

Although the AICPA strongly supports the Administration's proposal, we would prefer an alternative approach that would permit a fund to exempt the applicable portion of its dividend without regard to a threshold. For example, if 10% of a fund's dividend results from portfolio interest, 10% would be exempt from withholding. Similar treatment would apply to short-term capital gains or other interest, which if received through direct ownership, would be exempt from tax. Permitting the character of U.S.-source interest income and short-term capital gains to flow through to foreign investors would encourage foreign investment in a broader variety of U.S. RICs. It would eliminate the disparity between U.S. and non-U.S. equity and balanced funds, and encourage raising foreign equity capital.

I.H.7—SIMPLIFY THE ACTIVE TRADE OR BUSINESS REQUIREMENT FOR TAX-FREE SPIN-OFFS

The AICPA supports the Administration's proposal to improve the operation of Section 355. This is a longstanding one, well-known to the corporate tax community. Current law poses trouble for taxpayers: for the unwary, a trap; for the well-advised, sometimes a costly (and economically unproductive) detour.

The problem lies in the statute itself, which accommodates pure holding companies, but not hybrids. In applying the "active conduct" test to holding companies, Section 355(b)(2)(A) requires that "substantially all" of its assets consist of stock (and securities) of controlled subsidiaries that are themselves engaged in the "active conduct," etc. The "substantially all" requirement is not defined in either statute or regulations. The IRS has defined it, in the context of an advance ruling, as 90% of gross assets. This raises a very high threshold for holding companies, one that can be met only by pure (or virtually so) holding companies.

The unwary taxpayer will make a distribution to shareholders that may wind up as a tax controversy. The well-advised taxpayer will take a detour. The objective of the detour is to convert the hybrid holding company into an operating company. This can usually be accomplished, so long as the holding company has at least one controlled subsidiary that meets the "active conduct" test. For example, the holding company can cause the controlled subsidiary to be completely liquidated, so that the latter's active business is now operated directly by the holding company. From an economic perspective, this step is meaningless because it shouldn't matter whether a business is conducted directly or indirectly. But the step is a tax cure-all because, unlike a holding company, an operating company is not subject to a quantitative test. Rather, the latter is subject to a qualitative test: is it operating an active business?

There is no apparent reason for the statute's asymmetric approach to holding companies and operating companies, respectively. According to IRS advance ruling guidelines, at least 90% of a holding company's gross assets must be invested in

qualifying assets, i.e., stock in controlled subsidiaries that are engage in the active conduct," etc. On the other hand, according to the IRS advance ruling guidelines, an operating company need have as little at 5% of its gross assets invested in the active business.

The Administration's proposal would address this lack of symmetry by treating an affiliated group as a single taxpayer. No longer would a hybrid holding company be forced to relocate an active business within its corporate family in order to meet the "active conduct" requirement. This amendment is entirely consistent with the prevailing, single-entity theory of consolidated returns, and it has our full support.

II.A.1-6—CORPORATE TAX SHELTERS

The President's budget contains sixteen proposals addressing corporate tax shelters. The first six of these address the topic generically by imposing new penalties and sanctions and by establishing new tax rules to govern transactions generally. This section provides our comments on the issues addressed in the six generic proposals.

We begin by recognizing that tax laws are usually followed, but that they can also be abused. Where there are abuses, we hold no brief for them—whether they fall under the pejorative rubric of "tax shelters" or any other part of our tax system. Thus, we sympathize with and support efforts to restrict improper tax activities through appropriate sanctions. At the same time, changes in this area must be made with great care in order to avoid overreaching and other unintended consequences that would make our corporate tax system even more unworkable. For example, we favor the Administration's recommendation that Congress address exploitation of the tax system by the use of tax-indifferent parties. We also find some common ground with respect to principles suggested in the Administration's proposal regarding taxpayers taking positions inconsistent with the form of a transaction; but serious questions are raised by it and, with the abundance of case law in this area, we are reluctant to support additional legislation on the issue.

In addressing the Administration's proposals for penalizing corporate tax shelters, we want to state at the outset that the AICPA supports and defends the right of taxpayers to arrange their affairs to minimize the taxes they must fairly pay and, with that in mind, we have some serious concerns about where the President's proposals draw the distinction between legitimate tax planning and improper tax activities. We see the President's proposals as an overbroad grant of power to the Internal Revenue Service to impose extremely severe (what we describe as "extraordinary") sanctions on corporate taxpayers by applying standards that are far from clear and that could give examining revenue agents a virtual hunting license to go after corporate taxpayers (which, by the way include huge numbers of small and medium-sized businesses, not just Fortune 100 companies) and their advisors. This is inconsistent with the taxpayer rights thrust of last year's IRS restructuring legislation. In our view, the debate concerning the sanctions for improper corporate tax behavior must begin with a clear understanding of the standards that distinguish abusive transactions from legitimate tax planning. What standards justify the imposition of extraordinary punishment on a corporation (or tax adviser) whose tax treatment of a transaction is successfully challenged by the IRS?

Treasury's response to this question is to greatly expand the application of Code section 269's tax avoidance concept and to use it in a punitive penalty regime. We disagree with this approach. Section 269 has applied, since at least 1954, to a fairly narrow range of corporate transactions where the principal purpose of the transaction was avoidance or evasion of federal income taxes. Now, we would see the very strong disallowance powers of that section applied to transactions defined by an extremely broad and extremely hazy standard which, as we discuss in more detail below, gives far too much power to IRS agents. Delegation of disallowance authority to Treasury as has been proposed is unwise and would undermine the administrative and judicial processes that have served us well over time in protecting the rights of taxpayers as well as those of the government.

AICPA concerns

Our primary concern with the Treasury proposals as a whole is the potential imposition of extraordinary sanctions and penalties in the absence of a clear standard defining what is and what is not an abusive transaction. The proposals modifying the substantial understatement penalty for corporate tax shelters and denying certain tax benefits to persons avoiding income tax as a result of "tax avoidance transactions" set forth a vague definition of abusive uses of the income tax laws that must be narrowed to reduce the risk that penalties will be proposed to hassle, harass or otherwise encumber non-abusive corporate transactions.

Anti-abuse legislation should be directed at transactions that are contrivances designed to subvert the tax law. The Treasury proposals move beyond the scope we think is appropriate to reach transactions that are described, vaguely, as "the improper elimination or significant reduction of tax on economic income." This criterion, whatever meaning is ascribed to it, is certain to capture transactions that should not be considered abusive and other transactions that have been undertaken for legitimate business purposes.

We do recognize that there is a proposed exception under which a transaction would not be considered tax avoidance if the benefit is "clearly contemplated by the applicable provision . . . ." However, "clear contemplation" is generally in the eye of the beholder, and if that contemplation is intended to reflect what Congress had in mind when the provision was passed, we would respectfully suggest that many provisions in our highly complex tax laws have no "clear" Congressional contemplation.

Our second concern is that the Administration has proposed multiple and punitive sanctions some or all of which could be asserted on transactions that an IRS agent determines fall within the proposed parameters of a loosely-defined "tax avoidance transaction." These include a doubling of the substantial understatement penalty to 40%, an extension of that penalty at 20% to fully disclosed positions, the ability of the IRS to disallow any tax benefits derived from the transaction, disallowance of deductions for fees paid to promoters or for tax advice about the transaction, and an excise tax of 25% on the amount of such fees received. In addition, no reasonable cause exception will exist to argue against the penalty part of any deficiency. We note that the 35% corporate tax rate on disallowance plus the 40% substantial understatement penalty on the resulting tax deficiency will produce a 49% tax cost (in addition to the economic costs) for entering such a transaction—indeed a significant deterrent.[1] For the part of the deficiency attributable to fees or tax advice, an additional 25% excise tax is imposed, for a 74% tax cost (or "only" 67% if there is full disclosure under the terms of the proposals)—again, with no reasonable cause exception. If a rescission or guarantee arrangement were in effect, another 25% excise tax would apply.

These amounts approach the tax penalty level for civil fraud (75%). We recognize there may be those who believe that "tax avoidance transactions" are the equivalent of civil tax fraud and deserve this level of sanction. However, we would also note that the due process requirements for showing civil fraud are vastly higher than for these "tax avoidance transactions." For example, the government bears the burden of proof for showing civil fraud; for assessing sanctions on a "tax avoidance transaction," the burden of proof is on the taxpayer (it may or may not shift to the government if the case is litigated, depending on the size of the corporation and the development of the administrative proceeding). Further, for "tax avoidance transactions," some due process is removed since these proposals would legislate away the ability of a taxpayer to argue that the position was taken in good faith and there was reasonable cause for the taxpayer to act as it did.

While respecting the views on the other side, we do not believe the case has been made that "tax avoidance transactions" (under the loose proposed standard discussed above) rise to the level of civil fraud. We certainly do not understand why the due process requirements in place for civil fraud are absent here. And, we absolutely disagree with the proposal to remove the reasonable cause exception to "tax avoidance transaction" penalties—particularly where extraordinary sanctions are involved. Imposing a strict liability standard, in that contest, is wrong.

A third major concern (alluded to earlier) is that these proposals would result in an alarming shift in authority from Congress to the IRS. These proposals would result in a grant to the IRS of virtually unbridled discretion in the imposition of penalties and other sanctions—and this would come only one year after Congress had concluded there was a need to rein in an agency that had proved itself overzealous in pursuing taxpayers. The obscure manner in which the proposals define the term "tax avoidance transaction," combined with the wide range of penalties and other sanctions that could be invoked upon a finding of such a transaction, would provide IRS auditors with enormous opportunities and incentives to assert the existence of "tax avoidance transactions," almost at will. Unfortunately, within a very short time we would expect aggressive agents to use this weapon as a means of forcing corporate taxpayers to capitulate on other items under examination (this could become especially difficult for smaller corporations that may lack the financial resources to mount a full-fledged challenge to the IRS).

Further, the proposed excise taxes on promoters and tax advisers conceivably could be asserted against them before there is any resolution at the taxpayer's level as to the tax consequences of the transaction or imposition of a penalty and, possibly, regardless of whether the taxpayer ultimately prevails on such determination.

Our fourth concern is that the provisions are so broad they could negatively affect legitimate tax planning. Without backing away from our earlier point regarding abuses of the tax laws, appropriate planning to minimize taxes paid is still a fundamental taxpayer right that must be defended. "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted . . . " (Gregory v. Helvering, 293 U.S. 465, 1935).

Need for safe harbor

We believe that Congress should only consider extraordinary sanctions—such as 40% penalties and multiple sanctions—if the target to which they could apply is sufficiently narrowed so as to minimize the risk that penalties would be proposed to hassle, harass or otherwise encumber non-abusive corporate transactions. We recommend that, given the inherent subjectivity of this question, whatever definition is adopted expressly exclude those transactions that are, per se, not tax shelters. This approach would offer both a practicable and logically warranted measure of protection against potentially overzealous assertions of sanctions and inappropriate deterrents to legally permissible applications of the law.

Under this approach, no extraordinary sanctions would be allowed with respect to an income tax deficiency arising from a transaction which either:

- Was undertaken for reasons germane to the conduct of the corporation's business,
- Was expected to produce a pre-tax return that is reasonable in relation to the costs incurred, or
- Is reasonably consistent with the legislative purpose for which the tax provision was enacted.

These criteria are founded in the principles expressed in Treasury Regulations relating to tax avoidance under IRC sections 269 and 6662, and generally accord with judicial standards for determining whether a transaction should be respected for tax purposes. To illustrate further, what follows are examples of some corporate transactions that should be excluded from extraordinary penalties using these criteria and some that should not.

Examples—Safe-harbored transactions not subject to extraordinary penalties

Acquisition costs

A corporation engaged in manufacturing acquires all the assets of one of its suppliers. The corporation claims certain deductions for costs incurred in making the acquisition. The transaction was relevant to the conduct of the corporation's business, and, accordingly, extraordinary sanctions will not be imposed in the event that the cost allocations or deductions are not upheld.

Real estate investment

A corporation makes an investment in an office building that is unrelated to the conduct of its business. The corporation expects to derive a reasonable return in relation to the cost of the investment, before taking into account any tax benefits. Since a reasonable pre-tax return is expected on the investment, regardless of how the pre-tax return might compare with an after-tax return that takes into account tax benefits claimed by the corporation, extraordinary sanctions will not be imposed in the event that any tax benefits claimed on the investment are not upheld.

Low-income housing investment

A corporation makes an investment in a project that it expects to be treated as a qualified low-income building within the meaning of IRC section 42. The investment is unrelated to the conduct of the corporation's business, and it does not expect to derive a reasonable return on the investment before taking into account the tax credit allowed under IRC section 42. As long as the transaction is reasonably consistent with the purpose of section 42, extraordinary sanctions will not be imposed in the event that any tax benefits claimed on the investment are not upheld.

Characterization of capital instruments

A corporation issues instruments to raise capital for business purposes, and treats the instruments as debt for tax purposes. Extraordinary sanctions will not be imposed if the debt characterization is not upheld.

Examples—Non-safe harbored transactions potentially subject to extraordinary penalties

Step-down preferred

Transfers to and from a REIT are made pursuant to a corporation's arrangement to raise capital from a tax-indifferent party. The essential purpose for inserting the REIT is to permit the corporation to use the dividends paid deduction allowed to REITs to deduct what are effectively return of capital payments made to the tax-indifferent party. It cannot be established that the use of the REIT was relevant to the conduct of the corporation's business, that a reasonable pre-tax return was expected on the costs incurred with respect to the transaction, or that the transaction is reasonably consistent with the legislative purpose of the tax laws pertaining to REITs. Accordingly, the transaction could be subjected to extraordinary penalties.

Liquidating REIT

Within a short period of time, a corporation creates and liquidates a REIT, which it controls within the meaning of IRC section 332. The essential purpose for forming and liquidating the REIT is to enable the corporation to use the dividends paid deduction allowed to REITs to effectively eliminate the recognition of taxable income. It cannot be established that the use of the REIT was relevant to the conduct of the corporation's business, that a reasonable pre-tax return was expected on the costs incurred with respect to the transaction, or that the transaction is reasonably consistent with the legislative purpose of the tax laws pertaining to REITs. Accordingly, the transaction could be subjected to extraordinary penalties.

Lease-in/Lease-out transaction

A corporation leases property from a foreign entity and immediately leases it back to the lessor. The essential purpose for this transaction is to create deductions for the corporation. It cannot be established that the transaction was relevant to the conduct of the corporation's business, that a reasonable pre-tax return was expected on the costs incurred with respect to the transaction, or that the transaction is reasonably consistent with the purpose of the tax laws that provide for the deductions which are asserted. Accordingly, the transaction could be subjected to extraordinary penalties

The government has a sound interest in ensuring that the income tax laws enacted by Congress are applied for their intended purposes. At the same time, penalties should act as deterrents to noncompliance and encourage the desired behavior; only in rare circumstances should penalties be used punitively. The criteria suggested and illustrated above would provide much needed assurance that non-abusive corporate transactions would not be caught in the net of extraordinary sanctions.

With and only with such assurance could we support penalties at the level of 40%. Further, we believe such punitive measures should be reserved for transactions that are not disclosed—to recognize the cost to the government of ferreting out the transaction—and for which there is limited legal basis. Conversely, where there is a strong legal basis in fact and law, and there has been appropriate disclosure by the taxpayer, no penalties should be applied. We are prepared to support a high standard in this regard. To avoid penalty with disclosure, there should be substantial authority as well as a more likely than not belief that the treatment on the return is proper. This formulation would provide incentives for disclosure, a badly needed element that is missing from current law as well (in our view) as the Administration's proposal. It would also result in a level of penalty that better fits the abuse. (While we recognize that a disclosed transaction results in a 20% penalty rather than 40% under the President's proposals, we are not prepared to describe a 20% penalty on a fully-disclosed transaction, with no reasonable cause exception, as an "incentive to disclose.")

Disclosure

We strongly support an effective disclosure mechanism to advise the government of the essence of transactions being reported on the return. We think that to be effective, two conditions must exist:

1. There must be an incentive for taxpayers to disclose transactions that the IRS would reasonably want to examine. As indicated above, we believe the most effective incentive for disclosure is elimination of a penalty for appropriately disclosed transactions.
2. Disclosure must be in a form and at a time when it can be used effectively by the government.

With regard to form, we have inadequate information about what the government can use and when they can use it. In the absence of that information, we believe

that the benefits to the Internal Revenue Service of using an approach embodied in Form 8275 (which requires a concise statement of the legal issues or nature of the controversy) are significant and should not be abandoned. Additional information might also be requested by the IRS on Form 8275 for all corporate taxpayers, such as check boxes to determine whether contingent fees or warranties exist in connection with the transaction. We have also considered and would support a requirement that the corporate officer or representative of the taxpayer who has knowledge of the facts should aver that the facts, assumptions and conclusions relied upon in any opinion are true and correct.

With regard to time, we believe that the most appropriate time for disclosure is at the time of filing the return. The Administration is proposing disclosure within 30 days of closing a transaction. We are not unsympathetic with the desire to obtain information early in the process, and we would be pleased to work with Congress and the Treasury (including the IRS) to develop an effective approach that would result in discovering needed information sooner.

However, regardless of whether disclosure comes at the inception of a transaction or with the return that reports it, we question how effectively such disclosure will be used. If tax shelter problems are as pervasive as Treasury would seem to indicate, substantial IRS resources will need to be diverted from other areas to deal with all the disclosure, audit and enforcement issues that will arise.

We believe IRS already has very substantial tools at its disposal to attack tax law abuses. It has not, perhaps, been able to bring to bear a critical mass of its resources to effectively utilize those tools. An enhanced disclosure requirement will provide another tool—but it will not solve the problem of effective use. Thus, though we favor disclosure as the appropriate incentive, we believe it will have to be coupled with some internal priority shifting within the IRS before it benefits are fully realized.

Specifically with respect to pre-filing disclosure, we would support the concept only if it replaces or significantly revises the registration requirement of the 1997 Taxpayer Relief Act, and the standards for determining whether such advance disclosure is required are clearly defined. The Administration's disclosure proposals come on top of registration requirements that were enacted less than two years ago (on which we are still awaiting regulations). For those affected by the previous registration requirements, this proposal would be overkill (requiring disclosure for registration purposes as the transaction begins to be marketed, and additional disclosure to the IRS within 30 days of closing a transaction). We believe that provisions that do not aid the tax administrator but add tremendous burdens to preparers and taxpayers should be eliminated. We stand ready to work with you and the IRS on this issue.

Promoters and advisers

With respect to the issue of promoters and tax advisers, the fee disallowance and excise tax recommendations imply that there are presently inadequate deterrents in the law for those who advise on abusive corporate transactions. We agree that the law should be changed to insure that all parties to a tax shelter transaction have an incentive to ensure the soundness of the transaction. However, we do not support addressing this problem area with new excise taxes and the disallowance of deductions. Rather, we would prefer to see direct penalties on promoters and advisers, with adequate due process provided. For those who practice before the IRS, we believe consideration should be given to updating Circular 230 (the Treasury regulations governing the right to practice before the IRS) to deal with today's financial transaction environment more effectively. While any changes to Circular 230 would require careful consideration, we would welcome the opportunity to work with Treasury and IRS in such an endeavor.

Because we recognize that Circular 230 does not currently apply to some promoters and advisers (investment bankers for example), we would prefer to see a separate penalty imposed on fees earned by promoters and advisers of abusive corporate tax shelters, at a level that Congress considers sufficient to deter the promotion and sale of abusive tax shelters. We would like to see promoters and advisors made accountable for the quality of the tax shelter opinion letters or offering materials used. One possibility in this area would be to revise the current language in IRC section 6700, 6701 and 6703 in an effort to make them more effective as a tool for penalizing those who are not participants in abusive transactions but who are involved in their promotion. In addition, the burden of proof requirement in 6703 should be revised. We believe these types of penalties might best be assessed in the same manner as tax deficiencies with a provision that the Tax Court would have jurisdiction in these matters. Adequate attention must also be given to due process issues, as discussed earlier, so that promoters and advisers are not penalized automatically if,

for example, a corporation concedes a "tax avoidance transaction" as part of an overall settlement of multiple issues in an IRS examination.

In conclusion, on this broad subject, we are looking forward to continued work as to these issues with your committee and staff, as well as with Treasury and the IRS. We all have a keen interest in making the best decisions possible.

II.A.9—Modify Treatment of ESOP As S Corporation Shareholder

The AICPA strongly opposes the proposal in the "corporate tax shelter" segment of the Administration's revenue proposals that would modify the treatment of an employee stock ownership plan ("ESOP") that is a shareholder of an S corporation. This proposal would repeal a provision of the Taxpayer Relief Act of 1997 ("1997 Act") that Congress enacted to help provide greater capital availability for S corporations and better investment opportunities for ESOPs. These are worthwhile objectives, and Congress has previously considered and rejected the Administration's opposition to the 1997 Act provision. We continue to believe that the provision is worthwhile and oppose the Administration's repeal effort.

The 1997 Act provision exempts S corporation income that flows through to an ESOP shareholder from the unrelated business income tax ("UBIT"), thereby ensuring that the flow-through income is subject to tax only once (i.e., in general, when distributed to the participants). In its place, the Administration's proposal generally would allow the ESOP a deduction for distributions to participants and beneficiaries to the extent of the S corporation income on which it has paid UBIT. The proposal also would modify net operating loss rules in effect to allow for the carryback of "excess" distribution deductions for 2 years, and the carryforward of such deductions for 20 years.

As a threshold matter, the AICPA strongly disagrees with the characterization of the 1997 Act provision as a "corporate tax shelter." In contrast, the AICPA believes that the 1997 Act provision is facilitating the laudable goal of increasing employee ownership and should be given a chance to further achieve this objective. Although the provision only became effective for tax years beginning in 1998, there already are situations in which the 1997 Act provision has contributed to decisions to sell stock to ESOPs, thereby giving the employees a greater stake in the business and a potentially larger source of retirement funds. It is likely that the provision will encourage even more employee ownership in the future. Thus, we believe it would be premature and imprudent to enact the Administration's proposal.

Further, we believe that it is inappropriate as a matter of tax policy to encourage ESOP ownership of S corporations in 1996 and 1997 and, not even two years later, to fundamentally alter the tax consequences of such ownership. Taxpayers should be able to make decisions based on a relatively stable set of tax rules, rather than to suffer from "fickle" tax laws that become effective in one tax year and are repealed in the next. In this regard, it is important to note that establishing an ESOP is a costly process, which generally involves, among other things, conducting a feasibility study, having a valuation done, restructuring existing compensation arrangements, ensuring compliance with complex Department of Labor and ERISA requirements, and making difficult decisions about the extent to which employees should have access to information about, and be involved in, the business. In addition, in the case of a leveraged ESOP, significant financing costs may be incurred.

Similarly, converting to S corporation status often requires that companies incur significant costs to modify their ownership and/or capital structure to satisfy the S corporation eligibility requirements. If the company converting to S corporation status uses the LIFO method of accounting, the LIFO recapture tax can represent a significant toll charge for the conversion. In addition, if subsidiaries become Qualified Subchapter S Subsidiaries, the basis in their stock is lost forever, which can have adverse consequences on a future sale.

The issues of how an ESOP shareholder of an S corporation is taxed and how much cash an S corporation must distribute to allow shareholders to pay their taxes are critical factors when a business is determining whether the benefits of converting to S corporation status or establishing an ESOP offset the costs. In deciding whether or not to incur the costs to establish an ESOP and/or to qualify as, and convert to, an S corporation, companies and their employees anticipated that S corporation earnings allocated to an ESOP would not be subject to the UBIT. The availability of the UBIT exemption was also considered in analyzing the financial feasibility of establishing a leveraged ESOP.

The AICPA also is concerned that, if the Administration's proposal were enacted, S corporation income could improperly be subject to two levels of tax in some situations. The proposed carryback and carryforward rules would not necessarily ensure that the S corporation income would only be taxed once. For example, assume an

ESOP had S corporation income in excess of distributions for a number of years prior to the termination or revocation of the corporation's S election. In this situation, neither the carryback nor carryforward provisions would allow the ESOP to recover the UBIT taxes paid. Thus, the S corporation income would be subject to two levels of taxation— one at the ESOP level and one at the participant level (i.e., on distribution). This permanent double-tax ultimately would be borne by the employees.

The AICPA understands that the Congress may be concerned about particular transactions in which taxpayers may be using ESOPs in a manner not intended by the Congress in 1997. For example, the Joint Committee on Taxation, in its Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal, suggested that there may be concerns regarding S corporation ESOPs in cases where there are only one or two employees. In addition, it also referenced a technique described by Prof. Martin Ginsburg in which the ESOP provision can be used to create a "tax holiday" for other shareholders of an S corporation.[2] If Congress is concerned about these transactions, the appropriate response is to craft narrow solutions targeting these particular transactions, rather than to reject wholesale the decision made in the 1997 Act. The AICPA would be happy to work with this Committee in devising such solutions.

Other Recommendations Relating to ESOP S Corporations

In conjunction with a review of the Administration's proposal relating to the UBIT exemption, we respectfully recommend that this Committee review certain other ESOP provisions as they relate to S corporations. Our recommendations are below.

Gain from the Sale of S Corporation Stock Should Not Be Treated as UBTI

There is no policy reason why gain from the sale of S corporation stock recognized by an ESOP should be treated as unrelated business taxable income ("UBTI"). The Administration's apparent reason for proposing to treat S corporation earnings allocated to an ESOP as UBTI is to ensure that business income, including S corporation income, is subject to tax when earned. However, no similar reason exists for treating gain from the sale of S corporation stock by an ESOP as UBTI. In fact, for a C corporation, business earnings are taxed currently at the corporate level, regardless of whether stock of the corporation is held by an ESOP. However, dividends received by an ESOP from a C corporation and gain recognized by an ESOP from the sale of C corporation stock are not treated as UBTI, and therefore are not subject to tax. If the Administration's proposal to treat S corporation earnings allocated to an ESOP as UBTI were enacted, all current business earnings of an S corporation would be subject to immediate tax. The employee participants of an ESOP holding S corporation stock should not be treated worse than participants of an ESOP holding C corporation stock by also being taxed on gain from the sale of such stock.

Modify Application of ESOP Provisions to S Corporations

For no discernible policy reason, many of the tax advantages of ESOPs for C corporations are not available to S corporation ESOPs. Three significant examples are:

1. capital gain deferral under Section 1042 upon the sale of stock to an ESOP;
2. the Section 404(a)(9) increased deduction limitation to pay interest and principal on an ESOP loan without regard to the normal 15 percent deduction limitation for contributions to profit-sharing or stock bonus plans; and
3. the deduction for certain dividends paid on certain employer securities under Section 404(k)(1).

The ability for a seller to defer gain on the sale of stock to an ESOP was enacted to encourage employee ownership. This admirable goal should be equally applicable to C corporations and S corporations. Thus, to encourage employee stock ownership, an S corporation shareholder should be entitled to the same deferral benefits of Section 1042 as a C corporation shareholder.

The exclusion of S corporation earnings allocated to an ESOP from UBTI mitigates, to some extent, the disadvantages of S corporation status resulting from the unavailability of the increased deduction limitation and the deduction for certain dividends paid. This is because distributions paid on unallocated shares of S corporation stock held by an ESOP may be used to fund the ESOP's repayment of debt and participant benefits. However, if the Administration's proposal to treat S corporation earnings allocated to an ESOP as UBTI were enacted, the unavailability of these provisions would be extremely problematic. S corporation distributions that the ESOP currently uses to fund the repayment of debt or participant benefits instead would be needed to cover the UBIT liability. Yet, an ESOP owning S corporation stock would have the same obligation as an ESOP owning C corporation stock to fund the repayment of debt and participant benefits. In fact, in many cases, an

ESOP owning S corporation stock will have a greater need for cash flow because, while an ESOP holding C corporation stock may fund retirement benefits through the distribution of such stock, S corporation stock cannot be distributed without jeopardizing the company's S election. Thus, we respectfully recommend that this Committee consider removing these restrictions on S corporation ESOPs. If the Administration's proposal is enacted, absent the modifications suggested above, the employee participants of an ESOP holding employer securities of an S corporation may be at a serious disadvantage as compared to the employee participants of an ESOP holding employer securities of a C corporation.

II.A.16—Modify Company-Owned Life Insurance ("COLI") Rules

Life insurance purchased by companies on the lives of their employees provides financial protection for firms on their most valuable asset—their employees. These corporate owned life insurance contracts are used to protect and retain key employees and to fund employee benefits. The Administration's budget proposal would impose a pro-rata disallowance (in proportion to the policy cash surrender values and total assets) of unrelated business borrowing when COLI is used to protect anyone other than 20-percent owners. The AICPA opposes this proposal because it would cause businesses, regardless of their size, to choose between protecting against the premature death of a valued employee, officer or director, and legitimate borrowing to increase their business.

Before 1954 all COLI loan interest was deductible on a policy on the life of any individual and premiums were never deductible. A string of legislation in 1954, 1964, 1986, 1996 and 1997 has eroded such interest deductibility until at the present time COLI loan interest is deductible only if:

- The policy is not a single premium policy;
- Premiums are paid in four of the first seven years of the contract;
- The policy is on a key-person and within the 5 and 20 individual limitation; and
- The loan interest is not on loans in excess of an aggregate of $50,000 per individual and an interest rate cap is applied.

In addition, the 1997 law change provides that if a policy is not a single life policy on a 20% owner or officer, director or employee, or a joint-life policy on a 20% owner and his or her spouse, its unborrowed cash values may cause a pro rata loss of other business loan interest deductions.

The current proposal basically destroys the carefully crafted limitations as created in the 1996 and 1997 legislation by eliminating most key persons as defined in the 1996 Act and eliminating employees, officers and directors from the 1997 Act provisions.

II.B.2—REQUIRE CURRENT ACCRUAL OF MARKET DISCOUNT BY ACCRUAL METHOD TAXPAYERS

The administration's proposal would require accrual method taxpayers to include market discount in income as it accrues. The accrual would be limited to the greater of the original yield to maturity or the applicable federal rate, plus 5%. Under current law, a taxpayer is only required to include market discount in income when cash payments are received. Alternatively, a taxpayer may elect to currently include market discount in income. The AICPA does not support the administration's proposal regarding market discount for the reasons enumerated below.

Market discount may, in many circumstances, be economically equivalent to original issue discount ("OID"). In many situations, however, market discount may arise solely because of a decline in the credit-worthiness of the borrower and the resulting discount is not related to the time value of money. For this reason, the current market discount regime protects taxpayers from including in taxable income market discount that may very well never be collected. The Administration's proposal that market discount be accrued in an amount up to the greater of the original yield to maturity or the applicable federal rate, plus 5%, would, in many instances, require a taxpayer to accrue income that may very well never be collected.

The IRS and Treasury, to date, have not issued comprehensive guidance on how taxpayers should accrue interest, market discount and original issue discount on debt obligations where there is substantial uncertainty that the income will be collected. Accordingly, the mandatory accrual of market discount should not be required until guidance on non-accrual of discount is released.

The Administration is proposing to require the current accrual of market discount. A similar requirement exists for original issue discount. However, while substantial guidance has been issued in the form of Treasury Regulations and other published guidance with regard to OID, no such guidance has been issued under the market discount provisions. As a result, taxpayers have been struggling with com-

plex market discount provisions contained in the code since 1984 but with no guidance on how to apply the provisions. The AICPA believes that, substantive guidance should be issued to instruct a taxpayer exactly how to apply these provisions. Substantive guidance is needed to address the accrual of market discount in several areas, including, but not limited to, (1) obligations subject to prepayment; (2) obligations that become demand obligations after the original issue date; and (3) obligations purchased at significant discounts because of a decline in the credit rating of the issuer. Until such guidance is issued, the AICPA does not believe it is prudent to require the current accrual of market discount.

This proposal, if enacted, would expand complex tax rules applicable to sophisticated financial transactions to a broad universe of taxpayers. As it is, taxpayers are faced with a myriad of questions when determining how market discount is deemed to accrue. Thus, it is unrealistic to expand a complex regime to a broader universe of taxpayers without first issuing guidance with respect to the original provisions. For example, it is common for a taxpayer to hold a market discount obligation with OID. In this circumstance, most taxpayers will have to perform three computations to determine income with respect to these obligations, one for financial accounting purposes, one for tax purposes with respect to the OID and one for tax purposes regarding market discount. Even taxpayers "familiar with the complexities of reporting income under an accrual method" would find this burdensome.

Any perceived abuse by the administration that taxpayers are able to achieve a deferral by not recognizing market discount currently is unfounded as well. Many taxpayers (such as financial institutions) that hold market discount obligations use debt to purchase and carry such obligations. Generally, such taxpayers cannot deduct interest expense incurred to purchase and carry the market discount obligations thereby eliminating, much if not all, of the benefit resulting from the deferral of market discount.

II.D.1—REQUIRE PARTNERSHIP BASIS ADJUSTMENTS UPON DISTRIBUTIONS OF PROPERTY AND MODIFY BASIS ALLOCATION RULES

Overview

The Administration has proposed a fundamental overhaul of the rules governing partnerships. The AICPA is generally opposed to the changes as they (i) would subject garden variety transactions to tax that always have been, and from a policy standpoint ought to remain, tax free; (ii) would further complicate an already complex system of rules; (iii) would create disparities between the tax and economic treatment of partnership activities; and (iv) might create abusive planning opportunities. In addition, the Administration has proposed a number of anti-abuse tax shelter rules even though the Treasury already has effective curbs at its disposal (such as various regulatory anti-abuse rules as well as the common law doctrines of business purpose, sham transactions, etc.). In our opinion, the availability of these rules is sufficient to eliminate any actual or perceived abuse without causing the distortions described below. Finally, we believe that the proposals ignore a fundamental principle of Subchapter K in that they do not attempt to eliminate disparities between an asset's value and its basis. Rather, the proposals create these disparities, or allow them to continue, for the sake of preventing perceived abuses.

Specific proposals and comments

Basis adjustments to partnership property. A proposal to mandate inside basis adjustments where basis is allocated in relation to the value of property inside a partnership would be burdensome[3] and expensive as, at the very least, it would require a valuation of all partnership properties upon many distributions, even if believed to be made on a pro rata basis. The provision regarding tiered partnerships generally would be difficult (if not impossible) to administer except where the tiered entities were commonly controlled. For partnerships that hold more than a few assets, mandatory §734 adjustments would be a nightmare in that such partnerships would potentially be required to adjust the tax bases of nearly all their assets. In fact, we question whether many partnerships would be able to perform §734 computations with anything better than the crudest degree of accuracy.

Allocations of bases among partnership properties. The revised methodology for computing the §734 adjustment, while for the most part theoretically sound, would be confusing for many partnerships. Computation of the amount of a §734 adjustment under today's rules is a relatively straightforward process. Under the proposal, we believe that there would be many situations that would require guidance from the government and additional analysis by taxpayers, and there would be cases where the results under the proposal are uncertain. For example, in the case of a partial liquidation under the proposal, it would be necessary to determine a dis-

tributee-partner's pre-distribution and post-distribution interests in partnership assets to make the basis adjustment. This would not be an easy task except in the simplest of partnerships. In addition, the proposal would deprive partners of depreciable basis adjustments when depreciable property is distributed to a partner who has a §743 adjustment with respect to the distributed property, or when such a partner is redeemed out of the partnership for cash.

Treatment of partial liquidations. The proposed rule for partial liquidations, assuming that it does not change the definition of a partner's capital interest (as that term is commonly understood), would subject all sorts of common transactions to taxation that are tax-free today, such as disproportionate distributions for payment of income tax on allocable income shares. Every non-pro rata cash distribution to a partner whose partnership interest has a value that differs from basis would create a taxable gain or loss. This is because a partial liquidation would, in effect, be treated as a "slice" of a complete liquidation, with a portion of basis allocated to the distribution. Since a liquidating cash distribution in excess of basis is taxable, it apparently follows that a slice of a complete liquidation would be taxable to the same degree. This concept may be illustrated with the following simple example. A, B, and C form a partnership with contributions of $30 each. The partnership purchases three parcels of land for $30 each. Each parcel triples in value to $90, the partnership sells one of the parcels and ratably allocates the $60 gain. A withdraws its one-third share of the proceeds ($30), whereas B and C keep their shares of proceeds in the partnership. Under the proposal, A would recognize gain of $20 on the sale and another $13.30 of gain on the deemed partial liquidation ($30 less $16.70, one third of the $50 basis).[4] Under current law, the cash distribution is tax-free.

In addition, application of this rule in a tiered partnership structure is unclear: would a partially liquidated partner be required to look through tiers of partnerships and treat the distribution as a partial liquidation of its indirect interest in any lower tier partnerships? Further, enactment of a partial liquidation regime would appear to necessitate a review of the passive loss and at risk rules.

Repeal of §751(b). Repeal of §751(b) would permit partners to receive ordinary deductions and yet avoid ordinary income recapture upon exit from the partnership, a result that would appear to be contrary to sound tax policy. For example, assume A, B, and C form a partnership with contributions of $30 each and the partnership purchases two capital assets for $30 each and a §1245 asset for $30. The assets' values do not change and the partnership validly allocates all the depreciation from the §1245 asset to A, reducing its basis to zero. The partnership then distributes one of the capital assets to A in liquidation of its interest and A sells the capital asset. A will have recognized ordinary losses and a capital gain, whereas B and C will have received no deductions but will recognize ordinary income on the sale of the §1245 asset and a capital loss due to the proposed allocation of all basis increases to nondepreciable capital assets.

Acquisition of subsidiary corporations. The AICPA is not opposed to this provision, provided it is carefully drafted to deal with the specific abuses targeted by the proposals.

II.D.4—REPEAL OF TAX-FREE C-TO-S CONVERSIONS

The AICPA continues to strongly oppose the Administration's proposal to treat the conversion of a so-called "large" (greater than $5 million in value) C corporation to an S corporation as a taxable liquidation. The Administration's proposal also in effect would impose a new "merger tax" on certain acquisitions of C corporations by S corporations. We continue to believe that the proposal is short-sighted, would be harmful to small business, and is grossly inconsistent with Congressional efforts to reform Subchapter S to make it more attractive and more workable. We are pleased that the Congress has consistently rejected this included in the Administration's previous budget recommendations.

This proposal would repeal the section 1374 built-in gains tax for corporations whose stock is valued at more than $5 million when they convert to S corporation status. In place of the section 1374 built-in gains tax, which would tax built-in gains if and when built-in gain property is disposed of during the ten-year period after conversion, the proposal would require such converting corporations to recognize immediately all the built-in gain in their assets at the time of conversion. The proposal would be effective for conversions for taxable years beginning on or after January 1, 2000.

The AICPA strongly opposes this proposal. We believe this proposal constitutes a major change in corporate tax law, and one that would be contrary to sound tax policy. As stated above, we believe that any significant change affecting Subchapter

S should only be undertaken pursuant to a comprehensive review and not be the subject of piecemeal changes designed primarily to attain revenue goals.

Current section 1374 is designed to preserve a double-level tax on appreciation in assets that accrued in a corporation before it elected S corporation status. To accomplish this, section 1374 subjects S corporations to a corporate-level tax on asset dispositions during the ten years following conversion. Section 1374's primary purpose is to prevent a C corporation from avoiding the 1986 Tax Reform Act's repeal of the General Utilities doctrine, by converting to S corporation status prior to a sale of its business. Since its enactment, section 1374 has been refined several times in order to strengthen its operation, such as the addition of a suspense account mechanism to prevent built-in gains from escaping tax due to the taxable income limitation. The experiences of our members indicate section 1374 is effective in achieving its purpose. We see no reason to abandon this mechanism.

The proposal also is counter to well-established policy regarding the tax treatment of the conversion of C corporations to S corporation status. For example, in 1988, Section 106(f) of S. 2238 and Section 10206 of H.R. 3545, the then-pending Technical Corrections Bill, would have modified the computation of the built-in gains tax by removing the taxable income limitation. This provision was ultimately rejected under "wherewithal to pay" principles. At that time, the AICPA's position was articulated in the following passage from a letter from then Chairman of the AICPA Tax Division, Herbert J. Lerner, to the Honorable Dan Rostenkowski; this statement continues to reflect the position of the AICPA:

> Perhaps of even greater long-term concern is that this technical correction seems to be yet another manifestation of a fundamental change in tax philosophy. Several staff members from the tax writing committees have told us that they believe that any conversion from C to S status should be taxed as though the corporation had been liquidated and a new corporation formed. We believe that this is not sound tax policy and that it would be contrary to the underlying purpose of Subchapter S which has been widely used by small businesses for some 25-30 years. . . . This liquidation philosophy is a major change in tax policy and should be debated as such, should be subject to public hearings and should not be allowed to creep into the law through incremental changes.

It is noted that a similar attempt to repeal the taxable income limitation for elections made after March 30, 1988 was rejected by Congress in 1992 (Section 2 of H.R. 5626). A legislative proposal to effectively treat the conversion as a liquidation was also rejected by Congress in 1982.

The AICPA believes that the proposal under consideration would effectively repeal the availability of Subchapter S for so-called "large" corporations (i.e., corporations valued at over $5 million). As noted, the proposal would require such corporations to be taxed immediately on all unrealized gain in their assets, including goodwill, and to pay a tax on this gain. For large corporations with significant unrealized value, the cost of conversion would be exceedingly expensive and, therefore, Subchapter S status would in effect be rendered completely inaccessible to them. As a result, the proposal would generally leave Subchapter S status available only to those large corporations with either little or no built-in gain or sufficient net operating loss carryovers to offset the gain. We do not believe that restricting the benefits of Subchapter S to this latter class of C corporations represents sound tax policy.

A further objection we have to the proposal is the use of the $5 million fair market value threshold for determining the applicability of the tax. Basing the applicability of the provision, which could have devastating tax consequences, on such a subjective benchmark is simply untenable. If a corporation wished to convert to S corporation status, how could it conclusively determine whether or not the immediate taxation of built-in gains would apply? Even if the corporation incurred the cost of obtaining an appraisal, how would the corporation be sure the valuation would not later be challenged by the Internal Revenue Service? As a pure business matter, many corporations simply would not be willing to accept any significant level of uncertainty regarding this potentially devastating tax on paper gains. Adding such a burdensome and uncertain provision to the tax law clearly would be contrary to sound tax policy.

In summary, the AICPA feels strongly that the proposal to repeal section 1374 for large corporations and impose an immediate tax on all unrealized gain in their assets runs counter to long-standing tax policy which Congress has adhered to for many years. Further, although the proposal may serve the purpose of raising revenue, it would do so to the detriment of certainty and fairness in the tax law. The proposal would effectively eliminate new conversions to Subchapter S status for most corporations valued at more than $5 million; such a major change in the tax law should not be made without careful analysis. We, therefore, strongly urge you to remove the proposal from consideration.

II.E.3—DENY DEDUCTION FOR PUNITIVE DAMAGES

We disagree with the Administration's proposal to eliminate the deductibility of punitive damages. This would add complex new issues to tax controversies, litigation, and settlement. It would also inappropriately sanction punitive damages in the same way as fines and penalties paid to the government for breaking the law.

The character of damages could become a substantial tax issue, with the IRS routinely disallowing part or all of the deduction for a payment in an award or settlement where punitive damages have been alleged. This controversy could be complex, with varying state laws and unique aspects of each case. The tax results might vary from state to state, depending on how the courts award or withhold punitive damages.

The tax law does not allow deductions for fines and penalties levied by the government for violation of the law, and this is appropriate as a matter of public policy. Punitive damages are of a different character, and may bear little relationship to the taxpayer's conduct. Our society is litigious, and punitive damage awards are, unfortunately, an all too common expense of doing business. Punitive damages often result from unintentional acts, such as hind-sight product liability, and should not be treated the same way as a fine or penalty for breaking the law.

II.E.4—APPLY UNIFORM CAPITALIZATION RULES TO CERTAIN CONTRACT MANUFACTURERS

We disagree with the proposal that would require capitalization of certain costs for "tollers." Tollers perform certain manufacturing operations on property owned by their customers for a fee (toll). Section 263A was enacted to require capitalization of certain costs considered allocable to inventory, and since title is not held by the toller, they do not currently capitalize these costs under Section 263A.

There is no reason to change the law in this area. Capitalizing toller costs would make Section 263A more complex, particularly for smaller taxpayers, and the small amount of revenue from this proposal is for one year only while the complexity would then become permanent.

Capitalizing toller costs would raise a number of complexity issues. Tollers do not have title to the property, making it unclear when, or even if, the underlying products would be considered "sold" so that the costs could be expensed. This could lead to mismatching of revenues and expenses if income recognition is required for partial performance and related costs were not recovered on partial performance. Additionally, if such costs are considered "inventory," would they receive the benefits of inventory treatment such as LIFO? When is the processing of a customer's property considered production, and when is it merely providing a service. Are repairs production?

Just because the service is on property owned by others does not change the fact that the tollers are performing services, and tollers should be allowed the same exemption from the Section 263A UNICAP rules as all other service providers.

II.E.5—REPEAL THE LOWER OF COST OR MARKET INVENTORY ACCOUNTING METHOD

This proposal would eliminate the use of the lower of cost or market method for federal income tax purposes. This proposal has been made on a number of occasions in the past, and the AICPA has opposed each such proposal.

We continue to oppose this proposal. This method has been accepted in the tax law since 1918 and is an integral part of generally accepted accounting principles (GAAP). LCM conformity with GAAP does provide some needed simplicity. Further, there is no reason why this method should suddenly become impermissible. It is not a one-sided application of mark-to-market because once a taxpayer lowers the selling price of its goods below their cost, the taxpayer is not going to realize a profit on the eventual sale of the goods.

We are disappointed that a widely established and universally used tax accounting method, which finds its genesis in generally accepted accounting principles, would—after having been a part of our tax structure for over 80 years—be proposed for repeal. The process is particularly unfortunate because, when all is said and done, the LCM repeal proposal involves a timing difference only, rather than a truly substantive change in tax policy. At the end of the day, the issue becomes whether components of inventory transactions are recorded on a return this year or next year; there is no issue as to whether they will ever be recorded at all.

Now, suddenly, Congress is asked to change a basic tax rule that predates almost all of us. Taxpayers will have to live with this change for decades or longer. On that basis, particularly for an issue that involves only timing, it is particularly distress-

ing to see the change occur under this process. One would think that 76 years of totally accepted usage is precedential enough to warrant a more deliberate process for its removal from the law.

Without wishing to detract from our main point—LCM should not be repealed—let us note that if Congress determines to eliminate lower of cost or market, there needs to be a small business exception in the interest of simplicity. Many small businesses (particularly those meeting the retail de minimis exception to the uniform capitalization rules) are currently able to use their financial statement inventory numbers on their tax returns. Since the LCM method will still be required for financial reporting, it will no longer be possible for these taxpayers to use financial statement inventory on their returns. Market writedowns will have to be segregated for proper reporting as a book-tax difference. Thus, especially for small business, there will be a disproportionate additional cost of compliance on top of the added tax cost for not being able to use LCM.

We believe, therefore, it is imperative that there be a meaningful small business exception if LCM is repealed. The Administration proposal includes a small business exception modeled on present Code section 448 (ability to use the cash basis of accounting), which holds that the provisions are not applicable to businesses that average less than $5 million annual gross receipts (not to be confused with gross income, which can be a substantially lower number) over a three-year period. Since, however, we are considering an inventory method change, and inventories generally turn over several times a year, it could be a very small business indeed which meets a $5 million gross receipts test. Accordingly, we think it essential that, if a gross receipts exemption is used, it should be at least at the $10 million level, rather than $5 million. In fact, the most recent de minimis statutory rule involving inventories is the so-called "retail exception" in the uniform capitalization rules, and it is at a $10 million gross receipts level. Alternatively, Congress might consider a $5 million gross income de minimis rule (which would be gross receipts less cost of sales).

II.F.1—MODIFY TREATMENT OF START-UP AND ORGANIZATIONAL EXPENDITURES

The AICPA opposes the Administration's proposal to modify the treatment of start-up and organizational expenditures, and has two specific alternative recommendations to provide greater simplification, fairness, and startup business assistance.

It is often difficult to determine when a cost becomes an operating expense and is no longer a startup expense that should be amortized, and reasonable individuals can honestly differ on when the trade or business begins operations. Currently, the tax result of a misclassification by the taxpayer or the IRS is permanent disallowance of the deduction, and we believe this is much too severe in this area of uncertainty. The Administration's proposal does nothing to clarify this distinction or alleviate the problem, and controversy will likely increase under its proposals for those taxpayers that incur larger amounts of costs. We recommend a 60-month amortization to allow a taxpayer to write off the costs over a fair period of time. An increase in the amortization period to 15 years could encourage some taxpayers to take a more aggressive position in order to deduct amounts rather than amortize them over a period of time perceived as unreasonable. A proposal requiring businesses to amortize the costs over 60 months, unless they elect a longer life, could simplify current law.

We also recommend treating startup and organizational expenses the same, and consolidating reference to them throughout the Code. This would greatly simplify the tax law which now requires taxpayers and the IRS to distinguish between these costs and to account for them and report them separately. There is no need for this distinction, and its elimination would help taxpayers and not work against any government interest.

We encourage you to consider our recommended improvements, and we oppose the Administration's proposal because it is complex, the deduction limit is too low, and the modification of the treatment of these costs is unnecessary. The Joint Committee on Taxation's description of the President's proposal concluded that allowing a fixed amount of start-up and organizational expenditures to be deductible, rather than requiring their amortization, may help encourage the formation of new businesses that do not require significant start-up or organizational costs to be incurred. It also found that the requirement of amortizing start-up or organizational costs for businesses that incur costs greater than $55,000 may discourage the formation of businesses that would incur greater costs prior to the commencement of business. The AICPA agrees with these findings and would support a simpler provision that exempted a reasonable amount of start-up and organizational expenses from the

amortization provisions. This would benefit small business formation without unduly burdening the Treasury.

The Administration's proposal also seeks to tie the amortization of start-up and organizational expenditures to the provisions requiring a 15 year amortization for acquired intangibles. Start-up and organizational costs are inherently different in their nature from acquired intangibles which by their very acquisition have a value established by the market and, consequently, a life which can be said to extend beyond the year of acquisition. Start-up and organization costs do not have a market value. This speculative value makes it more difficult to justify extending their amortizable life beyond five years when the market has yet to speak to value. Indeed, the change to 15 year amortization was in part the result of controversy surrounding the measurement of the life of acquired intangibles. The election to amortize organization costs and start-up costs over 60 months affords a benefit to new businesses, especially small businesses, not otherwise allowed under the law.

The $5,000 deduction amount and the $55,000 threshold included in the proposal, although adequate for many small businesses, would be inadequate if it is designed to encourage the formation of businesses. Nontraditional and innovative businesses, such as Internet sites, generally have higher start-up costs. In the absence of a simplification, the $5,000 deduction should be increased and the proposed change in treatment on costs over $55,000 eliminated to encourage formation of new businesses.

II.H.1—SUBJECT INVESTMENT INCOME OF TRADE ASSOCIATIONS TO TAX

The President's budget proposals would impose a corporate-rate tax on "net investment income" of section 501(c)(6) organizations (trade associations and other business leagues). Our comments on this proposal are clearly made in our members' interests as well as for tax policy reasons: the AICPA is a section 501(c)(6) organization and it does have investment income which would be subject to this new proposed tax.

Nonetheless, we question the policy basis on which the proposals are being put forth. It is implied that current law provides an incentive to fund association operations on a tax-free basis (through the build up of non-taxed investment assets) because members receive a deduction for dues payments but would have been taxed on the earnings attributable to those payments had the payments not been made to a 501(c)(6) organization. Thus, according to the *Treasury Department General Explanation of the Administration's Revenue Proposals,* members are "avoiding tax" on the earnings from their dues.

While we understand the theoretical basis for this argument, it just does not comport with business reality. No business is going to view dues payments to a trade association as a prudent means of sheltering income from tax, on the grounds that earnings on the payments are tax free if for the account of the association but taxable if for the account of the member. In order to get the benefit of this "shelter," the member has to actually pay over money to the association, which puts those funds absolutely outside the members' control-a fairly ludicrous business decision if the thinking behind the extra or advance payment is the avoidance of income tax.

We would also note that associations accumulate surplus not to accelerate deductions or provide tax deferrals, but because it is prudent business practice. By providing cushions against membership fall-off in times of economic decline, for example, an association is able to protect against annual dues fluctuations. And, as an organization which relies predominantly on member dues to fund its exempt purposes, the AICPA is very much aware of member sensitivity to annual changes in dues. Associations need to provide a stable dues structure to smooth out member fall-off and increases from year to year (which, in turn, affects the association's annual operating budget for its normal activities). Further, prudence dictates that there be some cushion available for unanticipated business issues that arise during a year. (We do recognize that there is a $10,000 exemption from the proposed tax, but that amount applies equally to associations with 250 members and 250,000 members. Even for taxable entities (corporations), the Code permits earnings to be accumulated for the "reasonable needs of the business" before a penalty tax is imposed.)

Finally, we note that the Joint Committee on Taxation has estimated this provision as a $698 million revenue raiser over five years and a $1.6 billion revenue raiser over ten years. We do not know the basis of those revenue estimates, but we would point out that for any association that becomes subject to this additional tax, it will either have to curtail services to members or raise member dues to fund the tax. Those dues increases will result in additional deductible payments by members, with a concomitant reduction in federal revenues.

II.I.6—ELIMINATE NON-BUSINESS VALUATION DISCOUNTS

The administration's proposal would eliminate valuation discounts except as they apply to active businesses. This proposal is built upon the presumption that there is no reason other than estate tax avoidance for the formation of a family limited partnership (FLP). We disagree. There are any number of other reasons why a taxpayer might wish to set up an FLP including: management of assets in case of incompetency, increased asset protection, the reduction of family disputes concerning the management of assets, to prevent the undesired transfer of a family member's interests due to a failed marriage, and to provide flexibility in business planning not available through trusts, corporations or other business entities.

The beneficiaries of FLPs do not receive control over the underlying assets and generally have no say as to the management of those assets. Individuals receiving non-public, non-tradeable interests in a legally binding arrangement are not in as good a position as they would have been if they had received the underlying assets outright. Substantial economic data indicate that the value of these interests is less than the value of the underlying assets. Valuation discounts are a legitimate method of recognizing the restrictions faced by holders of FLP interests.

The wholesale change to the taxation of these entities is unreasonable and too broad. It assumes that FLPS are used only to avoid transfer taxes and disregards the non-tax reasons for their formation and the fact that these non-tax reasons do reduce the value of these interests to owners. In addition, the Internal Revenue Service already has tools to combat abuses in this area including valuation penalties, disclosure requirements on gift tax returns, and the ability to examine the business purpose of FLPs.

II.I.7—ELIMINATE GIFT TAX EXEMPTION FOR PERSONAL RESIDENCE TRUSTS

The administration's proposal would repeal the personal residence exception of section 2702(a)(3)(A)(ii). If a residence is used to fund a GRAT or a GRUT, the trust would be required to pay out the required annuity or unitrust amount; otherwise the grantor retained interest would be valued at zero for gift tax purposes.

The reasons for change include the inconsistency in the valuation of a gift made to a remainderman in a personal residence trust and in transactions not exempt from section 2702 and that the use value of a residence is a poor substitute for an annuity or unitrust interest. Because the grantor ordinarily remains responsible for the insurance, maintenance and property taxes on the residence, the administration contends that the actuarial tables overstate the value of the grantor's retained interest in the property.

In reply to the proposal, we would note that the present rules pertaining to personal residence trusts were enacted by Congress in 1990 as a specific statutory exception to the general rules of section 2702 to provide a mechanism for taxpayers to transfer a personal residence to family members with minimal transfer tax consequences. The proposal ignores the longstanding protected and preferred status the personal residence has held throughout the tax code. Examples of this status include the exemption provided to personal residences at the time section 2702 was originally enacted, maintenance of the itemized deduction for real estate taxes and mortgage interest on personal residences as provided in the Tax Reform Act of 1986 and the homestead exemption provided in the bankruptcy statutes. The acquisition and ownership of the personal residence has long been acknowledged as being central to the "realization of the American dream" and should continue to be protected and encouraged. In fact, it can be argued that the personal residence, or at least some portion of the value thereof, should be excluded from the transfer tax base altogether.

In addition, we dispute the contention that the use value of a residence is significantly less than the value of an annuity or unitrust interest. Commonly, real estate investments are predicated upon an assumed return (capitalization rate) ranging from 12%-15%. Even allowing for the payment of insurance, maintenance and property taxes expenses by the grantor and considering also that residential real estate appreciates on average by approximately 2% per year, it can be argued that the use value of the residence should be 7%-10% of the value of the property. As such, it can be argued that the actuarial tables do, in fact, assign an appropriate value to the grantor's retained interest.

The current law does not permit abusive application of the personal residence trust technique. Recently finalized regulations (Reg. Sec. 25.2702-5) prohibit the sale of the residence back to the grantor thus eliminating use of the technique as a means to circumvent the rules regarding GRATs and GRUTs. Furthermore, restrictions on the amount of property adjoining the residence which may be placed

into a personal residence trust eliminate the technique as a means to transfer investment real estate on a tax-protected basis.

II.L.2 and 4—COMPLIANCE PROVISIONS RELATING TO PENALTIES

We take no position the merits of these proposals, but oppose their enactment before completion of the penalty studies being conducted independently by the Joint Committee on Taxation and the Department of the Treasury. As was noted when Congress last overhauled our penalty system in 1989, a piecemeal approach to enacting penalties over the years causes a complex collection of penalties that are not rationally related to a taxpayer's conduct and not understood by taxpayers. This does not encourage taxpayers to modify their behavior in the intended way, and causes taxpayer frustration when applied.

With penalty studies already underway, we believe these provisions should be studied and considered as part of overall penalty reform legislation. Deferring enactment now would help assure that these penalties were consistent and rational in a reformed penalty system and could avoid a possible extra round of penalty changes in these areas. The AICPA has commented to Treasury on its penalty study and would be happy to work with Congress to develop a simple, fair and rational penalty system.

II.L.3—REPEAL EXEMPTION FOR WITHHOLDING ON CERTAIN GAMBLING WINNINGS

We disagree with the proposal to require withholding on bingo and keno winnings in excess of $5,000. Because gambling winnings are taxable only to the extent that they exceed gambling losses, this proposal could result in over-withholding by not taking into account gambling losses, particularly for smaller "winners." The currently required reporting of these winnings on Form 1099 should be sufficient to promote and track compliance in most cases. For the unusual large winner, say $100,000 or more, withholding would more likely be appropriate.

III.A—REINSTATE SUPERFUND EXCISE TAXES AND CORPORATE ENVIRONMENTAL INCOME TAX

The corporate environmental income tax lapsed at the end of 1995. This proposal would reinstate the tax for taxable years beginning after 1998 and before 2010. The tax would be imposed at a rate of 0.12 % of the amount of modified alternative minimum income of a corporation, over a threshold amount of $2 million. Modified alternative minimum income is defined as a corporation's alternative minimum taxable income (AMTI), determined without regard to the alternative minimum tax net operating loss deduction and the deduction for the corporate environmental income tax.

The AICPA opposed this particular tax when it was in the law, and we oppose its reinstatement in this form. We take no position respecting the need for re-imposing a tax to enhance the Superfund but, as advocates for simplicity in the tax law, we are extremely concerned that a new corporate tax that affects smaller corporations as well as giants would use AMTI as a base. Modified alternative minimum income of $2 million is not a level that will require only large corporations to make the incredibly difficult computations to determine if they must pay the new Superfund tax; medium-sized and some smaller corporations will have to do so as well.

It is ironic that the 1997 Taxpayer Relief Act totally exempts from the corporate alternative minimum tax those corporations whose average gross receipts do not exceed $7.5 million. Many of them will, however, wind up with modified alternative minimum income exceeding $2 million, so they will have to undertake all the AMT computations just to prove they do not owe the Superfund tax or, in the alternative, to pay a tax at a rate of only 0.12%. And, less than two years will have gone by since they were exempted (they thought) from these complexities.

If the revenue is needed, and if it is necessary to obtain it from a "new" tax, Congress should not hide behind a back-door approach such as AMTI. We recommend using regular taxable income, with whatever rate increase is required to produce the needed funds.

ENDNOTES

[1]: On a $1 million disallowance, the additional tax would be $350,000, and the 40% penalty on the deficiency would be $140,000, for a total of $490,000, or 49% of the amount disallowed.

[2]: Ginsburg, "The Taxpayer Relief Act of 1997: Worse Than You Think," 76 Tax Notes 1790 (September 29, 1997).

[3]: For example, securities partnerships, which have frequent complete and partial liquidations, would be required to make basis adjustments to each and every security by tax lot since the existing and proposed regulations do not permit grouping of assets.

[4]: Conversely, a cash distribution with respect to a partnership interest having a basis in excess of value would presumably trigger a tax loss to the distributee partner.

EXHIBIT A - Selected AGI Phase-Out Amounts

IRC Section	Provision	Ft nt.	Current - Joint	Current - Single & HOH	Current – Married/Sep.	*Proposed - Joint*	*Proposed - Single & HOH & M*
PHASE-OUT LEVELS FOR *LOW-INCOME TAXPAYERS*							
21	30 Percent Dependent Care Credit	(3)	$10,000-$20,000	$10,000-$20,000	No credit	*$15,000-$37,500*	*$7,500-$18,750*
22	Elderly Credit	(4)	$10,000-$25,000	$7,500-$17,500	$5,000-$12,500	*$15,000-$37,500*	*$7,500-$18,750*
32	EITC (No Child)	(2,3, 4)	$5,570-10,030	$10,030	No credit	*$15,000-$37,500*	*$7,500-$18,750*
32	EITC (1 Child)	(2,3, 4)	$12,260-$26,473	$12,260-$26,473	No credit	*$15,000-$37,500*	*$7,500-$18,750*
32	EITC (2 or More Children)	(2,3, 4)	$12,260-$30,095	$12,260-$30,095	No credit	*$15,000-$37,500*	*$7,500-$18,750*
PHASE-OUT LEVELS FOR *MIDDLE-INCOME TAXPAYERS*							
219	IRA Deduction w/retirement plan	(1,7,9)	$50,000-$60,000	$30,000-$40,000	No deduction	*$60,000-$75,000*	*$30,000-$37,500*
221	Education Loan Interest Exp.	(1,2,6)	$60,000-$75,000	$40,000-$55,000	No deduction	*$60,000-$75,000*	*$30,000-$37,500*
PHASE-OUT LEVELS FOR *HIGH-INCOME TAXPAYERS*							
24	Child Credit	(1,5,6)	$110,000-	$75,000-	$55,000-	*$225,000-$450,000*	*$112,500-$225,000*
25A	Hope Credit & Lifetm. Lrng. Cr.	(1,2,6)	$80,000-$100,000	$40,000-$50,000	No credit	*$225,000-$450,000*	*$112,500-$225,000*
23 & 137	Adoption Credit/ Exclusion	(1,7)	$75,000-$115,000	$75,000-$115,000	No benefit	*$225,000-$450,000*	*$112,500-$225,000*
55(d)	AMT Exemption	(1,8)	$150,000-$330,000	$112,500-$247,500	$75,000-$165,000	*$225,000-$450,000*	*$112,500-$225,000*

IRC Section	Provision	Ft Nt.	Current - Joint	Current - Single & HOH	Current – Married/Sep.	*Proposed - Joint*	*Proposed – Single & HOH & MF*
68	Itemized Deduction level	(2)	$124,500-	$124,500-	$62,250-	*$225,000- $450,000*	*$112,500- $225,000*
135	EE Bond int. Exclusion	(1,2,7)	$78,350- $108,350-	$52,250- $67,250	No exclusion	*$225,000- $450,000*	*$112,500- $225,000*
151	Personal Exemption	(2)	$186,800- $309,300	$124,500- $247,000 HOH$155,650 - $278,150	$93,400- $154,650	*$225,000- $450,000*	*$112,500- $225,000*
219 (g)(7)	IRA w/spouse w/retrmt plan	(1,6,7)	$150,000- $160,000	Not applicable	No deduction	*$225,000- $450,000*	*$112,500- $225,000*
408A	Roth IRA Deduction	(1,6)	$150,000- $160,000	$95,000- $110,000	No deduction	*$225,000- $450,000*	*$112,500- $225,000*
408A	IRA to Roth IRA Rollover	(1,6,7)	$100,000	$100,000	No rollover	*$225,000- $450,000*	*$112,500- $225,000*
469 (i)	$25,000 Rent Passive Loss	(1,7)	$100,000- $150,000	$100,000- $150,000	$50,000- $75,000	*$225,000- $450,000*	*$112,500- $225,000*
469 (i)	Passive Rehab. Credit	(1,7)	$200,000- $250,000	$200,000- $250,000	$100,000- $125,000	*$225,000- $450,000*	*$112,500- $225,000*
530	Education IRA Deduction	(1,6)	$150,000- $160,000	$95,000- $110,000	No deduction	*$225,000- $450,000*	*$112,500- $225,000*

Footnotes: (1) Modifications to AGI apply; (2) Inflation indexed; (3) Earned income limitations; (4) Low income only; (5) Phase-out range depends on number of children; (6) Newly enacted in 1997; (7) Also see section 221(b)(2); (8) Phase-out applies to alternative minimum taxable income rather than AGI; (9) Increases for future years are specifically provided in the statute.

EXHIBIT B - Current Method of Phase-Out

Code Section(s)	Tax Provision	Current Methodology for Phase-outs Application
21	Dependent Care Credit	Credit percent reduced from 30 percent to 20 percent in AGI range noted by 1 percent credit for each $2,000 in income
22	Elderly Credit	Credit amount reduced by excess over AGI range
23 & 137	Adoption Credit & Exclusion	Benefit reduced by excess of modified AGI over lowest amount noted divided by 40,000
24	Child Credit	Credit reduced by $50 for each $1,000 in modified AGI over lowest amount divided by 10,000 (single) and 20,000 (joint)
25A	Education Credits (Hope/Lifetime Learning)	Credits reduced by excess of modified AGI over lowest amount divided by 10,000 (single) and 20,000 (joint)
32	Earned Income Credit	Credit determined by earned income and AGI levels
55	AMT Exemption	Exemption reduced by 1/4 of AGI in excess of lowest amount noted
68	Itemized Deductions	Itemized deductions reduced by 3 percent of excess AGI over amount noted
135	Series EE Bonds	Excess of modified AGI over lowest amount divided by 15,000 (single), 30,000 (joint) reduces excludable amount
151	Personal Exemption	AGI in excess of lowest amount, divided by 2,500, rounded to nearest whole number, multiplied by 2, equals the percentage reduction in the exemption amounts
219	Traditional IRA w/ Retirement. Plan	Individual retirement account (IRA) limitation ($2,000/$4,000) reduced by excess of AGI over lowest amount noted divided by $10,000
219(g)(7)	IRA w/Spouse w/ Retiremt. Plan	Deduction for not active spouse reduced by excess of modified AGI over lowest amount noted divided by 10,000
221	Education Loan Interest Expense Deduction	Deduction reduced by excess of modified AGI over lowest amount noted divided by 15,000
408A	Roth IRA	Contribution reduced by excess of modified AGI over lowest amount noted divided by 15,000 (single) and 10,000 (joint)
408A	IRA Rollover-Roth IRA	Rollover not permitted if AGI exceeds 100,000 or if MFS
469(i)	Passive Loss Rental $25,000 Rule	Benefit reduced by 50 percent of AGI over lowest amount noted
530	Education IRA Deduction	Contribution reduced by excess of modified AGI over lowest amount noted divided by 15,000 (single) and 10,000 (joint)

PREPARED STATEMENT OF DONALD LUBICK

Mr. Chairman, Senator Moynihan, and Members of this committee, it is a pleasure to speak with you today about the revenue raising proposals included in the President's FY 2000 budget. Before addressing our specific revenue raising proposals, I believe it is helpful to understand the framework of the President's FY 2000 budget and the need for revenue offsets.

The nation has moved from an era of large annual budget deficits to an era of budget surpluses for many years to come. This has resulted from the fiscal policy of the last six years, the economy it helped produce, and the ongoing interaction between the two. Rather than facing an annual requirement to reduce the deficit, we now have before us the opportunity to face the serious challenges for generations to come by making wise policy choices. These challenges lie primarily in the area of the economic and fiscal pressures created by the retirement of the baby boom generation. Meeting those challenges is exactly what the President's budget does. The core of this budget is fiscal discipline, and thereby increased national savings, in order to promote continuing economic growth and retirement security in the years ahead.

In 1992, the deficit reached a record of $290 billion, the Federal debt had quadrupled during the preceding twelve years, and both the deficit and debt were projected to rise substantially. The deficit binge has left us with publicly held debt of $3.7 trillion, and an annual debt service requirement that amounts to 15 percent of the budget. Now however, for the next 15 years, OMB forecasts cumulative unified surpluses of over $4.85 trillion.

It is important to note that transformation from deficits to surpluses has come about concurrent with tax burdens on typical working families being at record lows for recent decades. For a family of four with a median income, the federal income and payroll tax burden is at its lowest level in 21 years, in part because of the child tax credit enacted in the 1997 balanced budget plan. For a family of four with half the median income, the income and payroll tax burden is at its lowest level in 31 years, in part because of the 1993 expansion of the Earned Income Tax Credit for fifteen million families as well as the 1997 enactment of the child tax credit. And for a family of four with double the median income, the federal income tax burden is at its lowest level since 1973. While overall tax revenues have risen as a percentage of GDP, that is in part because higher income individuals have had large increases in incomes, resulting from, among other things, bonuses based on high stock prices and increased realizations of capital gains, and in part because of increased corporate earnings.

When President Clinton was elected, publicly held debt equaled 50 percent of GDP. As a result of the President's plan, by 2014, publicly held debt will decline to about 7 percent of GDP. This reduction in debt will have three effects. First, the government will not have to refinance as much federal debt and thereby will consume less of national savings, thus making capital more readily available to the private sector. That, in turn, will reduce interest rates and increase confidence in the economy, increasing economic growth, job creation and standards of living. Second, debt service costs will decline dramatically. When the President came into office debt service costs of the federal government in 2014 were projected to constitute 27 percent of the federal budget. Under the President's proposal, and because of the progress we have made to date, we estimate the debt service costs will be 2 percent of the federal budget in 2014. Third, the decrease in debt means the federal government will have a greatly improved capacity to access external capital should the need arise.

This is not the time, with the economy running so well, for major tax cuts that are not offset by other measures. Public debt reduction is an opportunity that we must not let slip; it will reap broader and more permanent economic prosperity. Public debt reduction has many of the economic effects of a tax cut, but maintains the fiscal discipline necessary to meet future challenges.

Targeted incentives

Thus, the President's Budget also proposes a fully paid for package of about $34 billion in targeted tax reductions, including provisions to rebuild the nation's schools, make child and health care more affordable, revitalize communities, provide incentives for energy efficiency, promote retirement savings, provide for tax simplification, and extend expiring provisions.

More specifically, to enhance productivity and maintain our country's competitive position in the years ahead, and to provide relief for working families, the Administration proposes:

- increased funding for education, including tax credit bond programs totaling $25 billion to spur State and local government investment in elementary and secondary schools, expansion of the current-law tax incentive for employer-provided educational assistance, simplification and expansion of the deduction allowed for student loan interest payments, tax-free treatment for certain education awards, and a tax credit for certain workplace literacy and basic education programs;
- measures to make child care more affordable, by expanding the current-law child and dependent care tax credit and by providing a new employer credit to promote employee child care;
- providing tax relief (in the form of a $1,000 credit) to individuals with long-term care needs, or who care for others with such needs, and to workers with disabilities;
- measures to promote health insurance coverage for employees of small businesses;
- incentives to promote the livability and revitalization of urban and rural communities, including a tax credit bond program totaling $9.5 billion to help States and local governments finance environmental projects, a tax credit to attract new capital to businesses located in low-income communities, expansion of the current-law low-income housing tax credit program, and $3.6 billion in tax incentives to promote energy efficiency and reduce greenhouse gases;
- several provisions to expand, simplify, and increase the portability of retirement savings mechanisms, and to make it easier for individuals to save for retirement on their own; and
- extension of a recently enacted provision that allows individuals to claim nonrefundable tax credits—such as the education credits and the $500 child credit—without being affected by the alternative minimum tax; and
- extension of several tax provisions that are scheduled to expire, including the R&E tax credit, work opportunity and welfare-to-work tax credits, and the so-called "brownfields" expensing provision.

The President's plan also includes a package of provisions that would simplify the administration of the Federal tax laws.

Revenue offsets

Our revenue offsets would curtail corporate tax shelters, and close loopholes in the tax law in the areas of financial products, corporate taxes, pass-through entities, tax accounting, cost recovery, insurance, exempt organizations, estate and gift taxation, taxation of international transactions, pensions, compliance, and others. These offsets generally would be effective with respect to a future date (e.g., date of first committee action, or date of enactment). We look forward to working with the committee to develop grandfather rules where appropriate.

CORPORATE TAX SHELTERS

The Administration and many others in the tax community are concerned about the recent proliferation of corporate tax shelters. For example, testifying recently before the House Ways and Means Committee, the American Bar Association noted its "growing alarm [at] the aggressive use by large corporate taxpayers of tax 'products' that have little or no purpose other than the reduction of Federal income taxes," and its concern at the "blatant, yet secretive marketing" of such products.

Similarly, in the 1998 Griswold Lecture before the American College of Tax Counsel, Jim Holden stated "Many of us have been concerned with the recent proliferation of tax shelter products marketed to corporations . . . the marketing of these products tears at the fabric of the tax law. Many individual tax lawyers with whom I have spoken express a deep sense of personal regret that this level of Code gamesmanship goes on."

What are the reasons for our concern? First, corporate tax shelters reduce the corporate tax base. Second, corporate tax shelters breed disrespect for the tax system—both by the people who participate in the tax shelter market and by others who perceive unfairness. A view that well-advised corporations can and do avoid their legal tax liabilities by engaging in these tax-engineered transactions may cause a "race to the bottom." If unabated, this will have long-term consequences far more important than the short-term revenue loss we are experiencing. Finally, significant resources—both in the private sector and the Government—are currently being wasted on this uneconomic activity. Private sector resources used to create, implement and defend complex sheltering transactions are better used in productive activities. Similarly, the Congress (particularly the tax-writing committees and their staffs), the Treasury, and the IRS must expend significant resources to address and combat these transactions.

To date, most attacks on corporate tax shelters have been targeted at specific transactions and have occurred on an ad-hoc, after-the-fact basis—through legislative proposals, administrative guidance, and litigation. In the past few years alone, Congress has passed several provisions to prevent specific tax shelter abuses. These include:

- two provisions to prevent the abuse for tax purposes of corporate-owned life insurance. As Ken Kies, then Chief of Staff of the Joint Committee on Taxation, stated afterwards, "When you have a corporation wiring out a billion dollars of premium in the morning and then borrowing it back by wire in the afternoon and instantly creating with each year another $35 million of perpetual tax savings, that's a problem . . . . I think we were looking at a potential for a substantial erosion of the corporate tax base if something hadn't been done."
- the elimination of the ability to avoid corporate-level tax through the use of "liquidating REITs," which passed late last year. We, at Treasury, estimated that this legislation alone—to eliminate only one tax shelter product—saved the fisc upwards of $30 billion over the next ten years.
- Both the Senate Finance Committee and the House Ways and Means Committee have passed legislation this year aimed at section 357(c) basis creation abuses.

At the same time, we, at Treasury, have taken a number of administrative actions to address corporate tax shelters. On the regulatory front, we have issued guidance, such as the notice and proposed regulations on stepped-down preferred stock transactions, proposed regulations on lease strips, and Notice 98-5 regarding foreign tax credit abuses. Most recently, we have brought to light lease-in, lease-out transactions, or so-called "LILO" schemes. Like COLI, these transactions, through circular property and cash flows, offered participants millions in tax benefits with no real economic risk. The notion of a U.S. multinational leasing a town hall from a Swiss municipality and then immediately leasing it back to the municipality is, surely, odd on its face. Finally, we've recently won two important cases—*ACM (ACM Partnership V. Commissioner of Internal Revenue), and ASA (ASA Investerings Pshp. v. Commissioner,* T.C. Memo 1998-305).

Addressing corporate tax shelters on a transaction-by-transaction, ad hoc basis, however, raises certain concerns. First, because it is not possible to identify and address all current and future sheltering transactions; it leaves us barely scratching the surface of the problem. Taxpayers with an appetite for corporate tax shelters will simply move from those transactions that are specifically prohibited by the new legislation to other transactions the treatment of which is less clear. Second, legislating on a piecemeal basis further complicates the Code and seemingly calls into question the viability of common law tax doctrines such as sham transaction, business purpose, economic substance and substance over form. Finally, using a transactional legislation approach to corporate tax shelters may embolden some promoters and participants to rush shelter products to market on the belief that any reactive legislation would be applied only on a prospective basis.

The primary goal of any corporate tax shelter is to eliminate, reduce, or defer corporate income tax. To achieve this goal, corporate tax shelters are designed to manufacture tax benefits that can be used to offset unrelated income of the taxpayer or to create tax-favored or tax-exempt economic income. Most corporate tax shelters rely on one or more discontinuities in the tax law, or exploit a provision in the Code or Treasury regulations in a manner not intended by Congress or the Treasury Department. In doing so it appears that they have forgotten what was basic truth in my years of practice, as articulated by Learned Hand 65 years ago in *Gregory:*

> It is quite true . . . that as the articulation of a statute increases, the room for interpretation must contract; but the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create.

Corporate tax shelters may take several forms. For this reason, they are hard to define. However, corporate tax shelters often share certain common characteristics. For example, through hedges, circular cash flows, defeasements, or other devices, corporate participants in a shelter often are insulated from any risk of economic loss or opportunity for economic gain with respect to the sheltering transaction. Thus, corporate tax shelters are transactions without significant economic substance, entered into principally to achieve a desired tax result. Similarly, the financial accounting treatment of a shelter generally is significantly more favorable than the corresponding tax treatment; that is, the shelter produces a tax "loss" that is not reflected as a book loss. However, the corporate tax shelter may produce a book earnings benefit by reducing the corporation's effective tax rate.

Corporate tax shelter schemes often are marketed by their designers or promoters to multiple corporate taxpayers and often involve property or transactions unrelated to the corporate participant's core business. These two independent features may distinguish corporate tax shelters from traditional tax planning.

Many corporate tax shelters involve arrangements between corporate taxpayers and persons not subject to U.S. tax such that these tax indifferent parties absorb the taxable income from the transaction, leaving tax losses to be allocated to the corporation. The tax indifferent parties in effect "rent" their tax exempt status in return for an accomodation fee or an above-market return on investment. Tax indifferent parties include foreign persons, tax-exempt organizations, Native American tribal organizations, and taxpayers with loss or credit carryforwards.

Taxpayers entering into corporate tax shelter transactions often view such transactions as risky because the expected tax benefits may be successfully challenged. To protect against such risk, purchasers of corporate tax shelters often require the seller or a counterparty to enter into a tax benefit protection arrangement. Thus, corporate tax shelters are often associated with high transactions costs, contingent or refundable fees, unwind clauses, or insured results.

These themes run through our budget proposals and, we hope, help us to focus on finding broader, ex ante solutions to the corporate tax shelter problem.

The Administration therefore proposes several remedies to curb the growth of corporate tax shelters. We propose more general remedies to deter corporations from entering into any sheltering transactions. These proposals would disallow any tax benefit created in a corporate tax shelter, as so defined, and would address common characteristics found in corporate tax shelters as described above. Also, all the parties to a structured transaction would have an incentive, under our proposals, to assure that the transaction comports with established principles.

The Treasury Department recognizes that this more general approach to corporate tax shelters raises certain concerns. Applying various substantive and procedural rules to a "corporate tax shelter" or a "tax avoidance transaction" requires definitions of such terms. As described in greater detail below, the Administration's proposals define these terms. Critics of the proposals have suggested that these definitions are too broad or may create too much uncertainty and thus may inhibit otherwise legitimate transactions. We have attempted a definition of corporate tax shelter that is narrower and therefore less uncertain than other definitions and formulations used in the Code. Some examples of imprecise, but well understood formulae, already in the law are:

1. section 482, which grants authority to reallocate income, deductions etc., between organizations if necessary to prevent evasion of tax or clearly to reflect income;
2. section 446, which prescribes a change of method of accounting if necessary to clearly reflect income; and
3. sections 269 and 357, to pick at random two sections that contain as a test, a purpose of tax avoidance or evasion.

Moreover, our definition builds on the firm foundation of existing judicial doctrines articulated in *ACM, Sheldon,* and other decisions and may be viewed as largely enforcing the judicially-created concept of economic substance of current law.

Thus we strike no new ground in defining the nature of tax shelters. Taxpayers and practitioners have lived with the concepts our definitions embody as they have been enunciated by the courts since the 1920's. Whatever uncertainty is inherent in the law today has been well tolerated.

This is really no more than a debate on rules vs. standards. Bright-line/safe-harbor tests, although appropriate in some circumstances, encourage aggressive positions and playing the examination lottery. As Professor James Eustice wrote in 1976, "I personally have viewed some transactions that seem to me to fly only by principles of levitation. . . . [E]xcessive concentration on technical matters to the exclusion of the broader issues has obviously raised the level of complexity throughout the entire tax system." Standards, in contrast, require the application of common olfactory sense. Some level of uncertainty is unavoidable with respect to complex transactions. Moreover a degree of uncertainty may be useful in discouraging taxpayers from venturing too close to the edge, and thereby going over the edge, of established principles.

Let me assure you, however, the Treasury Department does not intend to affect legitimate business transactions and looks forward to working with the tax-writing committees in refining the corporate tax shelter proposals. We have announced, and repeat here, that we will work with Congress and the corporate community to refine our definition in a manner that will protect from penalty any legitimate, normal-course-of-business transactions.

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Deputy Secretary Larry Summers, in a speech to the Tax Executives Institute, recently spoke of the importance of building a culture of compliance. He announced an intention to develop an intensive and extensive dialogue with practitioner groups—the tax bar, the accounting profession, and corporate tax executives—so that we can come to common understandings of the norms of appropriate behavior in this area. This dialogue has already begun. We have met with, and are evaluating comments from, many different interested individuals and groups. For example, some have suggested that advance disclosure to the IRS should be sufficient to avoid the penalty and have asked us to consider the establishment of an advance ruling procedure. Under such a procedure, if a transaction is fully disclosed to the IRS in advance, it would be made possible to obtain an expedited ruling from the Service on the tax shelter penalty question without determining the underlying substantive liability questions. Others have suggested that an issue escalation mechanism, such as coordinated review of corporate tax shelters, be implemented. This could be facilitated by the in-process reorganization of the IRS. We are currently considering these suggestions. Also, we look forward to analyzing the comments raised by others in testimony presented to this Committee. We will develop and discuss these and other issues in our White Paper on corporate tax shelters, which we expect to issue soon.

The Administration's proposals that generally would apply to corporate tax shelters are:

Deny certain tax benefits in tax avoidance transactions.—Under current law, if a person acquires control of a corporation or a corporation acquires carryover basis property of a corporation not controlled by the acquiring corporation or its shareholders, and the principal purpose for such acquisition is evasion or avoidance of Federal income tax by securing certain tax benefits, the Secretary may disallow such benefits to the extent necessary to eliminate such evasion or avoidance of tax. However, this current rule has been interpreted narrowly. The Administration proposes to expand the current rules to authorize the Secretary to disallow a deduction, credit, exclusion, or other allowance obtained by a corporation in a tax avoidance transaction.

For this purpose, a tax avoidance transaction would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction. In addition, a tax avoidance transaction would be defined to cover transactions involving the improper elimination or significant reduction of tax on economic income. The proposal would not apply to tax benefits clearly contemplated by the applicable current-law provision (e.g., the low-income housing tax credit).

Modify substantial understatement penalty for corporate tax shelters.—The current 20-percent substantial understatement penalty imposed on corporate tax shelter items can be avoided if the corporate taxpayer had reasonable cause for the tax treatment of the item and good faith. The Administration proposes to increase the substantial understatement penalty on corporate tax shelter items to 40 percent. The penalty will be reduced to 20 percent if the corporate taxpayer discloses to the National Office of the Internal Revenue Service within 30 days of the closing of the transaction appropriate documents describing the corporate tax shelter and files a statement with, and provides adequate disclosure on, its tax return. The penalty could not be avoided by a showing of reasonable cause and good faith. For this purpose, a corporate tax shelter would be defined as any entity, plan, or arrangement (to be determined based on all the facts and circumstances) in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction.

Deny deductions for certain tax advice and impose an excise tax on certain fees received.—The proposal would deny a deduction for fees paid or accrued in connection with the promotion of corporate tax shelters and the rendering of certain tax advice related to corporate tax shelters. The proposal would also impose a 25-percent excise tax on fees received in connection with the promotion of corporate tax shelters and the rendering of certain tax advice related to corporate tax shelters.

Impose excise tax on certain rescission provisions and provisions guaranteeing tax benefits.—The Administration proposes to impose on the purchaser of a corporate tax shelter an excise tax of 25 percent on the maximum payment to be made under the arrangement. For this purpose, a tax benefit protection arrangement would include certain rescission clauses, guarantee of tax benefits arrangement or any other arrangement that has the same economic effect (e.g., insurance purchased with respect to the transaction).

Preclude taxpayers from taking tax positions inconsistent with the form of their transactions.—Under current law, if a taxpayer enters into a transaction in which the economic substance and the legal form are different, the taxpayer may take the position that, notwithstanding the form of the transaction, the substance is controlling for Federal income tax purposes. Many taxpayers enter into such transactions in order to arbitrage tax and regulatory laws. Under the proposal, except to the extent the taxpayer discloses the inconsistent position on its tax return, a corporate taxpayer, but not the Internal Revenue Service, would be precluded from taking any position (on a tax return or otherwise) that the Federal income tax treatment of a transaction is different from that dictated by its form, if a tax indifferent person has a direct or indirect interest in such transaction.

Tax income from corporate tax shelters involving tax-indifferent parties.—The proposal would provide that any income received by a tax-indifferent person with respect to a corporate tax shelter would be taxable, either to the tax-indifferent party or to the corporate participant.

The Administration also proposes to amend the substantive law related to specific transactions that the Treasury Department has identified as giving rise to corporate tax shelters. No inference is intended as to the treatment of any of these transactions under current law.

Require accrual of income on forward sale of corporate stock.—There is little substantive difference between a corporate issuer's current sale of its stock for a deferred payment and an issuer's forward sale of the same stock. In both cases, a portion of the deferred payment compensates the issuer for the time-value of money during the term of the contract. Under current law, the issuer must recognize the time-value element of the deferred payment as interest if the transaction is a current sale for deferred payment but not if the transaction is a forward contract. Under the proposal, the issuer would be required to recognize the time-value element of the forward contract as well.

Modify treatment of built-in losses and other attribute trafficking.—Under current law, a taxpayer that becomes subject to U.S. taxation may take the position that it determines its beginning bases in its assets under U.S. tax principles as if the taxpayer had historically been subject to U.S. tax. Other tax attributes are computed similarly. A taxpayer may thus "import" built-in losses or other favorable tax attributes incurred outside U.S. taxing jurisdiction (e.g., from foreign or tax-exempt parties) to offset income or gain that would otherwise be subject to U.S. tax. The proposal would prevent the importation of attributes by eliminating tax attributes (including built-in items) and marking to market bases when an entity or an asset becomes relevant for U.S. tax purposes. This proposal would be effective for transactions in which assets or entities become relevant for U.S. tax purposes on or after the date of enactment.

Modify treatment of ESOP as S corporation shareholder.—Pursuant to provisions enacted in 1996 and 1997, an employee stock ownership plan (ESOP) may be a shareholder of an S corporation and the ESOP's share of the income of the S corporation is not subject to tax until distributed to the plan beneficiaries. The Administration proposes to require an ESOP to pay tax on S corporation income (including capital gains on the sale of stock) as the income is earned and to allow the ESOP a deduction for distributions of such income to plan beneficiaries.

Prevent serial liquidation of U.S. subsidiaries of foreign corporations.—Dividends from a U.S. subsidiary to its foreign parent corporation are subject to U.S. withholding tax. In contrast, if a domestic corporation distributes earnings in a tax-free liquidation, the foreign shareholder generally is not subject to any withholding tax. Some foreign corporations attempt to avoid dividend withholding by serially forming and liquidating holding companies for their U.S. subsidiaries. The proposal would impose withholding tax on any distribution made to a foreign corporation in complete liquidation of a U.S. holding company if the holding company was in existence for less than five years. The proposal would also achieve a similar result with respect to serial terminations of U.S. branches.

Prevent capital gains avoidance through basis shift transactions involving foreign shareholders.—To prevent taxpayers from attempting to offset capital gains by generating artificial capital losses through basis shift transactions involving foreign shareholders, the Administration proposes to treat the portion of a dividend that is not subject to current U.S. tax as a nontaxed portion and thus subject to the basis reduction rules applicable to extraordinary dividends. Similar rules would apply in the event that the foreign shareholder is not a corporation.

Limit inappropriate tax benefits for lessors of tax-exempt use property.—The Administration is concerned that certain structures involving tax-exempt use property are being used to generate inappropriate tax benefits for lessors. The proposal would deny a lessor the ability to recognize a net loss from a leasing transaction involving

tax-exempt use property during the lease term. A lessor would be able to carry forward a net loss from a leasing transaction and use it to offset net gains from the transaction in subsequent years. This proposal would be effective for leasing transactions entered into on or after the date of enactment.

Prevent mismatching of deductions and income inclusions in transactions with related foreign persons.—The Treasury Department has learned of certain structured transactions designed to allow taxpayers inappropriately to take advantage of the certain current-law rules by accruing deductions to related foreign personal holding company (FPHC), controlled foreign corporation (CFC) or passive foreign investment company (PFIC) without the U.S. owners of such related entities taking into account for U.S. tax purposes an amount of income appropriate to the accrual. This results in an improper mismatch of deductions and income. The proposal would provide that deductions for amounts accrued but unpaid to related foreign CFCs, PFICs or FPHCs would be allowable only to the extent the amounts accrued by the payor are, for U.S. tax purposes, reflected in the income of the direct or indirect U.S. owners of the related foreign person. The proposal would contain an exception for certain short term transactions entered into in the ordinary course of business.

Restrict basis creation through section 357(c).—A transferor generally is required to recognize gain on a transfer of property in certain tax-free exchanges to the extent that the sum of the liabilities assumed, plus those to which the transferred property is subject, exceeds the basis in the property. This gain recognition to the transferor generally increases the basis of the transferred property in the hands of the transferee. If a recourse liability is secured by multiple assets, it is unclear under current law whether a transfer of one asset where the transferor remains liable is a transfer of property "subject to the liability." Similar issues exist with respect to nonrecourse liabilities. Under the Administration's proposal, the distinction between the assumption of a liability and the acquisition of an asset subject to a liability generally would be eliminated. The transferor's recognition of gain as a result of assumption of liability would not increase the transferee's basis in the transferred asset to an amount in excess of its fair market value. Moreover, if no person is subject to U.S. tax on gain recognized as the result of the assumption of a nonrecourse liability, then the transferee's basis in the transferred assets would be increased only to the extent such basis would be increased if the transferee had assumed only a ratable portion of the liability, based on the relative fair market values of all assets subject to such nonrecourse liability.

Modify anti-abuse rule related to assumption of liabilities.—The assumption of a liability in an otherwise tax-free transaction is treated as boot to the transferor if the principal purpose of having the transferee assume the liability was the avoidance of tax on the exchange. The current language is inadequate to address the avoidance concerns that underlie the provision. The Administration proposes to modify the anti-abuse rule by deleting the limitation that it only applies to tax avoidance on the exchange itself, and changing "the principal purpose" standard to "a principal purpose."

Modify corporate-owned life insurance (COLI) rules.—In general, interest on policy loans or other indebtedness with respect to life insurance, endowment or annuity contracts is not deductible unless the insurance contract insures the life of a "key person" of a business. In addition, the interest deductions of a business generally are reduced under a proration rule if the business owns or is a direct or indirect beneficiary with respect to certain insurance contracts. The COLI proration rules generally do not apply if the contract covers an individual who is a 20-percent owner of the business or is an officer, director, or employee of such business. These exceptions under current law still permit leveraged businesses to fund significant amounts of deductible interest and other expenses with tax-exempt or tax-deferred inside buildup on contracts insuring certain classes of individuals. The Administration proposes to repeal the exception under the COLI proration rules for contracts insuring employees, officers or directors (other than 20-percent owners) of the business. The proposal also would conform the key person exception for disallowed interest deductions attributable to policy loans and other indebtedness with respect to life insurance contracts to the 20-percent owner exception in the COLI proration rules.

Other Revenue Provisions

In addition to the general and specific corporate tax shelter proposals, the Administration's budget contains other revenue raising proposals that are designed to remove unwarranted tax benefits, ameliorate discontinuities of current law, provide simplification and improve compliance. Some of these proposals are described below.

PROPOSALS RELATING TO FINANCIAL PRODUCTS

The proposals relating to financial products narrowly target certain transactions and business practices that inappropriately exploit existing tax rules. Three of the proposals address the timing of income from debt instruments. Other proposals address specific financial products transactions that are designed to achieve tax results that are significantly better than the results that would be obtained by entering into economically equivalent transactions. At the same time, a number of these proposals contain provisions that are designed to simplify existing law and provide relief for taxpayers in cases where the literal application of the existing rules can produce an uneconomic result.

Mismeasurement of economic income.—The tax rules that apply to debt instruments generally require both the issuer and the holder of a debt instrument to recognize interest income and expense over the term of the instrument regardless of when the interest is paid. If the debt instrument is issued at a discount (that is, it is issued for an amount that is less than the amount that must be repaid), the discount functions as interest—as compensation for the use of money. Recognizing this fact, the existing tax rules require both parties to account for this discount as interest over the life of the debt instrument.

The Administration's budget contains three proposals that are designed to reduce the mismeasurement of economic income on debt instruments: (1) a rule that requires cash-method banks to accrue interest income on short-term obligations, (2) rules that require accrual method taxpayers to accrue market discount, and (3) a rule that requires the issuer in a debt-for-debt exchange to spread the interest expense incurred in the exchange over the term of the newly-issued debt instrument.

Specific transactions designed to exploit current rules.—There are a number of strategies involving financial products that are designed to give a taxpayer the "economics" of a particular transaction without the tax consequences of the transaction itself. For example, so-called "hedge fund swaps" are designed to give an investor the "economics" of owning a partnership interest in a hedge fund without the tax consequences of being a partner. These swaps purportedly allow investors to defer the recognition of income until the end of the swap term and to convert ordinary income into long-term capital gain.

Another strategy involves the use of structured financial products that allow investors to monetize appreciated financial positions without recognizing gain. If a taxpayer holds an appreciated financial position in personal property and enters into a structured financial product that substantially reduces the taxpayer's risk of loss in the appreciated position, the taxpayer may be able to borrow against the combined position without recognizing gain. Under current law, unless the borrowing is "incurred to purchase or carry" the structured financial product, the taxpayer may deduct its interest expense on the borrowing even though the taxpayer has not included the gain from the appreciated position.

The Administration's budget contains proposals that are designed to eliminate the inappropriate tax benefit these transactions create. The "constructive ownership" proposal would limit the amount of long-term capital gain a taxpayer could recognize from a hedge fund swap to the amount of long-term capital gain that would have been recognized if the investor had invested in the hedge fund directly. Another proposal would clarify that a taxpayer cannot currently deduct expenses (included interest expenses) from a transaction that monetizes an appreciated financial position without triggering current gain recognition.

PROPOSALS RELATING TO PASS-THROUGH ENTITIES

There are five coordinated proposals relating to basis adjustments and gain recognition in the partnership area. The proposals have three purposes: simplification, rationalization, and prevention of tax avoidance. The proposals accomplish these goals through a variety of means. In one proposal, the ability of taxpayers to elect whether or not to adjust the basis of partnership assets is eliminated in a situation where the election is leading to tax abuses. In another proposal, we would limit basis adjustments with respect to particular types of property, which enables us, in a different proposal, to repeal a provision that has been widely criticized as overly complex and irrational.

In addition to the partnership proposals, two REIT proposals are included in the budget. One proposal allows REITs to conduct expanded business activities in situations where a corporate level tax will be collected with respect to such activities. The other REIT proposal limits closely held REITs, which have been the primary vehicle for carrying out such corporate tax shelters as step-down preferred stock and the liquidating REIT transactions.

A final proposal in the pass-through area would impose a tax on gain when a large C corporation converts to an S corporation.

PROPOSALS RELATING TO CORPORATE PROVISIONS

The corporate proposals focus on a developing trend in structuring dispositions of assets or stock that technically qualify as tax-free transactions, but circumvent the repeal of General Utilities by allowing corporations to "sell" appreciated property without recognizing any gain. There has been a proliferation of highly publicized transactions in which corporations exploit the purposes of the tax-free reorganization provisions, (i.e., to allow a corporation to change its form when the taxpayer's investment remains in corporate solution), to maximize their ability to cash out of their investments and minimize the amount of tax paid. In addition, the corporate proposals attempt to simplify the law and prevent whipsaw of the government in certain tax-free transactions.

Modify tax-free treatment for mere adjustments in form.—In order for an acquisition or distribution of appreciated assets to qualify as wholly or partly tax-free, the transaction must satisfy a series of relatively stringent requirements. If the transaction fails to satisfy the requirements, it will be taxed in accordance with the general recognition principles of the Code. After the repeal of General Utilities, there are few opportunities to dispose of appreciated assets without a tax liability, and our proposals would help to ensure that those remaining exceptions to the repeal of General Utilities are not circumvented. The provisions of the Code that allow for tax-free treatment date back to the early years of the tax system and did not contemplate the creative tax planning that has taken place in the last several years. As a result, many of the corporate tax provisions have been manipulated, resulting in avoidance of tax.

The Administration's budget contains several proposals that are designed to eliminate opportunities under current law for corporations to achieve tax-free treatment for transactions that should be taxable. The proposals include (1) modifying the "control" test for purposes of tax-free incorporations, distributions and reorganizations to include a value component so that corporations may not "sell" a significant amount of the value of the corporation while continuing to satisfy the current law control test that focuses solely on voting power, (2) requiring gain recognition upon the issuance of "tracking stock" or a recapitalization of stock or securities into tracking stock, and (3) requiring gain recognition in downstream transactions in which a corporation that holds stock in another corporation transfers its assets to that corporation in exchange for stock.

Preventing taxpayers from taking inconsistent positions in certain nonrecognition transactions.—No gain or loss is recognized upon the transfer of property to a controlled corporation in exchange for stock. There is an inconsistency in the treatment by the Internal Revenue Service and the Claims Court as to the treatment of a transfer of less than all substantial rights to use intangible property. Accordingly, transferor and transferee corporations have taken the position that best achieves their tax goals. The proposal would eliminate this whipsaw potential by treating any transfer of an interest in intangible property as a tax-free transfer and requiring allocation of basis between the retained rights and the transferred rights based upon respective fair market values.

PROPOSALS RELATING TO TAX ACCOUNTING AND COST RECOVERY

The Administration's budget contains measures that are principally designed to improve measurement of income by eliminating methods of accounting that result in a mismeasurement of economic income or provide disparate treatment among similarly situated taxpayers.

Repeal installment method for accrual basis taxpayers.—The proposal would repeal the installment method of accounting for accrual method taxpayers (other that those taxpayers that benefit from dealer disposition exceptions under current law) and eliminate inadequacies in the installment method pledging rules in order to better reflect the economic results of a taxpayer's business during the taxable year.

Apply uniform capitalization rules to tollers.—To eliminate the disparate treatment between manufacturers and tollers and better reflect the income of tollers, the proposal would require tollers (other than small businesses) to capitalize their direct costs and an allocable portion of their indirect costs to property tolled.

Provide consistent amortization periods for intangibles.—To encourage the formation of new businesses, the proposal would allow a taxpayer to elect to deduct up to $5,000 each of start-up and organizational expenditures. Start-up and organizational expenditures not currently deductible would be amortized over a 15-year period consistent with the amortization period for acquired intangibles.

Clarify recovery period of utility grading costs.—The proposal would clarify and rationalize current law by assigning electric and gas utility clearing and grading costs incurred to locate transmission and distribution lines and pipelines to the class life assigned to the benefitted assets, giving these costs a recovery period of 20 years and 15 years, respectively. The class life assigned to the benefitted assets is a more appropriate estimate of the useful life of these costs, and thus will improve measurement of the utility's income.

Deny change in method treatment to tax-free formations.—The proposal would eliminate abuses with respect to changes in accounting methods by expanding the transactions to which the carryover of method of accounting rules apply to include tax-free contributions to corporations and partnerships.

Deny deduction for punitive damages.—The deductibility of punitive damage payments under current law undermines the role of such damages in discouraging and penalizing certain undesirable actions or activities. The proposal would disallow any deduction for punitive damages to conform the tax treatment to that of other payments, such as penalties and fines, that are also intended to discourage violations of public policy.

Disallow interest on debt allocable to tax-exempt obligations.—Under current law, security dealers and financial intermediaries other than banks are able to reduce their tax liabilities inappropriately through double Federal tax benefits of interest expense deductions and tax-exempt interest income, notwithstanding that they operate similarly to banks. The proposal would eliminate the disparate treatment between banks and financial intermediaries, such as security dealers and other financial intermediaries, by providing that a financial intermediary investing in tax-exempt obligations would be disallowed deductions for a portion of its interest expense equal to the portion of its total assets that is comprised of tax-exempt investments.

Eliminate the income recognition exception for accrual method service providers.—Under current law, accrual method service providers are provided a special exception to the general accrual rules that permit them, in effect, to reduce current taxable income by an estimate of future bad debt losses. This method of estimation results in a mismeasurement of a taxpayer's economic income and, because this tax benefit only applies to amounts to be received for the performance of services, discriminates in favor of service providers. The proposal would repeal the special exception for accrual method service providers.

Repeal lower-of-cost-or-market inventory accounting method.—The allowance of write-downs under the lower-of-cost or market (LCM) method or subnormal goods method is an inappropriate exception from the realization principle and is essentially a one-way mark-to-market method that understates taxable income. The proposal would repeal the LCM and subnormal goods methods.

PROPOSALS RELATING TO INSURANCE

The Administration's budget contains proposals to more accurately measure the economic income of insurance companies by updating and modernizing certain provisions of current law. The proposals would (1) require recapture of policyholder surplus accounts, (2) modify rules for capitalizing policy acquisition costs of life insurance companies, and (3) increase the proration percentage for property casualty (P&C) insurance companies.

Between 1959 and 1984, stock life insurance companies deferred tax on a portion of their profits. These untaxed profits were added to a policyholders surplus account (PSA). In 1984, Congress precluded life insurance companies from continuing to defer tax on future profits through PSAs. However, companies were permitted to continue to defer tax on their existing PSAs. Most pre-1984 policies have terminated so there is no remaining justification for allowing these companies to continue to defer tax on profits they earned between 1959 and 1984.

Under current law, pursuant to a provision enacted in 1990, insurance companies capitalize varying percentages of their net premiums for certain types of insurance contracts, and generally amortize these amounts over 10 years (five years for small companies). These capitalized amounts are intended to serve as proxies for each company's actual commissions and other policy acquisition expenses. However, data reported by insurance companies to State insurance regulators each year indicates that the insurance industry is capitalizing less than half of its policy acquisition costs, which results in a mismatch of income and deductions. The Administration proposes that insurance companies be required to capitalize modified percentages of their net premiums for certain lines of business.

In computing their underwriting income, P&C insurance companies deduct reserves for losses and loss expenses incurred. These loss reserves are funded in part with the company's investment income. In 1986, Congress reduced the reserve de-

ductions of P&C insurance companies by 15 percent of the tax-exempt interest or the deductible portion of certain dividends received. In 1997, Congress expanded the 15-percent proration rule to apply to the inside buildup on certain insurance contracts. The existing 15-percent proration rule still enables P&C insurance companies to fund a substantial portion of their deductible reserves with tax-exempt or tax-deferred income. Other financial intermediaries, such as life insurance companies, banks and brokerage firms, are subject to more stringent proration rules that substantially reduce or eliminate their ability to use tax-exempt or tax-deferred investments to fund currently deductible reserves or deductible interest expense.

PROPOSALS RELATING TO ESTATE AND GIFT TAXATION

There are seven proposals relating to estate and gift taxation. One proposal would restore the phaseout of the unified credit for large estates. This provision was inadvertently omitted in the Taxpayer Relief Act of 1997 and it has not been restored as a technical correction. Three of the proposals concern the basis a donee or heir takes in property received by gift or bequest. These proposals require basis allocation in part gift/part sale transactions, require consistent treatment for estate and income tax purposes, and conform the treatment of surviving spouses in community property and common law states. The remaining proposals would eliminate estate and gift tax valuation discounts on non-business property, require inclusion in the surviving spouse's estate of any remaining QTIP trust property for which a marital deduction is allowed in the estate of the first spouse to die, and repeal the current exception to the special gift tax valuation rules for personal residence trusts.

PROPOSALS RELATING TO INTERNATIONAL PROVISIONS

The Administration's budget contains proposals designed to ensure that economically similar international transactions are taxed in a similar manner, prevent manipulation and inappropriate use of exemptions from U.S. tax, allocate income between U.S. and foreign sources in a more appropriate manner, and determine the foreign tax credit in a more accurate manner. Specific proposals include:

Expand section 864(c)(4)(B) to interest and dividend equivalents.—Under U.S. domestic law, a foreign person is subject to taxation in the United States on a net income basis with respect to income that is effectively connected with a U.S. trade or business (ECI). The test for determining whether income is effectively connected to a U.S. trade or business differs depending on whether the income at issue is U.S. source or foreign source. Only enumerated types of foreign source income—rents, royalties, dividends, interest, gains from the sale of inventory property, and insurance income—constitute ECI, and only in certain circumstances.

The proposal would expand the categories of foreign-source income that could constitute ECI to include interest equivalents (including letter of credit fees) and dividend equivalents in order to eliminate arbitrary distinctions between economically equivalent transactions.

Recapture overall foreign losses upon disposition of CFC stock.—If deductions against foreign income result in (or increase) an overall foreign loss which is then set against U.S. income, current law has recapture rules that require subsequent foreign income or gain to be recharacterized as domestic. Recapture can take place when directly-owned foreign assets are disposed of. However, there may be no recapture when stock in a controlled foreign corporation (CFC) is disposed of. The proposal would correct that asymmetry by providing that property subject to the recapture rules upon disposition would include stock in a CFC.

Amend 80/20 company rules.—Interest or dividends paid by a so-called "80/20 company" generally are partially or fully exempt from U.S. withholding tax. A U.S. corporation is treated as an 80/20 company if at least 80 percent of the gross income of the corporation for the three year period preceding the year of a dividend is foreign source income attributable to the active conduct of a foreign trade or business (or the foreign business of a subsidiary). Certain foreign multinationals improperly seek to exploit the rules applicable to 80/20 companies in order to avoid U.S. withholding tax liability on earnings of U.S. subsidiaries that are distributed abroad.

The proposal would prevent taxpayers from avoiding withholding tax through manipulations of these rules.

Modify foreign office material participation exception.—In the case of a sale of inventory property that is attributable to a nonresident's office or other fixed place of business within the United States, the sales income is generally treated as U.S. source. The income is treated as foreign source, however, if the inventory is sold for use, disposition, or consumption outside the United States and the nonresident's foreign office or other fixed place of business materially participates in the sale. Income that is treated as foreign source under this rule is not treated as effectively con-

nected with a U.S. trade or business and is not subject to U.S. tax. The proposal would provide that the foreign source exception shall apply only if an income tax equal to at least 10 percent of the income from the sale is actually paid to a foreign country with respect to such income.

Stop abuses of CFC exception under section 833.-A foreign corporation is subject to a four-percent tax on its United States source gross transportation income. The tax will not apply if the corporation is organized in a country (an "exemption country") that grants an equivalent tax exemption to U.S. shipping companies or is a controlled foreign corporation (the "CFC exception"). The premise for the CFC exception is that the U.S. shareholders of a CFC will be subject to current U.S. income taxation on their share of the foreign corporation's shipping income and, thus, the four-percent tax should not apply if the corporation is organized in an exemption country. Residents of non-exemption countries, however, can achieve CFC status for their shipping companies simply by owning the corporations through U.S. partnerships. The proposal would stop this abuse by narrowing the CFC exception.

Replace sales-source rules with activity-based rules.—If inventory is manufactured in the United States and sold abroad, Treasury regulations provide that 50 percent of the income from such sales is treated as earned by production activities and 50 percent by sales activities. The income from the production activities is sourced on the basis of the location of assets held or used to produce the income. The income from the sales activity (the remaining 50 percent) is sourced based on where title to the inventory transfers. If inventory is purchased in the United States and sold abroad, 100 percent of the sales income generally is deemed to be foreign source. These rules generally produce more foreign source income for Unites States tax purposes than is subject to foreign tax and thereby allow U.S. exporters that operate in high-tax foreign countries to credit tax in excess of the U.S. rate against their U.S. tax liability. The proposal would require that the allocation between production activities and sales activities be based on actual economic activity.

Modify rules relating to foreign oil and gas extraction income.—To be eligible for the U.S. foreign tax credit, a foreign levy must be the substantial equivalent of an income tax in the U.S. sense, regardless of the label the foreign government attaches to it. Current law recognizes the distinction between creditable taxes and non-creditable payments for specific economic benefit but fails to achieve the appropriate split between the two in a case where a foreign country imposes a levy on, for example, oil and gas income only, but has no generally imposed income tax. The proposal would treat as taxes payments by a dual-capacity taxpayer to a foreign country that would otherwise qualify as income taxes or "in lieu of" taxes, only if there is a "generally applicable income tax" in that country. Where the foreign country does generally impose an income tax, as under present law, credits would be allowed up to the level of taxation that would be imposed under that general tax, so long as the tax satisfies the new statutory definition of a "generally applicable income tax." The proposal also would create a new foreign tax credit basket for foreign oil and gas income.

MISCELLANEOUS REVENUE PROPOSALS

The President's budget also includes miscellaneous revenue proposals, many of which were proposed in prior budgets. Some of these proposals are: (1) taxing the investment income of trade associations, (2) the repeal of the percentage depletion for non-fuel minerals mined on Federal lands, (3) the reinstatement of the oil spill excise tax, with an increase in the full funding limitation from $1 billion to $5 billion, (4) a modification of the FUTA deposit requirement, (5) simplification of the foster child definition for purposes of the earned income tax credit, (6) an excise tax on the purchase of structured settlements, (7) several proposals to improve compliance, (8) repeal of the de minimis rental income rule, and (9) certain pension and compensation-related provisions. The budget proposals also include various other provisions that affect receipts. These are the reinstatement of the environmental tax imposed on corporate taxable income ($2.7 billion), reinstatement of the Superfund excise taxes ($3.8 billion), and receipts from tobacco legislation ($34.5 billion). The budget also converts a portion of the aviation excise taxes into cost-based user fees and replaces the Harbor Maintenance Tax with a user fee.

In conclusion, Mr. Chairman and Senator Moynihan, and members of this committee, the Administration looks forward to working with you as you examine our proposals. We want to thank you for your comments about our corporate tax shelter proposals, and your willingness to listen.

PREPARED STATEMENT OF STEFAN F. TUCKER

Mr. Chairman and Members of the Committee:

My name is Stefan F. Tucker. I appear before you today in my capacity as Chair of the American Bar Association Section of Taxation. This testimony is presented on behalf of the Section of Taxation. Accordingly, except as otherwise indicated, it has not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the Association.

The Section of Taxation appreciates the opportunity to appear before the Committee today. We believe that several proposals in the President's Fiscal Year 2000 Budget raise very important issues. While the Section does not necessarily endorse the specific proposals set forth by the President, we believe that such proposals highlight growing problems with our tax system that should be addressed by this Committee and the Congress. Our testimony today will not include comments on each and every item in the President's Budget. We do anticipate, however, that additional individual comments on various proposals will be submitted in the near future. In addition, individual members of the Tax Section would be pleased to provide assistance and comments to members of the Finance Committee and your Staff on any proposals you might identify.

As you know, the ABA Tax Section is comprised of approximately 20,000 tax lawyers. As the largest and broadest based professional organization of tax lawyers in the country, we serve as the national representative of the legal profession with regard to the tax system. We advise individuals, trusts and estates, small businesses, exempt organizations and major national and multi-national corporations. We serve as attorneys in law firms, as in-house counsel, and as advisors in other, multidisciplinary practices. Many of the Section's members have served on the staffs of the Congressional tax-writing Committees, in the Treasury Department and the Internal Revenue Service, and the Tax Division of the Department of Justice. Virtually every former Assistant Secretary of the Treasury for Tax Policy, Commissioner of Internal Revenue, Chief Counsel of the Internal Revenue Service and Chief of Staff of the Joint Committee on Taxation is a member of the Section.

We have limited our specific comments today to two areas: corporate tax shelters and the taxation of investment income of trade associations. Before we shift to those specific issues, however, I would like to reiterate the Tax Section's concerns about the growing complexity of the Tax Code and the need for this Committee and the Congress to dedicate themselves to broad simplification of the tax laws.

SIMPLIFICATION AND COMPLEXITY

My colleague, Bill Wilkins, Director of Communications of the Tax Section, testified before this Committee on April 15, 1999, on behalf of the Tax Section, concerning simplification and complexity. I will not restate the many thoughtful proposals contained in Bill's statement. I would, however, like to reiterate the urgency with which we view this problem.

As Bill's statement makes clear, the ABA and its Tax Section are not Johnny-come-latelies to this debate. The ABA has long-standing resolutions urging tax law simplicity, a broad tax base and lower tax rates. We have reiterated this position in testimony before the House Ways and Means and Senate Finance Committees on numerous occasions.

We remain very concerned. Over the past two decades, the Code has become more and more complex. That trend must be stopped and reversed. Otherwise, we fear that the weight of these various complicated provisions could cause the collapse of our system, as more and more taxpayers find it more and more difficult to cope with the intricate and arcane system, or quit out of frustration. You no doubt hear often about our voluntary tax system. While that is somewhat of a misnomer, there is no question that individual willingness to satisfy one's tax obligations without coercion is central to the smooth functioning of the system. Complexity takes a tremendous toll on taxpayer confidence, evidence of which can be found in the broad public support for the IRS restructuring legislation championed by the Chairman of this Committee last year. The willingness and ability of the taxpaying public to keep up with the pace and complexity of changes is at a point beyond which it should not be pushed.

We urge this Committee to do two things during the next few months. First, do not, under any circumstances, make things worse than they are already. There are many proposals being discussed, some of which are contained in the President's Budget that would add significant new complexity to an already overloaded Tax Code. We urge you to resist the political seductiveness of many of these proposals and avoid the layering of new complexity over old. It is very easy to focus on the

merits of a particular provision in isolation, and ignore the cumulative effect of a series of changes, such as was done in the context the 1997 tax act. To paraphrase Hippocrates, if Congress chooses to reduce taxes in 1999, we urge you to do no harm.

Second, we urge you, wherever possible, to rectify the mistakes of the past. Our testimony of April 15 set forth a list of areas we believe can, and clearly should, be addressed. The individual alternative minimum tax and phase-outs top that list, but there are many others.

It is vital that this Committee take on and deal with the hard choices that simplification presents. To date, simplification has not achieved the commitment we believe is required. Too often, other objectives have tended to crowd simplification out as a priority. We urge this Committee to adjust this balance. Simplification may not garner political capital or headlines, but it is crucial. Complexity breeds non-compliance; simplification enhances understanding and compliance.

Members of the Finance Committee must endorse simplification as a bedrock principle, and that principle must be communicated to all involved in the tax-writing process. The time must be taken, and the effort must be made, to ensure that this goal remains paramount.

We would now like to address the growing problem we perceive with regard to corporate tax shelters.

PROVISIONS RELATING TO CORPORATE TAX SHELTERS

The Administration's Budget includes no fewer than 16 provisions dealing in one way or another with the issue of aggressive corporate tax shelters.[1] We will not in this statement provide detailed comments on the Administration's proposals. The Treasury Department has stated that it will shortly release a "white paper" on the issues presented by the corporate tax shelter problem. It is our plan to provide an analysis of the proposals following issuance of the Treasury white paper. In the meantime, we wish to offer our own comments on the corporate tax shelter problem and suggest a course of action.

The sheer number of proposals included in the Budget obviously reflects the Treasury Department's concern about the growing corporate tax shelter phenomenon. Our initial conclusion is that some of Treasury's proposed solutions are vague and incomplete. Thus, we believe that the Committee should carefully and critically analyze the proposals included in the Budget, their possible overlap and their potential impact on normal business transactions.

However, the Tax Section strongly shares the Treasury's concerns about very aggressive positions being taken by taxpayers and their advisors in connection with tax-motivated transactions and the fact that these transactions frequently are being mass marketed. We think Congressional action to address this problem is definitely called for. We understand that the Chairman shares these concerns.

A. The Problem

We have witnessed with growing alarm the aggressive use by large corporate taxpayers of tax "products" that have little or no purpose other than reduction of Federal income taxes. We are particularly concerned about this phenomenon because it appears that the lynchpin of these transactions is the opinion of the professional tax advisor. The opinion provides a level of assurance to the purchaser of the tax plan that it will have a good chance of achieving its intended purpose. Even if the taxpayer ultimately loses, the existence of a favorable opinion is generally thought to insulate the taxpayer from penalties for attempting to understate its tax liability. While some might dispute this as a legal conclusion, recent cases tend to support the absence of risk for penalties where favorable tax opinions have been given.

Because of our concern that opinions of tax professionals are playing such a key role in the increased use of corporate tax shelters, the Tax Section has established a task force to consider amendments to the American Bar Association's rules for standards of practice of our members. We undertook a similar project in the early 1980s when so-called "retail" tax shelters aimed at high-income individuals proliferated. That effort resulted in the promulgation of ABA Formal Ethics Opinion 346 and in the adoption of a similar standard in Treasury's Circular 230, which contains the ethical standards that tax professionals must observe under threat of losing the right to practice before Treasury and IRS. We expect that our task force will recommend changes in these disciplinary rules to address the current tax shelter phenomenon.

Likewise, we are concerned about the blatant, yet secretive, marketing of these corporate tax shelters. As discussed below, unless penalties that cannot be seen as mere minor costs of doing business by the promoters are imposed upon the promoters, and strongly and diligently enforced, no end is or will be in sight.

The tax shelter products that concern us generally have the following features. First, there is a discrepancy between the book treatment of the transaction and its treatment for Federal income tax purposes (stated simply, the creation of a significant tax loss with no similar loss for financial accounting purposes). Second, there is little economic risk to the corporation from entering into the transaction other than transaction costs. Third, one party to the transaction is frequently what Treasury refers to as "tax indifferent" (that is, a foreign taxpayer not subject to U.S. tax, a U.S. organization exempt from Federal income tax, or a taxable U.S. corporation that has large net operating loss carryovers). Finally, and most telling, it is generally assumed by the promoter, by counsel and apparently by the taxpayer itself that, if the "product" comes to the attention of Treasury or Congressional staffs, it will be blocked, but almost invariably prospectively, by administrative action or by legislation.

The hallmark of the aggressive tax shelters that concern us is not the use of tax benefits consciously granted by Congress (such as accelerated depreciation or credits), nor is it the use of tax-favored methods of accomplishing a business acquisition or financing. It is transactions that achieve economic results that the parties themselves would generally concede have little or no support in sound tax policy, but achieve very substantial tax benefits that, the parties assert, are not clearly prohibited by existing law. It is not surprising, therefore, that explicit or implicit confidentiality is also a common feature of today's tax shelter products.

The modern tax shelter transaction usually feeds off a glitch or mistake in the tax law, often one that is accessed by finding, or even creating, a purported business purpose for entering into the transaction. Tax shelter products that capitalize solely on mistakes in the Code are not as troublesome to us as those that also depend upon the existence of questionable facts to support the success of the product. Mistakes in the Code will eventually be discovered and corrected by the IRS, Treasury or the tax-writing Committees of Congress. When mistakes are discovered and corrected by legislation, it is the prerogative of Congress to determine whether the situation warrants retroactive application of the correction.

Far more troublesome is the practice of reducing taxes by misusing sound provisions of the Code. Exploitation of rules that generally work correctly by applying them in contexts for which they were never intended, supported by questionable factual conclusions, is the hallmark of the most aggressive tax shelters today. Discovery on audit is the tax system's principal defense, but, in a self-assessment system, the audit tool cannot be expected to uncover every sophisticated tax avoidance device. The law should provide clear incentives for taxpayers to comply with the rules and, in all events, properly to disclose the true substance of complex transactions.

Thus, our concern is centered on the transaction that depends upon a dubious factual setting for success. Foremost among these is the conclusion or assertion that there is a real, non-tax business purpose or motive for entering into the transaction. There are others. In some cases, it will be essential for the opinion-giver to conclude that the transaction in question is not a step in a series of transactions which, if collapsed into a single transaction, would not achieve the tax benefits sought. A third type of factual underpinning often essential to the delivery of a favorable tax opinion is the permanence, or intended long-term economic viability, of a business arrangement among the parties (for example, a joint venture, partnership or newly formed corporation). A venture may be represented to be a long-term business undertaking among the parties, when in fact it is a complex, single-purpose, tax-motivated arrangement which was formed shortly before and will be dissolved shortly after the tax benefit is realized.

In most of these cases, the tax law is quite clear. Without the presence of a sufficient business purpose, unless the transaction is not a step in a series of related events, or unless the new business venture represents a valid business arrangement with a sufficient degree of longevity, the tax benefit claimed is simply not available under existing law. That bears repeating. Most if not all of the tax shelter transactions that concern us depend upon avoidance of well-established principles of law such as the business purpose doctrine, the step transaction rule, the substance-over-form doctrine, or the clear reflection of income standard. Thus, the role of the opinion giver often disintegrates into the job of designing or blessing a factual setting to support applicability of the Code provisions that will arguably produce the desired benefit. The result is the application of a provision of the Internal Revenue Code that otherwise has a logical and sound policy purpose to reach a result that is nonsensical, and in some cases almost ludicrous.

A sad additional fact is that all parties to these transactions know there is a substantial likelihood that the device employed, including the imaginative assertion of the proper factual setting, will not be uncovered by IRS agents even if the corporation is audited, as most large taxpayers are. The tax law is too complex and the

returns of major taxpayers are too voluminous. Many tax shelter products involve numerous parties and complex financial arrangements, and invoke very sophisticated provisions of the tax law. It often takes extensive time and painstaking analysis by well-informed auditors to ascertain that what is reported as a legitimate business transaction has little, if any, purpose other than the avoidance of Federal income taxes. Accordingly, there is a very reasonable prospect that a product will win the "audit lottery." This aspect of the problem is compounded by the fact that present law gives no reward for full disclosure in the case of corporate tax shelter transactions.

Let me emphasize that the transactions that concern us—and the tax opinions that support them—are altogether different than attempts to reduce taxes on a business transaction that has a true business or economic objective independent of reduction of Federal income taxes. But drawing distinctions between tax-dominated transactions and true business transactions that may involve major tax planning is sometimes tricky, particularly in the legislative context. For that reason, we recommend that the Congressional response to the tax shelter problem be measured and appropriate. It should not overreach; it should not inhibit legitimate business transactions. As we all know, taxpayers clearly have the right to arrange their financial affairs to pay the minimum amount of tax required under the law. Our desire is that in doing so they not avoid the intent of the law by benignly neglecting the judicial and administrative principles in which the tax law is quite properly grounded. These principles require the presence of substantial non-tax business or economic objectives in all business transactions; these principles are an essential part of the fabric of our tax law.

B. Possible Solutions

We recommend that you require clear disclosure of the true nature and economic impact of specified classes of transactions. The emphasis should be on the quality and clarity of the disclosure, not the volume of material furnished. You should also require that the individuals implementing the transaction be personally accountable for the factual conclusions on which the transaction is grounded. No taxpayer, or taxpayer's advisor, has the right to ignore or obfuscate the actual facts of a transaction in order to support a legal position relied upon to produce a desired tax benefit. Nor should any such party be allowed to claim a significant tax benefit relying on crucial facts without having the duty to investigate their accuracy.

Thus, we recommend that provisions be added to the Code that would give the parties a clear incentive to focus on the essential facts relied upon to bring the transaction within the applicable Code provisions. If that factual underpinning, and its legal significance, is properly understood by the taxpayer and its advisors at the time the transaction is entered into, and is clearly disclosed on the tax return, then the system will work much better. The facts to which we refer include objective facts that bear on the subjective business purpose inquiry the law requires. The inquiry would not need to state a conclusion as to the taxpayer's state of mind, but the objective facts that indicate the taxpayer's actual intent or purpose should be fully understood by the parties and clearly disclosed and explained on the tax return.

In order to focus the inquiry on the facts relied upon to support these tax-sensitive transactions, there should be a realistic possibility that penalties will be levied where the non-tax economic benefits from a transaction are slight when compared to the potential tax benefits. We agree with the Treasury Department that, in these types of transactions, promoters who market the tax shelter and professionals, including attorneys, who render opinions supporting them should face penalties as well as the taxpayer. The Treasury Department has, in addition, suggested that tax indifferent parties should face a potential tax if the transaction is ultimately found wanting. Under proper circumstances, that may be appropriate as well. All essential parties to a tax-driven transaction should have an incentive to make certain that the transaction is within the law.

In addition to better disclosure and accountability for the factual underpinnings of large tax shelter transactions, we think a substantive clarification of the law is likely necessary. Taxpayers and their advisors sometime support tax-driven transactions by citing court opinions that are not consistent with the mainstream of the case law. For example, authorities exist which can be read to say that even a scintilla of pre-tax profit potential, or any plausible non-tax purpose, no matter how insignificant, will support a tax-driven transaction. Treasury has proposed a significant broadening of the Commissioner's authority under Code section 269 to disallow claimed tax benefits in such cases. We do not think such a broad change in section 269 is appropriate or desirable. The application of section 269 is not uniform and leaves too much discretion to the agent in the field.

In lieu of Treasury's proposed section 269 amendment, we suggest a new Code provision applicable only to transactions to which the economic substance doctrine now applies. In such cases, the Code should make it clear that the expected economic benefits of the transaction must be meaningful (i.e., more than a de minimis or nominal amount) in relation to the expected tax benefits.[2] We think this would serve to restate and reinforce the intent of Congress, the rule applied by most courts and the advice given by most, if not all, careful tax advisors. It would remove the cover questionable or unclear judicial opinions now provide for less careful advisors.

You may hear the argument that changes such as those we are advocating will cause uncertainty and unreliability in the tax law. As noted earlier in our testimony today and in our April 15 testimony, the Tax Section strongly supports, and indeed urges, as much simplicity and clarity as possible throughout the Code. However, total certainty is impossible where complex transactions are involved. This is particularly true when the parties seek to avoid judicial principles developed to deny tax benefits to overly tax-motivated transactions. Taxpayers and their advisors know that relative certainty can easily be achieved in legitimate business transactions by steering a safer course and staying in the middle of the road. The more clearly the transaction stays within established judicial and administrative principles, the more certainty is assured. When they venture to the outer edge, certainty cannot be assured, nor should it be; the parties who consciously risk going over the edge should clearly understand there are severe consequences for doing so.

In an important way, the protection of common law and general anti-abuse principles contributes to certainty and reliability in the tax law. Tax shelter transactions commonly depend in large part on very literal interpretations of the words of the Code or regulations. They utilize the clarity in the way the tax law is written to undermine its purpose. In so doing, these transactions discourage the writing of clear and certain tax law in favor of more vaguely stated principles that cannot be so easily misused. One of the important results of anti-abuse principles developed by the courts is the protection of clearly-stated provisions of law on which taxpayers can rely with certainty for every day business transactions.

As you can see, we think the best and most effective route for this Committee to follow in dealing with the corporate tax shelter problem is more meaningful and clearer disclosure, with proper due diligence of, and accountability for, the factual conclusions relied upon by the taxpayer. This may, perforce, have to involve an expanded penalty structure, as well to provide the appropriate incentives and disincentives for certain types of behavior. If this is done properly, there should be no need for some of the more complex and broader changes Treasury has proposed. Consistent with our often-expressed views on simplicity, we would encourage the Committee to be mindful of the significant complexity that could be imposed on thousands of taxpayers who are not employing tax shelters if the solutions selected to address this problem are overly broad.

Finally, this Committee and the Congress need to be certain that the Internal Revenue Service's resources are adequate to deal with the tax shelter issues. In part, promoters of tax shelters are successful in marketing their products because they and large taxpayers have concluded that the IRS is less to be feared today. They are aware of the problems within the agency, the Congressional criticism it has received, and its dwindling resources. Our recommendations are directed primarily at more meaningful reporting and disclosure for "large tax shelters." We think such changes, together with expanded penalties, will increase voluntary compliance. However, the Internal Revenue Service must have the resources to analyze the information reported and to pursue noncompliance vigorously, or the additional reporting will be a paper tiger.

C. Specific Proposals

We suggest the following changes in the Internal Revenue Code to accomplish the goals outlined:

1. Require specific, clear reporting for large "tax shelters"

A question should be added to the corporate income tax return requiring the taxpayer to state whether any item on the return is attributable to an entity, plan, arrangement or transaction that constitutes a "large tax shelter" (as defined below). If the answer is yes, specific information describing the nature and business or economic objective of the transaction should be required to be furnished with the return, including:

(a) A detailed description of the facts, assumptions of facts and factual conclusions with respect to the business or economic purposes or objectives of the transaction that are relied upon to support the manner in which it is reported on the return;

(b) A description of the due diligence performed to ascertain the accuracy of such facts, assumptions and factual conclusions;

(c) A statement signed by one or more corporate officer with detailed knowledge of the business or economic purposes or objectives of the transaction that the facts, assumptions or factual conclusions relied upon in reporting the transaction are true and correct as of the date the return is filed, to the best of such person's knowledge and belief. If the actual facts varied materially from the facts, assumptions or factual conclusions relied upon, the statement would need to describe such variances;

(d) Copies of any written material provided in connection with the offer of the tax shelter to the taxpayer by a third party;

(e) A full description of any express or implied agreement or arrangement with any advisor, or with any offeror, that the fee payable to such person would be contingent or subject to possible reimbursement; and

(f) A full description of any express or implied warranty from any person with respect to the anticipated tax results from the tax shelter.

The questions should elicit clear and accurate responses, not voluminous material that might serve to obfuscate the true nature of the transaction. The required statements of business officers of the taxpayer should impose personal accountability for the accuracy of the factual underpinning of the transaction.

2. Broaden the substantial understatement penalty to cover outside advisors, promoters and "tax indifferent parties"

If the substantial understatement penalty of existing law is imposed on the taxpayer, a penalty should be imposed on any outside advisors who rendered favorable tax opinions, and promoters who actively participated in the sale, planning or implementation of the tax shelter. The same type of penalty should also be imposed on any "tax indifferent party," unless any such party can establish that it had no reason to believe the transaction was a tax shelter with respect to the taxpayer.

Such penalties should be set at levels commensurate with the fees or benefits such parties stood to realize if the transaction were successful. In addition, separate procedural rules should be provided to assure such parties of due process, similar to the rules applicable in the case of penalties on tax return preparers.

3. Define "large tax shelter" for purposes of the substantial understatement penalty

The definition of "tax shelter" presently contained in section 6662(d)(2)(C)(iii) should be retained. The term "large tax shelter" would be defined as any tax shelter involving more than $10 million of tax benefits in which the potential business or economic benefit is immaterial or insignificant in relation to the tax benefit that might result to the taxpayer from entering into the transaction. In addition, if any element of a tax shelter that could be implemented separately would itself be a " large tax shelter" if it were implemented as a stand-alone event, the entire transaction would constitute a "large tax shelter."

4. Provide specific new penalties in the case of tax shelters that fail to disclose the required information (whether or not the tax shelter is ultimately sustained or rejected by the courts)

In a self-assessment system, accurate reporting and disclosure are essential. Where that does not occur, stringent penalties are necessary. This is particularly true in the case of large and complex tax-motivated transactions. There should be a clear disincentive to playing the audit lottery in these types of transactions. This could be coupled with a reduction in the rate of any otherwise applicable penalties for those taxpayers that comply with the disclosure requirements set forth in 1, above. This would provide an incentive (and not just a disincentive) to make such disclosures.

5. Clarify that, where the economic substance doctrine applies, the nontax considerations must be substantial in relation to the potential tax benefits

Most courts, as well as careful tax advisors, apply the economic substance doctrine by weighing the potential tax and nontax results of a contemplated transaction. We think this is entirely consistent with long-standing Congressional intent Codification of this rule would provide a clear statement of the standard generally applied by courts under the economic substance doctrine, and would prevent reliance on unclear or conflicting judicial articulations of that standard in rendering opinions on tax-driven transactions. Any such codification would not, however, displace current law where the business purpose test is currently applied without a weighing of the tax and business objectives, such as the business purpose rules applied in the context of section 355 and in most tax-free corporate acquisitions.

6. Articulate a clear Congressional policy that existing enforcement tools should be utilized to stop the proliferation of large tax shelters

Congress should make clear its view that examination of large tax shelter transactions by the Internal Revenue Service should be considered a tax administration priority. This should include the application of both civil and criminal penalties when appropriate.

Mr. Chairman, the Section of Taxation is convinced that the concerns being voiced about corporate tax shelters are very real; these concerns are not hollow or misplaced, as some would assert. We deal with corporate and other major taxpayer clients every day who are bombarded, on a regular and continuous basis, with ideas or "products" of questionable merit. The sophistication of these proposals and the daunting task they present to IRS auditors lead us to conclude that Congress cannot, and should not, ignore this growing—and very troubling—trend. We have offered to you today what we view to be workable solutions that do not overreach. We would be pleased to discuss them further with you and your staff.

TAXATION OF INVESTMENT INCOME OF TRADE ASSOCIATIONS

Finally, on behalf of the entire American Bar Association, I wish to raise concerns about one of the proposals included in the President's Budget. We have been asked by the ABA to convey to this Committee its grave concerns about this proposal.

The proposal would tax all net investment income of trade associations, business leagues, chambers of commerce and professional sports leagues (under IRC * 501(c)(6)) in excess of $10,000 per year. The tax would be imposed at generally applicable corporate rates. The tax would not be imposed to the extent such net income was set aside to be used for any charitable purpose described in IRC * 170(c)(4).

The principal basis for the Administration's proposal is the erroneous assumption that the endowments accumulated by some trade associations represent excessive dues payments by the members of these organizations. Thus, the Administration argues, the investment income earned on these excessive dues payments should be subject to tax just as they would have been if the dues had been set at the proper level, and the "excess" invested individually by the members of the association.

The ABA has serious reservations about this analysis. Even if it were, for purposes of argument, correct to assume that these endowments represent excessive dues payments received in earlier years, the investment income earned on the excess (whether earned by the trade association or by its members) has the practical effect of reducing dues that become payable in future years. Therefore, the only significant consequence of permitting these excess dues to be invested by a tax exempt entity without taxation is to defer the government's receipt of the tax on such income from the year of the initial dues payment to the year in which the excess dues are applied to carry out the trade association's exempt activities.

We understand the theoretical economic analysis that underlies this proposal. We would submit, however, that this theoretical analysis ignores the real world, practical implications of the proposal. As a large trade association, the ABA must point out that this proposal will discourage the accumulation of endowments, severely hamper multi-year planning, and limit the ability of these organizations to fund socially desirable programs.

For example, these organizations (like any other) fund large outlays over time, rather than in the year of the outlay. Dues of trade associations and other section 501(c)(6) organizations are set at levels necessary to fund such outlays by allowing them to accumulate funds for capital expenditures, etc. A tax on investment income would make planning for such large expenditures very difficult, and highly impractical. The organizations would be forced either to collect their dues on a level basis and incur the tax (thus necessitating higher, fully deductible dues to make up the difference) or to lower their dues, not accumulate any savings, and then make special assessments in the year of the large expenditure in order to fund the project (with such special assessments also being tax deductible). There is simply no good reason to put these organizations to that choice.

There is also no valid policy reason for singling out trade associations for this treatment, but excluding other mutual-benefit organizations such as labor unions, agricultural and horticultural organizations, and civic associations. All these types of organizations, although exempt from income tax under different provisions of the Code, are essentially treated the same for tax purposes. Given this identity of treatment, it is not appropriate to single out organizations exempt from tax under section 501(c)(6) for this new investment tax.

CONCLUSION

Mr. Chairman, thank you for the opportunity to appear before the Committee today. I will be pleased to respond to any questions.

ENDNOTES

[1]: While we refer to "corporate" tax shelters, consistent with Treasury's proposed solutions, the problem is not necessarily limited to corporate taxpayers. Consideration should be given to making some or all of the solutions adopted by this Committee applicable to all large business taxpayers, lest we soon witness a surge of "tax products" directed at limited liability companies, large partnerships, trusts and wealthy individuals.

[2]: This new rule would not alter the law applicable to most corporate acquisitions or divisions, where established law and IRS administrative policy require a significant and meaningful business purpose, but involve no weighing of the tax versus business benefits of the transaction.

PREPARED STATEMENT OF NANCY H. WORMAN

Mr. Chairman and members of the Committee, I am Nancy H. Worman, Executive Vice President, Finance of KeyCorp. As chairman of the Taxation Committee of the American Bankers Association (ABA), I am pleased to appear before you today to present the views of the ABA on the revenue raising provisions of the Administration's fiscal year 2000 budget proposal.

The ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, and savings banks—makes ABA the largest banking trade association in the country.

The Administration's 2000 budget proposal contains a number of significant proposals about which we are once again deeply concerned. Many of the subject revenue provisions are, in fact, thinly disguised tax increases rather than "loophole closers." Others involve reductions in tax expenditures that were enacted to achieve a specific social or economic policy objective. As a package, they could inhibit job creation and inequitably penalize business. The package may also lead to the reduction of employee and retiree benefits provided by employers.

I will limit my comments today to the most troublesome of the Administration's proposals.

REVENUE INCREASE MEASURES

Modify the Corporate-Owned Life Insurance Rules

The ABA strongly opposes the Administration's proposal to modify the corporate-owned life insurance (COLI) rules. We urge you not to enact any further restrictions on the availability of corporate-owned life insurance arrangements. We believe that the Administration's proposal will have unintended consequences that are inconsistent with other congressional policies, which encourage businesses to act in a prudent manner in meeting their liabilities to employees. Corporate-owned life insurance as a funding source has a long history in tax law as a respected tool. The Health Insurance Portability Act of 1996 eliminated deductions for interest paid on indebtedness with respect to policies covering officers, employees, or financially interested individuals. However, that legislation allowed deductions with respect to indebtedness on COLI covering up to 20 "key persons" (defined generally as an officer or a 20 percent owner). The Taxpayer Relief Act of 1997 applied a pro rata formula to disallow the deduction of a portion of a taxpayer's total interest expense with respect to COLI. That legislation provided a broad exception for policies covering 20 percent owners, officers, directors, or employees. Accordingly, Congress has effectively ratified continued use of COLI, pursuant to the requirements of those rules. In this connection, taxpayers have, in good faith, made long term business decisions based on existing tax law. They should be protected from the retroactive effects of legislation that would result in substantial tax and non-tax penalties.

Moreover, federal banking regulators recognize that corporate-owned life insurance serves a necessary and useful business purpose. Bank regulatory guidelines confirm that purchasing life insurance for the purpose of recovering or offsetting the expense of employee benefit plans is an appropriate purpose that is incidental to banking.

The subject provision would effectively eliminate the use of corporate-owned life insurance to offset escalating employee and retiree benefit liabilities (such as health insurance, survivor benefits, etc.). It would also penalize companies by imposing a retroactive tax on those that have purchased such insurance. Cutbacks in such programs may lead to the reduction of benefits provided by employers. We urge you, once again, to reject this revenue proposal.

However, should legislative change in this area be contemplated, certain principles must apply. Any proposal should:

- Apply equally to all businesses purchasing COLI. Banks should not be solely targeted.
- Be prospective and not put businesses that made decisions based on existing law in a disadvantaged position.
- Only apply to contracts entered into after the date of enactment. Any premiums paid after the date of enactment with respect to contracts written prior to the date of enactment should be grandfathered.
- Continue to allow tax-free exchanges of insurance contracts.
- Create a "safe harbor" exception to general interest disallowance for COLI to protect a certain level of COLI going forward.

Increased Information Reporting / Substantial Understatement Penalties

The ABA strongly opposes the Administration's proposal to increase penalties for failure to file information returns. The Administration's reasons that the current penalty provisions may not be sufficient to encourage timely and accurate reporting. We disagree. The banking industry prepares and files a significant number of information returns annually in good faith for the sole benefit of the Internal Revenue Service (IRS). The suggestion that the Administration's proposal closes "corporate loopholes" presumes that financial institutions are non-compliant, a conclusion for which there is no substantiating evidence. Further, there is no evidence available to support the assertion that the current penalty structure is inadequate. Certainly, the proposed penalty increase is unnecessary and would not represent sound tax policy. We urge you, once again, to reject this revenue proposal.

The ABA also opposes the Administration's proposals to modify the substantial understatement penalty. The proposed increases would be overly broad and could penalize innocent mistakes and inadvertent errors. The establishment of an inflexible standard could effectively discourage legitimate business tax planning. We urge you to reject this revenue proposal.

S Corporations—Repeal Section 1374 for Large Corporations

The ABA opposes the proposal to repeal Internal Revenue Code section 1374 for large S corporations and treat the conversion of C corporations to S corporations with greater than $5 million in value as a taxable liquidation. The new rule would also apply to the merger of a C corporation into an S corporation.

Section 1374 imposes a tax on built-in gains when the property is disposed of during the ten-year period following conversion. The Administration would require that such gains be recognized immediately upon conversion rather than disposal. The proposal would accelerate net unrealized built-in gains (BIG) and create a corporate level tax on BIG assets while also creating a shareholder level tax with respect to their stock. The BIG tax would apply to gains attributable to assets held on the first day, negative adjustments due to accounting method change, intangibles such as core deposits and excess servicing rights and recapture of the bad debt reserve.

Financial institutions have only recently been allowed by Congress (per the Small Business Job Protection Act of 1996) to elect subchapter S status. Effectively, this proposal would close the window of opportunity for them to elect sub S by making the cost of conversion prohibitively expensive, which we believe is contrary to congressional intent of removing unreasonable burdens placed on S corporations. We urge you to reject the Administration's proposal and instead, to enact legislation that would assist community banks in qualifying under the current subchapter S rules.

Structured Settlements

The Administration's Fiscal Year 2000 budget contains a proposal to impose an excise tax on "the purchase of structured settlements." These proposals could have unintended and harmful consequences for banking institutions that make loans, pursuant to blanket security agreements, to consumers who receive structured settlement payments.

A blanket security agreement generally provides that a loan made by a lending institution is secured by all property (tangible and intangible) that the borrower presently owns or subsequently acquires. As currently drafted, the proposal could impose excise taxes on banking institutions that use such agreements to secure

loans, even though the intent is never to ultimately obtain the structured settlement payments from the borrower. Indeed, a financial institution may unknowingly become subject to the excise tax on outstanding loans to a recipient of structured settlement payments upon rollover or renewal of the loan, or if the borrower acquires settlement payment rights subsequent to receiving the secured loan. The lending institution would be subject to tax even though it did not rely on the existence of the settlement either for the decision to make the loan or for repayment purposes. In fact, the institution might not even be aware of the existence of the borrower's right to a structured settlement.

Certain Members of Congress believe that by imposing the excise tax on the amount of the discount, rather than on the entire amount of the payment stream, the proposal is more targeted than the prior Administration proposal. However, the proposal remains overly inclusive in that banking institutions may unknowingly be unfairly snared in a punitive tax trap.

Further, enactment of the proposed legislation as currently drafted would impose new and unduly burdensome administrative costs on lenders, who would be forced to research and re-write their outstanding loans in the attempt to avoid imposition of this unwarranted excise tax. We urge you to reject the Administration's proposal.

Eliminate Dividends-Received Deduction for Certain Preferred Stock/Modify the Rules for Debt-Financed Portfolio Stock

The ABA strongly opposes the Administration's proposals to deny the dividends-received deduction for non-qualified preferred stock and to modify the standard for determining whether portfolio stock is debt financed. The Administration states that taxpayers have taken advantage of the dividends received deduction for payments on instruments that economically appear to be more akin to debt. We disagree. The ABA, along with other members of the financial services community, has steadfastly opposed all attempts to further limit the dividends received deduction.

Originally corporations were not taxed on dividends received from other corporations in order to prevent multiple taxation of corporate earnings as the earnings passed from one corporation to another—often within the same chain of ownership. The deduction was first cut back (to 85 percent) in an attempt to simplify corporate structures and to discourage the use of multiple entities for tax avoidance. The deduction remained at 85 percent until 1986, when it was reduced to 80 percent. It was further scaled back in 1987 to 70 percent. In several years since, the deduction has been identified as a possible revenue item almost anytime that revenue is needed. Currently, the dividends received deduction is a necessary tool in maintaining corporate viability rather than an implement of tax avoidance. The Administration's proposal would impose a full triple tax on profitable banks and thrifts. It would also disrupt the preferred stock market with resulting harm to investors, such as IRAs, pension funds and corporations. Clearly, this triple tax could not and should not be labeled a "corporate loophole." We urge you to reject the Administration's proposal.

The proposal to modify the rules for debt-financed portfolio stock should also be rejected. In an attempt to tighten the "directly attributable" standard, the Administration proposes a pro rata formula that would be overly inclusive and would effectively eliminate the dividends received deduction for financial institutions.

Additionally, the subject proposals would also effectively increase state tax liabilities for institutions that file separate state tax returns with respect to subsidiaries operating in certain states, since federal taxable income is used in calculating state tax liabilities. We strongly urge that these proposals be rejected.

Disallow Interest on Debt Allocable to Tax-Exempt Obligations

The ABA strongly opposes the Administration's proposals to extend section 265 pro rata disallowance of tax-exempt interest expense and repeal the two percent de minimis exception for non-bank financial intermediaries. The Administration reasons that since it is difficult to trace funds within all financial intermediaries, non-banking financial intermediaries should be included in the pro rata disallowance rule that applies to banks.

The proposed change would increase financing costs for state and local government, and increase federal tax complexity. Moreover, it can be expected to affect the cost and availability of municipal credit. Tax reform legislation enacted in 1982, 1984 and 1986, reduced the interest expense banks could deduct from holdings in municipals, reducing their after-tax return on these investments below that of other investments. This caused a dramatic and steady decline in bank holdings of tax exempt securities. The proposed change could be expected to have a similar impact on local community finance.

Expand Reporting of Cancellation of Indebtedness Income

The Administration's budget proposes to require that information reporting on discharges of indebtedness be done by any entity involved in the business of lending money. The ABA opposes this proposal, as it would increase the administrative burdens and costs borne by credit card companies and other financial institutions and, ultimately, taxpayers. We continue to believe that the level of reporting required solely for IRS purposes is unduly burdensome on financial institutions. We urge you to reject the Administration's proposal.

Require Current Accrual of Market Discount

The ABA opposes the Administration's proposal to require current accrual of market discount by accrual method taxpayers. The proposal would exacerbate the incongruity in the current tax treatment of market discount, increase administrative complexity and raise taxes on business unnecessarily. Market discount, the difference between the bond's purchase price and its face value, is treated as interest income. Under current law, taxpayers are not required to recognize market discount until the bond is sold or redeemed (similar to capital gain). The Administration's proposal would require accrual method bondholders to pay tax on market discount annually. However, the seller of the bond would continue to incur a capital loss, while the buyer would continue to recognize ordinary income earlier in the process, further aggravating the lack of symmetry in the treatment of market discount. We urge you to reject the Administration's proposal.

Modify Treatment of Start-up and Organizational Expenses

The Administration's proposal would lengthen the amortization period for start-up and organizational expenses in excess of $55,000 from 5 to 15 years. Such change could have a negative impact on the formation of small financial institutions as well as financial services entities, which typically involve start-up costs well in excess of the threshold amount. We urge you to reject the Administration's proposal.

Limit Tax Benefits for Lessors of Tax-Exempt Use Property

The ABA opposes the Administration's actions with respect to tax-exempt use property. Recent IRS action in this area would retroactively impact agreements that were entered into in accordance with the Internal Revenue Code. Since this proposal is subject to congressional action, we believe that any change to the current treatment of such transactions should be prospective. Action by the IRS is not appropriate at this time. We are most concerned about legislation or regulations that would have a negative impact on taxpayers that have, in good faith, made long term business decisions based on existing tax law. They should be protected from the retroactive effects of legislation or regulations that would result in substantial tax and non-tax penalties.

Other Issues

The Administration's proposal contains a number of other provisions that will negatively impact many different types of appropriate business activities. Some are overly broad, which may have unintended consequences in the long and short term. The impact of those provisions will affect businesses in various ways, depending upon their structures. Some of the consequences are foreseeable; others are unforeseeable. One result may be a restriction or change in products and services provided to consumers. Another may be a restriction on the ability of financial institutions to compete globally.

CONCLUSION

The ABA appreciates having this opportunity to present our views on the revenue raising provisions contained in the President's fiscal year 2000 budget proposal. We look forward to working with you in the future on these most important matters.

Response of Ñancy Worman on behalf of the American Bankers Association to Senator Chafee with respect to Hearing of April 27, 1999

Question 1.

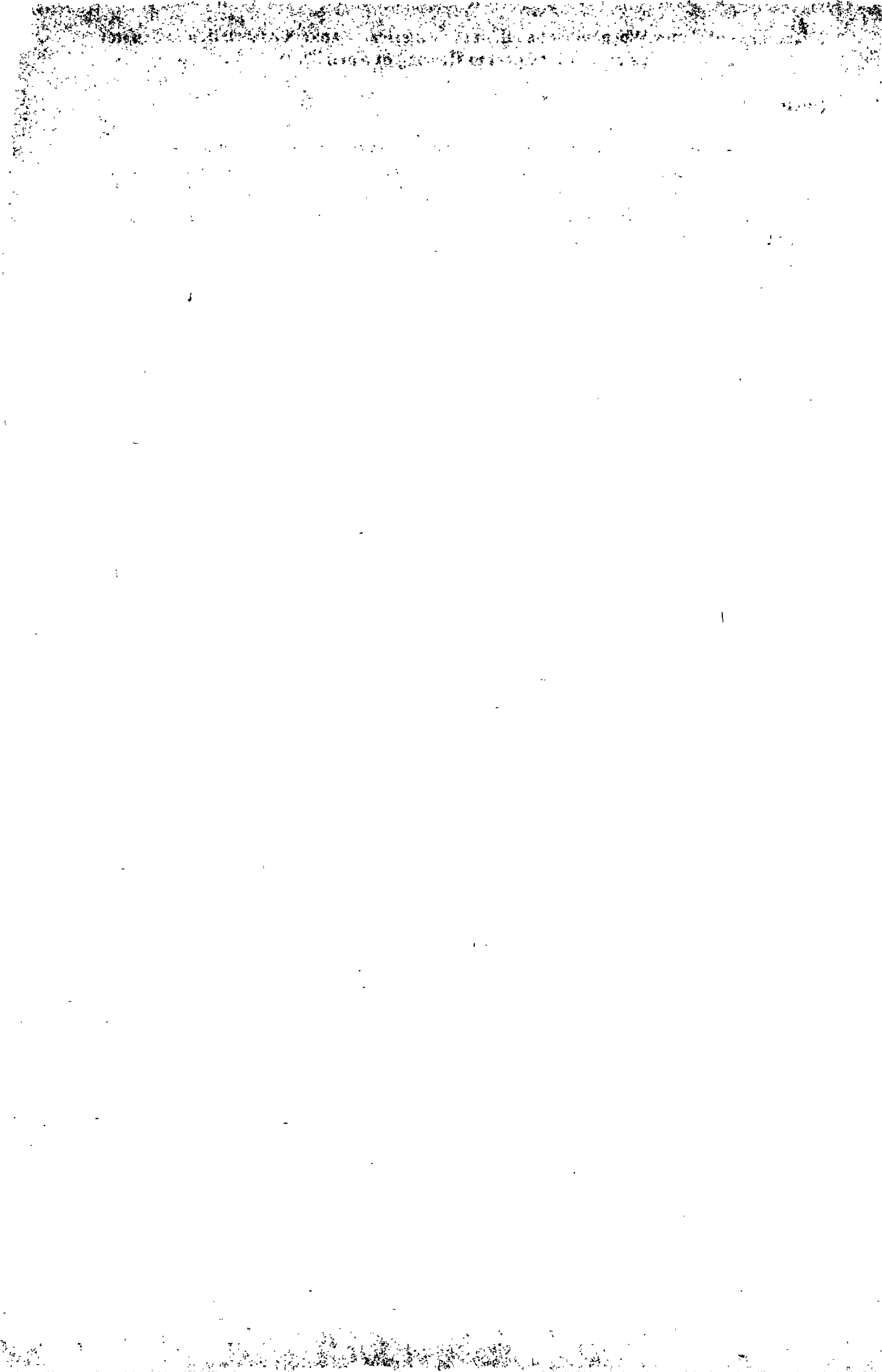
I am confused about the ABA's opposition to the excise tax on structured settlements. Is it the ABA's position that banks lend against structured settlement payments as collateral, even though the payments cannot be pledged or assigned? I understand that banks may take these payments into consideration when making a loan, but your testimony makes me think banks are attempting to obtain a security interest in these payments. I do not think that is possible the way the current law is written.

It is not our position that banks lend against structured settlements as collateral. However, we are concerned about the potential for imposition of the excise tax with respect to bank loans made in the ordinary course of business under certain blanket security agreements. State law on the subject is not uniform and it is not clear that structured settlement payments can not be pledged or used as a security interest. The proposed legislation would create a degree of uncertainty as to whether such loans are covered by the proposed legislation. Enactment of the proposed legislation would impose a new administrative cost burden on banks (that they otherwise would not have) to review and re-write impacted loan documents.

Question 2.

It seems to me that banks should support proposals like the Structured Settlement Protection Act because it protects the income stream -- namely the structured settlement payments -- on which the bank made the loan, from being sold to a factoring company. Absent this proposal, one of your members might make a loan to an injured victim assuming that it would be repaid from the structured settlement payment only to have that income stream sold to a factoring company! Doesn't this proposal provide banks with greater protection?

Banks do not as a practice lend against structured settlement agreements. However, we are concerned that the impact of the proposal would differ from state-to-state, increasing confusion and uncertainty. The ABA is sympathetic to, and does not oppose, the underlying objective of the proposed legislation. However, we suggest the proposal contain language that specifically excludes a pledge to a bank in the ordinary course of business. We are most interested in working with the Committee to resolve our concerns. In this connection, we are currently drafting proposed legislative language for your consideration. We look forward to further discussion.



COMMUNICATIONS

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION

[SUBMITTED BY HOGAN & HARTSON, LLP]

SUMMARY

The American Bankers Association testimony regarding the President's proposed penalty tax on factoring company purchases of structured settlement payments from injured victims expresses concern that banks could be subject to the proposed penalty tax if they make loans secured by blanket security interests to consumer borrowers who receive structured settlement payments.

In limiting its concern to the blanket security interest context, the American Bankers Association's testimony implicitly acknowledges that banks do not make loans against the security of structured settlement payments, because bankers recognize that the payments are non-transferable by the structured settlement recipient and cannot be validly pledged or encumbered as collateral for a loan. For similar reasons, banks do not lend against the security of military retirement, Social Security, and other such protected payment streams.

A bank's use of a blanket security agreement for a loan to a structured settlement recipient should create no realistic possibility that the proposed penalty tax would be triggered:

- Banks rarely use blanket security agreements for consumer loans.
- Any blanket security interest that otherwise might extend to structured settlement payments generally would be legally ineffective under the Uniform Commercial Code and under state laws restricting transfers of annuity payments and transfers of recoveries under various types of claims.
- Unless the bank took some affirmative step to assert or realize upon its purported security interest in the structured settlement payments, the bank could not be said to have acquired the structured settlement payment rights for consideration—the transaction that is necessary to trigger potential penalty tax liability under the President's proposal and the Structured Settlement Protection Act.
- If, despite all of this, a bank has a lingering concern about the theoretical possibility that the proposed penalty tax on factoring company purchases of structured settlement payments from injured victims could somehow be triggered in a rare case, in light of the prospective effective date of the legislation the bank could readily and simply modify its loan documents on a going forward basis to exclude structured settlement payments upon which the bank does not intend in any event to rely for collateral.

Banks and hospitals have been willing to recognize the structured settlement payments as an assured source of income when extending credit on an *unsecured* basis. This practice can continue, clearly unaffected by the structured settlement protection legislation.

Indeed, the American Bankers Association ought to be in favor of the President's proposal and the bipartisan Structured Settlement Protection Act because such legislation protects the banks' current ability to lend on an unsecured basis to structured settlement recipients in reliance on their assured future structured settlement payments, without fearing that settlement recipients may have secretly sold and redirected the payments to a factoring company in violation of the anti-alienation restrictions of the structured settlement.

I. STRUCTURED SETTLEMENT PAYMENTS ARE NON-ALIENABLE, IN ORDER TO PROTECT THE INJURED VICTIM AND THE STRUCTURED SETTLEMENT

The structured settlement agreements entered into by the parties to a structured settlement and the annuity used to fund the structured settlement customarily con-

tain provisions stating that the periodic payments cannot be accelerated, deferred, increased or decreased, anticipated, sold, assigned, pledged, or encumbered.

These anti-alienation provisions are included for several reasons—all of which protect the injured victim and the structured settlement. The key reasons are:

(1) to implement the Congressional policy underlying the structured settlement tax rules of insulating injured victims from pressures to prematurely dissipate their awards;

(2) to avoid triggering a tax risk under the economic benefit or constructive-receipt-of-income doctrines that would cause the injured victim to be treated as having received a deemed lump sum recovery giving rise to taxable investment earnings if the victim were able to pledge, transfer, and otherwise exercise control over the payment stream;

(3) to comply with the tax rules governing structured settlements under I.R.C. § 130 which require that the structured settlement payments constitute tax-free damages in the hands of the recipient and which bar the acceleration of the payments by the recipient;

(4) to insulate the structured settlement payment stream from claims of creditors by triggering the protections of state exemption statutes that exclude from the reach of creditors payments under annuities and related agreements which contain anti-alienation restrictions; and

(5) to give effect to state statutes that in many cases expressly prohibit assignment of recoveries under settlements (*e.g.*, worker's compensation).

Further, in many states, state statutes also make payments under annuities, including structured settlement annuities, non-transferable if the annuity contracts or related agreements contain anti-alienation provisions. (*See, e.g.*, General Laws of Rhode Island, § 4–12).

II. FACTORING COMPANIES ACQUIRE STRUCTURED SETTLEMENT PAYMENTS BY SECURED LOAN AS WELL AS BY PURCHASE, IN VIOLATION OF THE ANTI-ALIENATION RESTRICTIONS

Although factoring companies most often characterize their acquisitions of structured settlement payments from injured victims as purchases of payment rights, some factoring companies recast the acquisition as a loan secured by the injured victim's pledge of the structured settlement payment rights. However, the injured victim never actually repays the "loan." The factoring company simply receives the structured settlement payments directly upon redirection from the injured victim by means of a phony change of address or direct deposit bank account.

Recasting the factoring transaction as a "secured loan," however, does not alter the fact that the transaction in which the factoring company acquires the injured victim's future structured settlement payments violates the contractual terms of the structured settlement as well as the governing federal tax requirements, thwarts the Congressional policy of long-term financial security for the injured victim free of reliance on taxpayer-financed programs, and exposes the original structured settlement parties to tax and double liability risks.

Accordingly, the Structured Settlement Protection Act applies to "a transfer of structured settlement payment rights (including portions of structured settlement payments) made for consideration by means of sale, assignment, pledge, or other form of encumbrance or alienation for consideration." This is consistent with the terms of the structured settlement itself which expressly bar any acceleration, deferral, increase or decrease, anticipation, sale, assignment, pledge, or encumbrance of the structured settlement payments.

III. BANKS DO NOT LEND AGAINST STRUCTURED SETTLEMENT PAYMENTS AS SPECIFIC COLLATERAL UNDER CURRENT LAW

The American Bankers Association written statement regarding the President's proposed penalty tax on factoring company purchases of structured settlement payments from injured victims expresses concern that banks could be subject to the proposed penalty tax if they make loans secured by blanket security interests to consumer borrowers who receive structured settlement payments. (Testimony of Nancy H. Worman, on behalf of the American Bankers Association, on Revenue Raising Provisions in the Administration's Fiscal Year 2000 Budget Proposal, before the Senate Finance Committee, April 27, 1999, pp. 3–4). In limiting its concern to the blanket security interest context, the Bankers Association's testimony implicitly acknowledges that banks do not make loans against the security of structured settlement payments, because bankers recognize that the payments are non-transferable by the structured settlement recipient and cannot be pledged or encumbered as collateral.

In light of the anti-alienation provisions of the structured settlement, including the express bar against pledge or encumbrance of the structured settlement payments, the structured settlement payments cannot serve as specific collateral for a loan and cannot be the subject of an enforceable, perfected security interest under the Uniform Commercial Code.

Accordingly, banks and other regulated financial institutions do not make loans to structured settlement recipients secured by the payment stream as specific collateral. This has been borne out by the experience of the last 17 years since the structured settlement tax rules were adopted.

For many of these same reasons, banks do not lend against the security of military retirement, Social Security, and other such protected payment streams.

Factoring companies recognize that traditional regulated lenders do not attempt to make loans collateralized by structured settlements. In fact, the factoring companies emphasize the point in their advertising. A marketing publication of the largest factoring company, J.G. Wentworth, flatly states: "banks will not loan a family money using the structured settlement as collateral."

IV. THE BANKERS ASSOCIATION'S PERCEIVED CONCERN ABOUT THE BLANKET SECURITY AGREEMENT IS UNWARRANTED

The American Bankers Association testimony expresses concern that the structured settlement protection legislation "could have unintended and harmful consequences for banking institutions that make loans, pursuant to blanket security agreements, to consumers who receive structured settlement payments." (Written Statement of Nancy H. Worman, on behalf of the American Bankers Association, *supra,* at p. 3). A "blanket security agreement," it is said, "generally provides that a loan made by a lending institution is secured by all property (tangible and intangible) that the borrower presently owns or subsequently acquires." (*Id.,* at p. 3).

The Bankers Association expresses the concern that: "As currently drafted, the proposal could impose excise taxes on banking institutions that use such agreements to secure loans, even though the intent is never to ultimately obtain the structured settlement payments from the borrower. * * * The lending institution would be subject to tax even though it did not rely on the existence of the settlement either for the decision to make the loan or for repayment purposes. In fact, the institution might not even be aware of the existence of the borrower's right to a structured settlement." (*Id.,* at pp. 3–4). Finally, the testimony asserts that the proposed penalty tax could be triggered on outstanding loans to structured settlement recipients that are renewed or rolled over or where the borrower subsequently becomes the recipient of a structured settlement.

As a threshold matter, it should be noted that banking institutions generally do not make consumer loans to individuals that are collateralized by blanket security interests in the borrowers' assets, because federal and state consumer credit laws and regulations prohibit consumer lenders from taking various forms of collateral that are covered by blanket security interests. *See, e.g.,* 16 C.F.R. § 444.2 (Federal Trade Commission Credit Practices Rule barring assignments of earnings and prohibiting non-possessory security interests in certain household goods as collateral for consumer credit transactions); 12 C.F.R. § 535.2 (corresponding rule of Office of Thrift Supervision); 12 C.F.R. § 227.13 (corresponding rule of Federal Reserve Board); Uniform Consumer Credit Code § 2.407 (limiting permissible collateral in connection with credit transactions financing consumer purchases).

Thus, in practice, a banking institution will rarely be in a situation in which it inadvertently receives a security interest in structured settlement payments by reason of a blanket lien on the assets of a structured settlement recipient.

Even if a banking institution does make a consumer loan collateralized by a blanket security interest in the assets of a borrower who has a structured settlement, that security interest will seldom (if ever) apply to the borrower's rights under the structured settlement. In light of the anti-alienation restrictions of the structured settlement, including the express bar against pledge or encumbrance, the structured settlement payments cannot be the subject of an enforceable, perfected security interest under the Uniform Commercial Code. Moreover, in many states, Uniform Commercial Code security interests do not apply to the rights of the payee under a structured settlement. *See, e.g., Wonsey* v. *Life Ins. Co. of North America,* 32 F. Supp. 2d 939 (E.D. Mich. 1998) (security interest in structured settlement payments precluded by UCC provision (§ 9–104(g) making UCC Article 9 wholly inapplicable to any "transfer of an interest in or a claim in or under any policy of insurance"); Ala. Code § 7–9–104(g) (modified version of UCC § 9–104(g) confirming inapplicability of Article 9 to transfers of interests in annuity contracts); N.Y. Uniform Commercial Code § 9–104(g) (same); Utah Code Ann. § 70A–9–104(g) (same); Va. Code Ann.

§8.9–104(g) (same); *cf. Ins. Co. of North America* v. *Della Industries, Inc.*, 998 F. Supp. 159 (D. Conn. 1998) (security interest in proceeds of tort settlement excluded by UCC provision (§9–104(k)) making UCC Article 9 inapplicable to transfers of claims "arising out of tort").

Further, in many situations, creation of an effective security interest in structured settlement payments is also precluded by state insurance codes, workers' compensation laws, and other state statutes. In many states, state statutes make payments under annuities non-transferable if the annuity contracts or related agreements contain anti-alienation provisions, as structured settlement agreements and annuity contracts customarily do. In addition, state laws commonly restrict alienation of payments due under various types of claims, such as wrongful death, medical malpractice, and worker's compensation. *See, e.g.*, Tex. Ins. Code Ann. Art. 21.22 §5 (making "wholly void" any assignment or attempted assignment of money or benefits or rights under an annuity contract that prohibits assignment); Ky. Rev. Stat. Ann. §304.14–330(2) (annuity contract benefits and rights "shall not be transferable" where the applicable contract prohibits transfer); Fla. Stat. §440.22 ("[n]o assignment . . . of [workers'] compensation or benefits due or payable under this chapter . . . shall be valid"); R.I. Gen. Laws §28–33–27 ("[n]o claims or payments due for [workers'] compensation . . . shall be assignable, or subject to attachment, or liable in any way for debts"); 735 Ill. Comp. Stat. §5/2–1715 ("[a]n assignment of or an agreement to assign any right to periodic installments for future damages" under a medical malpractice judgment is enforceable only to secure family support obligations, pay the assignee for medical care, or pay costs incurred in obtaining the judgment); N.Y. Civ. Prac. L. & R. Law §5048 (same; applies to personal injury and wrongful death actions).

Even in the rare instance in which a banking institution somehow has obtained a blanket security interest in assets of a consumer borrower who has a structured settlement, unless the bank took some affirmative step to assert or realize upon its purported security interest in the structured settlement payments, the bank could not be said to have acquired the structured settlement payment rights for consideration—the transaction that is necessary to trigger potential penalty tax liability under the President's proposal and the Structured Settlement Protection Act.

A similar theoretical possibility of application of a blanket security agreement exists with respect to the borrower's account balance in a tax-qualified retirement plan or Individual Retirement Account. As with a structured settlement, a participant in a tax-qualified retirement plan is barred under the terms of the plan from alienating his or her account balance. Yet no one has pointed to a concern that a blanket security agreement would cause a constructive distribution of the borrower's retirement plan account balance and trigger the 10 percent penalty tax on premature retirement plan distributions under I.R.C. sec. 72(t).

Similarly, the pledge of any portion of an Individual Retirement Account as security for a loan is treated as a taxable distribution to the account-holder under I.R.C. sec. 408(e)(4), subject to the 10 percent penalty tax on premature distributions under I.R.C. sec. 72(t). This situation is even starker than the tax-qualified retirement plan context because the IRA account-holder does have the legal right (subject to the adverse tax consequences) to transfer IRA assets to others. Yet there has been no suggestion that a blanket security interest sweeps in IRA assets or causes a taxable distribution pursuant to Code section 408(e)(4) that would trigger the 10 percent penalty tax.

Accordingly, for all of these reasons we believe that the Bankers Association's concern about the theoretical possibility that the proposed penalty tax on factoring company purchases of structured settlement payment from injured victims could be triggered by a blanket security agreement is unwarranted.

We would note that the effective date of the proposed penalty tax is prospective under both the President's proposal and the Structured Settlement Protection Act, applying to structured settlement factoring transactions occurring after date of enactment. Hence, if individual banks are concerned about a theoretical possibility that the proposed penalty tax could be triggered by use of a blanket security agreement that inadvertently sweeps in a structured settlement payment stream, the bank may easily and simply modify its loan documents for future transactions to expressly carve out structured settlement payments from the category of security.[1]

Accordingly, the provision in the Structured Settlement Protection Act that defines a transfer of structured settlement payment rights made for consideration to include pledges or other forms of encumbrance made for consideration adds no new bar or impediment to current law with respect to the use of structured settlement payments as collateral for loans by banks or other regulated financial institutions.

V. Banks Lending on an Unsecured Basis Should Welcome the Protections Afforded by the Structured Settlement Protection Act

While banks cannot rely on structured settlement payments as collateral under current law, banks have been willing to recognize the structured settlement payments as an assured source of income when extending credit on an *unsecured* basis. This practice can continue, clearly unaffected by the structured settlement protection legislation.

Indeed, the banks and their trade association ought to favor the legislation because it protects against diversion by the factoring companies of this assured stream of payments on which the bank has relied as an income source in extending unsecured credit to the injured victim. With the growth of structured settlement factoring transactions—which rely on phony address changes and other subterfuges designed to divert the payments to the factoring company without alerting the structured settlement company—it has become increasingly risky for a bank or other regulated financial institution to assume that the structured settlement recipient actually will receive the non-assignable structured settlement payments that he or she is supposed to receive.

By discouraging structured settlement factoring transactions except in hardship cases approved in open court, the Structured Settlement Protection Act will make it safer for banks and other regulated lenders to extend unsecured credit to structured settlement recipients in reliance on their future structured settlement payments as an income source, without fearing that the payments have been or will be secretly sold and redirected to a factoring company in violation of the anti-alienation restrictions of the structured settlement.

CONCLUSION

In short, structured settlements cannot properly serve as collateral for a loan by a bank, and the use by banks of blanket security agreements should create no realistic possibility of triggering the proposed penalty tax applicable to factoring company purchases of structured settlement payments from injured victims. Indeed, the American Bankers Association ought to be in favor of the Structured Settlement Protection Act and the President's similar proposal because such legislation protects the banks' ability to continue to lend to structured settlement recipients on an unsecured basis without fear of diversion of the structured settlement payments by factoring companies.

ENDNOTES

[1] The American Bankers Association suggests that a bank could "unknowingly become subject to the excise tax" if the bank makes a consumer loan collateralized by a blanket security interest covering existing and after-acquired collateral and the consumer later enters into a structured settlement. Under these unlikely circumstances, the proposed penalty tax would not apply at all because, even assuming that the acquisition of a security interest under an after-acquired property clause somehow could be viewed as a transfer of structured settlement payment rights, there would be no new consideration for that transfer.

STATEMENT OF THE AMERICAN NETWORK OF COMMUNITY OPTIONS AND RESOURCES (ANCOR)

INTRODUCTION AND OVERVIEW

This testimony outlines the comments and suggestions of the American Network of Community Options and Resources ("ANCOR") on the Administration's proposal to simplify the foster child definition under the earned income tax credit ("EITC").

Formed in 1970 to improve the quality of life of persons with disabilities and their families by coordinating the efforts of concerned providers of private support services, ANCOR is comprised of more than 650 organizations from across the United States together providing community supports to more than 150,000 individuals with disabilities.

ANCOR supports the underlying goals of the Administration's EITC proposal to clarify the scope of current tax law as it applies to foster families. However, ANCOR also strongly recommends that the proposal be drafted to reflect a proposed amendment to Section 131 of the Internal Revenue Code of 1986, as amended (the "Code"). This amendment would eliminate inequities and uncertainties of current law and uniformly allow foster care providers to exclude from income the foster care payments they receive from a governmental source. ANCOR believes that amending Section 131 in this manner would (i) support State and local government efforts to reduce bureaucracy and costs, (ii) simplify the tax treatment of foster care pay-

ments, and (iii) encourage much-needed foster care providers to participate in foster care programs.

DESCRIPTION OF CURRENT LAW AND ADMINISTRATION'S PROPOSAL

I. Current law.

Section 32 of the Code allows a taxpayer to claim the EITC if he or she lives with a child or grandchild for more than half the year. In addition, a taxpayer may claim the EITC if he or she lives with a "foster child." "Foster child" is defined as an individual who lives with the taxpayer for the entire year and for whom the taxpayer cares as such taxpayer's own child. To qualify for the EITC, the individual must be (i) younger than 19 years of age if not a full time student, (ii) younger than 24 years of age if a full time student, or (iii) any age if permanently and totally disabled. Section 32 does not require that a foster child for whom a family takes the EITC be placed in the household by any particular type of foster care agency.

II. Administration's proposal.

For purposes of qualifying for the EITC under Section 32, the Administration proposes defining "foster child" to include, *inter alia,* children (or disabled individuals) placed in the taxpayer's home by an agency of a State, one of its political subdivisions, or tax-exempt child placement agency licensed by a State. This language tracks the language in Section 131, another Code provision relating to taxation of foster families.

ANALYSIS OF THE ADMINISTRATION'S PROPOSAL

I. The Administration's proposal would help clarify who qualifies for the EITC under Code Section 32.

We believe that clarifying who qualifies as a foster child or individual as suggested by the Administration will help prevent the unintentional mistakes of countless taxpayers who now question whether their situations meet the qualifications of Section 32. Additionally, such clarifying changes would provide qualifying foster care providers with an adequate guarantee of their eligibility to take the EITC. Clarity would also help reduce the expense qualifying foster care providers often incur when they are forced to prove that they have claimed the EITC lawfully. Any such clarifying amendments, however, should parallel those proposed for Section 131, as explained below.

II. Congress should further clarify the tax treatment of foster care payments by amending Code Section 131.

Defining the term "foster child" as it applies to the EITC is only a first step in simplifying the complicated tax rubric associated with the provision of foster care services. Additional changes should be made to Section 131 of the Code, which creates a dichotomy in the tax treatment of foster care providers for individuals under 19 years of age and those who provide treatment to individuals over 19 years of age. These Section 131 changes should also be applied to the treatment of a "foster child" under Section 32.

For children under 19 years old, Section 131 of the Code currently permits foster care providers to exclude foster care payments from taxable income when a government entity or charitable tax-exempt organization directly places the individual and makes the foster care payments. For individuals 19 years of age or older, Section 131 excludes foster care payments from taxable income only when a government entity makes the placement and the payment. Thus, the excludability of foster care payments, even though such payments are derived from government funds, is linked to the type of agency that places the individual with a foster care provider.

This inflexible and dated treatment of taxpayers who provide services to children and special needs individuals has become more evident as foster care placement has developed as a preferred means of service provision to many individuals. In addition to the benefits this form of service produces for special needs individuals, foster homes have proven their efficacy for these individuals when compared to institutional services and are a growing choice of State and local governments. Governmental entities have found that foster care provides better service to certain special needs individuals and is less expensive and onerous for them to maintain. This type of residential alternative also adds to the available stock of community housing and expands the availability of qualified individuals to provide support to both adults and children with disabilities.

A realization that foster care placement is the best solution in certain circumstances, added with a desire to reduce government involvement in the day-to-day placement and service decisions, has resulted in governmental agencies becom-

ing more reliant on private agencies to arrange foster care services for both children and adults. The private sector continues to play an important and growing role on behalf of government by arranging for and supervising these homes through licensing or certification by State or local governments.

Congress should amend Section 131 to allow all foster care providers the ability to exclude from income foster care payments received from a governmental source regardless of whether a governmental entity placed the foster child, as long as a governmental entity has either certified or licensed the placement agency. Amending Section 131 in such a way would not only support the efforts of State and local governments to address the needs of their communities more effectively, but would also simplify the treatment of foster care payments and reduce the administrative burden of the Internal Revenue Service ("IRS").

A. Current law fails to support the decisions of State and local governments.

Governmental entities are becoming increasingly reliant on private agencies to place both children and special needs adults in foster care. In particular, governmental entities have found that foster care for special needs adults reduces the expense that is usually incurred when maintaining group homes and institutional settings. Additionally, State and local governments often use outside entities to make case-specific decisions (such as identification of those individuals who would benefit from foster care and those foster care families with whom such individuals should be placed) as a means of reducing bureaucracy in an already trying situation. Current law, however, fails to provide the same tax treatment to those foster care families identified by private entities acting under a license or certification with States, counties and municipalities as is provided to foster care families that are identified directly by the State. Disparate treatment exists despite the fact that from the governmental entities' perspectives, the activities are the same. As a result of the difference in treatment, State and local governments are discouraged from contracting with private agencies to make placement decisions. The tax code should support State and local governments that decide to cut costs, reduce bureaucracy and support the special needs individuals in their communities through expanding their foster care programs.

B. Current law is confusing to taxpayers and to the IRS.

As illustrated by Table 1, incongruent treatment of foster care providers has created a complex system of determining when providers can exclude their foster care payments from income.

Table 1.—Excludability of Foster Care Payments From Income Under Section 131

Placement Agency	Payor	Age of Foster Care Individual	Payment Excludable?
State or political subdivision	State or political subdivision	<19 years	Yes
State or political subdivision	State or political subdivision	≥19 years	Yes
State or political subdivision	501(c)(3)	<19 years	Yes
State or political subdivision	501(c)(3)	≥19 years	No
State or political subdivision	Not 501(c)(3)	<19 years	No
State or political subdivision	Not 501(c)(3)	≥19 years	No
Licensed 501(c)(3)	State or political subdivision	<19 years	Yes
Licensed 501(c)(3)	State or political subdivision	≥19 years	No
Licensed 501(c)(3)	501(c)(3)	<19 years	Yes
Licensed 501(c)(3)	501(c)(3)	≥19 years	No
Licensed 501(c)(3)	Not 501(c)(3)	<19 years	No
Licensed 501(c)(3)	Not 501(c)(3)	≥19 years	No
Not 501(c)(3)	State or political subdivision	<19 years	No
Not 501(c)(3)	State or political subdivision	≥19 years	No
Not 501(c)(3)	501(c)(3)	<19 years	No
Not 501(c)(3)	501(c)(3)	≥19 years	No
Not 501(c)(3)	Not 501(c)(3)	<19 years	No
Not 501(c)(3)	Not 501(c)(3)	≥19 years	No

The confusion presented by current law was exemplified by the recent decision in *Micorescu* v. *Commissioner,* T.C. Memo 1998–398. In *Micorescu,* the Tax Court held that an Oregon family providing foster care services to adults in the family's home could not exclude from income payments received from the private agency that placed the foster individuals with the family. The court reasoned that because the adult foster individuals were placed with the family by a private agency rather than

by the State or an agency of the State, the foster individuals were not "qualified foster individuals" within the meaning of Section 131. The court reached this conclusion even though the organization that placed the adults in the family's home both contracted with and received funds from the State of Oregon. Equal treatment of all foster care families (i) who receive payments from an agency that operates under a license or certification by a government entity or (ii) who receive payments directly from a government entity would reduce the confusion that currently exists. Foster families, like the family involved in the *Micorescu* case, would know with certainty whether they could exclude their income.

Taxpayers are not alone in their confusion. Section 131 has proven so confusing, in fact, that IRS officials and experienced certified public accountants and tax attorneys also have difficulty ascertaining when a payment is excludable. Our members can cite various examples of situations in which foster care providers have been told informally by an IRS official and/or an experienced tax advisor that their foster care payments were to be excluded from taxable income, when in fact those payments were not excludable. Amending Section 131 would, therefore, prevent not only the confusion taxpayers and their tax advisors have over whether foster care payments are excludable, but also the confusion experienced by the IRS officials that are charged with administering the law.

C. Current treatment of foster care payments discourages much-needed foster care families from participating in foster care programs.

Current law discourages families from becoming foster care providers, even though these rules allow families to offset taxable foster care payments (paid by non-qualified agencies) by treating expenditures made on behalf of a foster individual as a business expense deduction. Such deductions are permitted only if the families maintain detailed expense records. Accordingly, otherwise willing foster care families are discouraged from accepting individuals placed by non-qualified agencies because such providers are forced to endure the time and inconvenience associated with keeping extensive records. In addition, the confusion created by Section 131's complex rules discourages many potential foster care families from participating in these programs. The result is a smaller pool of available, qualified and willing foster care providers and a growing pool of special needs individuals for whom group housing or institutional living is inappropriate. Amending Section 131 as suggested would help address the increasing demand for foster care providers.

D. Legislation introduced this year would remedy these problems.

Bills were introduced in the Senate (S. 670) and in the House (H.R. 1194) that propose to eliminate the illogical differences in the tax treatment of payments received by foster care providers. These bills would simplify the current rules under Section 131 for foster care payments. Under the legislation, foster care providers would avoid onerous record keeping by excluding from income any foster care payment received regardless of the age of the foster care individual and the type of entity that placed the individual, as long as foster care payments are funded by governmental monies and the placement agency licensed or certified by a State or local government to make payments.

CONCLUSION

The Administration's proposal clarifies when a taxpayer, who is caring for a foster individual, may take the EITC and thus reduces taxpayer confusion and unintentional mistakes. The Administration's proposal is but one needed step, however, toward removing confusion created by the complicated rubric associated with the taxation of foster care payments. Therefore, we additionally recommend amending Section 131 of the Internal Revenue Code so that all governmental payments received by foster care providers be treated the same. This change should also be reflected in any change affecting the definition of "foster child" in Section 32. If enacted, current law's confusing and unfair tax rules would no longer discourage much-needed foster care families from participating in foster care programs. Amending Section 131 and Section 32 in this fashion also will support State and local governments in their efforts to reduce bureaucracy and cut costs, provide more alternatives to institutionalization and simplify tax administration.

STATEMENT OF THE AMERICAN PETROLEUM INSTITUTE

INTRODUCTION

This testimony is submitted by the American Petroleum Institute (API) for the April 27, 1999 Senate Finance hearing on the tax provisions in the Administration's FY 2000 budget proposal. API represents approximately 400 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining, and marketing.

The U.S. oil and gas industry is suffering through its worst times in recent memory. The collapse of world oil prices that began in late 1997 continued and worsened through 1998. While there has been some recovery in prices in recent weeks, many analysts view this recovery as transitory, and see little firm basis for sustained recovery in market conditions for several years. It is especially troubling that at this time when the industry is already reeling, the Administration has come forward with proposals that would increase taxes on oil and gas companies by as much as $6 billion over the next five years. Congress can help to ensure that no additional harm is done to this industry by rejecting the Administration's proposal to increase taxes on the foreign source income of oil and gas companies, and the proposals to reinstate the Superfund taxes and the Oil Spill tax.

BACKGROUND

By the end of 1998, as a result of reduced worldwide demand and excess production, U.S. wellhead crude oil prices had fallen to their lowest inflation-adjusted levels since the Great Depression. At year's end the average U.S. wellhead price was less than $8 per barrel, barely half the $15.06 average for the same month one year earlier. For the year, the annual average wellhead price was an estimated $10.85 per barrel, down by more than a third from $17.24 in 1997.

Domestic oil exploration and development activity suffered dramatically from the lower oil prices. The total number of operating rigs in the U.S. fell 44% from February 98 to February 99. The decline for oil rigs was 69% and for gas rigs 28%. Oil and gas companies' current upstream spending plans for 1999 for the U.S. have been cut by 20 percent, according to a recent survey conducted by Salomon Smith Barney. U.S. companies have been forced to delay or outright cancel projects in other regions of the world, as well.

Industry employment has suffered. Bureau of Labor Statistics data show that from October 1998 to February 1999 the oil and gas extraction industry, including field service companies, lost 26,000 jobs. That 4 month loss was 6,000 more jobs than were lost during the entire year from October 1997 to October 1998. The most recent decline reduced the number of upstream jobs in the U.S. to about 291,000—60 percent less than the peak in early 1982 of 754,000 jobs.

For petroleum refiners lower crude oil prices generally have not yielded higher refinery profit rates. Gasoline prices for 1998, adjusted for inflation, were the lowest observed since 1920. Regular gasoline prices dropped to 96 cents per gallon by year-end. They averaged about $1.06 per gallon for the year. The low product prices have come on the heels of major operating cost increases resulting from compliance with numerous government regulations, especially regulations aimed at environmental improvement. In 1997 (the latest year available), the refining sector spent slightly over $4 billion on U.S. environmental expenditures.

ADMINISTRATION PROPOSALS

Our testimony will address the following proposals:

- modify rules relating to foreign oil and gas extraction income;
- reinstate excise taxes and the corporate environmental tax deposited in the Hazardous Substance Superfund Trust Fund;
- reinstate the oil spill excise tax;
- corporate tax shelters;
- Harbor Maintenance Tax Converted to User Fee; and
- tax investment income of trade associations

RULES RELATING TO FOREIGN OIL AND GAS EXTRACTION INCOME

President Clinton's budget proposal includes the following provisions:

- In situations where taxpayers are subject to a foreign income tax and also receive an economic benefit from the foreign country, taxpayers would be able to claim a credit for such taxes under Code Section 901 only if the country has a "generally applicable income tax" that has "substantial application" to all types of taxpayers,

and then only up to the level of taxation that would be imposed under the generally applicable income tax.

- Effective for taxable years beginning after enactment, new rules would be provided for all foreign oil and gas income (FOGI). FOGI would be trapped in a new separate FOGI basket under Code Section 904(d). FOGI would be defined to include both foreign oil and gas extraction income (FOGEI) and foreign oil related income (FORI).
- Despite these changes, U.S. treaty obligations that allow a credit for taxes paid or accrued on FOGI would continue to take precedence over this legislation (e.g., the so-called "per country" limitation situations.)

This proposal, aimed directly at the foreign operations of U.S. petroleum companies, seriously threatens the ability of those companies to remain competitive on a global scale, and API strongly opposes the proposal.

If U.S. oil and gas concerns are to stay in business, they must look overseas to replace their diminishing reserves, since the opportunity for domestic reserve replacement has been restricted by both federal and state government policy. The opening of Russia to foreign capital, the competition for investment by the countries bordering the Caspian Sea, the privatization of energy in portions of Latin America, Asia, and Africa—all offer the potential for unprecedented opportunity in meeting the challenges of supplying fuel to a rapidly growing world economy. In each of these frontiers U.S. companies are poised to participate actively. However, if U.S. companies cannot economically compete, foreign resources will instead be produced by foreign competitors, with little or no benefit to the U.S. economy, U.S. companies, or American workers.

With non-OPEC development being cut back, and OPEC market share once again rising, a key concern of federal policy should be that of maintaining the global supply diversity that has been the keystone of improved energy security for the past two decades. The principal tool for promotion of that diversity is active participation by U.S. firms in the development of these new frontiers. At a time when those operations are especially vulnerable, federal policy should be geared to enhancing the competitiveness of U.S. firms operating abroad, not reducing it with new tax burdens.

The foreign tax credit (FTC) principle of avoiding double taxation represents the foundation of U.S. taxation of foreign source income. The Administration's budget proposal would destroy this foundation on a selective basis for foreign oil and gas income only, in direct conflict with long established tax policy and with U.S. trade policy of global integration, embraced by both Democratic and Republican Administrations.

THE FTC IS INTENDED TO PREVENT DOUBLE TAXATION

Since the beginning of Federal income taxation, the U.S. has taxed the worldwide income of U.S. citizens and residents, including U.S. corporations. To avoid double taxation, the FTC was introduced in 1918. Although the U.S. cedes primary taxing jurisdiction for foreign income to the source country, the FTC is intended to prevent the same income from being taxed twice, once by the U.S. and once by the source country. The FTC is designed to allow a dollar for dollar offset against U.S. income taxes for taxes paid to foreign taxing jurisdictions. Under this regime, foreign income of foreign subsidiaries is not immediately subject to U.S. taxation. Instead, the underlying earnings become subject to U.S. tax only when the U.S. shareholder receives a dividend (except for certain "passive" or "Subpart F" income.) Any foreign taxes paid by the subsidiary on such earnings is deemed to have been paid by any U.S. shareholders owning at least 10% of the subsidiary, and can be claimed as FTCs against the U.S. tax on the foreign dividend income (the so-called "indirect foreign tax credit").

BASIC RULES OF THE FTC

The FTC is intended to offset only U.S. tax on foreign source income. Thus, an overall limitation on currently usable FTCs is computed by multiplying the tentative U.S. tax on worldwide income by the ratio of foreign source income to worldwide taxable income. The excess of FTCs can be carried back 2 years and carried forward 5 years, to be claimed as credits in those years within the same respective overall limitations.

The overall limitation is computed separately for not less than 9 "separate limitation categories." Under present law, foreign oil and gas income falls into the general limitation category. Thus, for purposes of computing the overall limitation, FOGI is treated like any other foreign active business income. Separate special limitations still apply, however, for income: (1) whose foreign source can be easily changed; (2)

which typically bears little or no foreign tax; or (3) which often bears a rate of foreign tax that is abnormally high or in excess of rates of other types of income. In these cases, a separate limitation is designed to prevent the use of foreign taxes imposed on one category to reduce U.S. tax on other categories of income.

FTC LIMITATIONS FOR OIL AND GAS INCOME

Congress and the Treasury have already imposed significant limitations on the use of foreign tax credits attributable to foreign oil and gas operations. In response to the development of high tax rate regimes by OPEC, taxes on foreign oil and gas income have become the subject of special limitations. For example, each year the amount of taxes on FOGEI may not exceed 35% (the U.S. corporate tax rate) of such income. Any excess may be carried over like excess FTCs under the overall limitation. FOGEI is income derived from the extraction of oil and gas, or from the sale or exchange of assets used in extraction activities.

In addition, the IRS has regulatory authority to determine that a foreign tax on FORI is not "creditable" to the extent that the foreign law imposing the tax is structured, or in fact operates, so that the tax that is generally imposed is materially greater than the amount of tax on income that is neither FORI nor FOGEI. FORI is foreign source income from (1) processing oil and gas into primary products, (2) transporting oil and gas or their primary products, (3) distributing or selling such, or (4) disposing of assets used in the foregoing activities. Otherwise, the overall limitation (with its special categories discussed above) applies to FOGEI and FORI. Thus, as active business income, FOGEI and FORI would fall into the general limitation category.

THE DUAL CAPACITY TAXPAYER "SAFE HARBOR" RULE

As distinguished from the rule in the U.S. and some Canadian provinces, mineral rights in other countries vest in the foreign sovereign, which then grants exploitation rights in various forms. This can be done either directly or through a state owned enterprise (e.g., a license or a production sharing contract). Because the taxing sovereign is also the grantor of mineral rights, the high tax rates imposed on oil and gas profits have often been questioned as representing, in part, payment for the grant of "a specific economic benefit" from mineral exploitation rights. Thus, the dual nature of these payments to the sovereign have resulted in such taxpayers being referred to as "dual capacity taxpayers."

To help resolve controversies surrounding the nature of tax payments by dual capacity taxpayers, the Treasury Department in 1983 finalized the "dual capacity taxpayer rules" of the FTC regulations. Under the facts and circumstances method of these regulations, the taxpayer must establish the amount of the intended tax payment that otherwise qualifies as an income tax payment and is not paid in return for a specific economic benefit. Any remainder is a deductible rather than creditable payment (and in the case of oil and gas producers, is considered a royalty). The regulations also include a safe harbor election (see Treas. Reg. 1.901–2A(e)(1)), whereby a formula is used to determine the tax portion of the payment to the foreign sovereign, which is basically the amount that the dual capacity taxpayer would pay under the foreign country's general income tax. Where there is no generally applicable income tax, the safe harbor rule of the regulation allows the use of the U.S. tax rate in a "splitting" computation (i.e., the U.S. tax rate is considered the country's generally applicable income tax rate).

THE PROPOSAL DISALLOWS FTCS OF DUAL CAPACITY TAXPAYERS WHERE THE HOST COUNTRY HAS NO GENERALLY APPLICABLE INCOME TAX

If a host country had an income tax on FOGI (i.e., FOGEI or FORI), but no generally applicable income tax, the proposal would disallow any FTCs on FOGI. This would result in inequitable and destructive double taxation of dual capacity taxpayers, contrary to the global trade policy advocated by the U.S.

The additional U.S. tax on foreign investment in the petroleum industry would not only eliminate many new projects; it could also change the economics of past investments. In some cases, this would not only reduce the rate of return, but also preclude a return of the investment itself, leaving the U.S. business with an unexpected "legislated" loss. In addition, because of the uncertainties of the provision, it would also introduce more complexity and potential for litigation into the already muddled world of the FTC.

The unfairness of the provision becomes even more obvious if one considers the situation where a U.S. based oil company and a U.S. based company other than an oil company are subject to an income tax in a country without a generally applicable income tax. Under the proposal, only the U.S. oil company would receive no foreign

tax credit, while the other taxpayer would be entitled to the full tax credit for the very same tax.

The proposal's concerns with the tax versus royalty distinction were resolved by Congress and the Treasury long ago with the special tax credit limitation on FOGEI enacted in 1975 and the Splitting Regulations of 1983. These were then later reinforced in the 1986 Act by the fragmentation of foreign source income into a host of categories or baskets. The earlier resolution of the tax versus royalty dilemma recognized that (1) if payments to a foreign sovereign meet the criteria of an income tax, they should not be denied complete creditability against U.S. income tax on the underlying income; and (2) creditability of the perceived excessive tax payment is better controlled by reference to the U.S. tax burden, rather than being dependent on the foreign sovereign's fiscal choices.

THE PROPOSAL LIMITS FTCS TO THE AMOUNT WHICH WOULD BE PAID UNDER THE GENERALLY APPLICABLE INCOME TAX

By elevating the regulatory safe harbor to the exclusive statutory rule, the proposal eliminates a dual capacity taxpayer's right to show, based on facts and circumstances, which portion of its income tax payment to the foreign government was not made in exchange for the conferral of specific economic benefits and, therefore, qualifies as a creditable tax. Moreover, by eliminating the "fall back" to the U.S. tax rate in the safe harbor computation where the host country has no generally applicable income tax, the proposal denies the creditability of true income taxes paid by dual capacity taxpayers under a "schedular" type of business income tax regime (i.e., regimes which tax only certain categories of income, according to particular "schedules"), merely because the foreign sovereign's fiscal policy does not include all types of business income.

For emerging economies of lesser developed countries which may not be ready for an income tax, as for post-industrial nations which may turn to a transaction tax, it is not realistic to always demand the existence of a generally applicable income tax. Even if the political willingness exists to have a generally applicable income tax, such may not be possible because the ability to design and administer a generally applicable income tax depends on the structure of the host country's economy. The available tax regimes are defined by the country's economic maturity, business structure and accounting sophistication. The most difficult problems arise in the field of business taxation. Oftentimes, the absence of reliable accounting books will only allow a primitive presumptive measure of profits. Under such circumstances the effective administration of a general income tax is impossible. All this is exacerbated by phenomena which are typical for less developed economies: a high degree of self-employment, the small size of establishments, and low taxpayer compliance and enforcement. In such situations, the income tax will have to be limited to mature businesses, along with the oil and gas extraction business.

THE PROPOSAL INCREASES THE RISK OF DOUBLE TAXATION

Adoption of the Administration's proposals would further tilt the playing field against overseas oil and gas operations by U.S. business, and increase the risk of double taxation of FOGI. This will severely hinder U.S. oil companies in their competition with foreign oil and gas concerns in the global oil and gas exploration, production, refining, and marketing arena, where the home countries of their foreign competition do not tax FOGI. This occurs where these countries either exempt foreign source income or have a foreign tax credit regime which truly prevents double taxation.

To illustrate, assume foreign country X offers licenses for oil and gas exploitation and also has an 85% tax on oil and gas extraction income. In competitive bidding, the license will be granted to the bidder which assumes exploration and development obligations most favorable to country X. Country X has no generally applicable income tax. Unless a U.S. company is assured that it will not be taxed again on its after-tax profit from country X, it very likely will not be able to compete with another foreign oil company for such a license because of the different after tax returns.

Because of the 35% additional U.S. tax, the U.S. company's after tax return will be more than one-third less than its foreign competitor's. Stated differently, if the foreign competitor is able to match the U.S. company's proficiency and effectiveness, the foreigner's return will be more than 50% greater than the U.S. company's return. This would surely harm the U.S. company in any competitive bidding. Only the continuing existence of the FTC, despite its many existing limitations, assures that there will be no further tilting of the playing field against U.S. companies' efforts in the global petroleum business.

SEPARATE LIMITATION CATEGORY FOR FOGI

To install a separate FTC limitation category for FOGI would single out the active business income of oil companies and separate it from the general limitation category or basket. There is no legitimate reason to carve out FOGI from the general limitation category or basket. The source of FOGEI and FORI is difficult to manipulate. The source of FOGI was determined by nature millions of years ago. FORI is generally derived from the country where the processing or marketing of oil occurs which presupposes substantial investment in nonmovable assets. Moreover, Treasury has issued detailed regulations addressing this sourcing issue. Also, unless any FORI is earned in the extraction or consumption country, it is very likely taxed currently, before distribution, as subpart F income even though it is definitely not passive income.

THE FTC PROPOSALS ARE BAD TAX POLICY

Reduction of U.S. participation in foreign oil and gas development because of misguided tax provisions will adversely affect U.S. employment, and any additional tax burden may hinder U.S. companies in competition with foreign concerns. Although the host country resource will be developed, it will be done by foreign competition, with the adverse ripple effect of U.S. jobs losses and the loss of continuing evolution of U.S. technology. By contrast, foreign oil and gas development by U.S. companies increases utilization of U.S. supplies of hardware and technology. The loss of any major foreign project by a U.S. company will mean less employment in the U.S. by suppliers, and by the U.S. parent, in addition to fewer U.S. expatriates at foreign locations. Many of the jobs that support overseas operations of U.S. companies are located here in the United States—an estimated 350,000 according to a 1998 analysis by Charles River Associates, a Cambridge, Massachusetts-based consulting firm. That figure consists of: 60,000 in jobs directly dependent on international operations of U.S. oil and gas companies; over 140,000 employed by U.S. suppliers to the oil and gas industry's foreign operations; and, an additional 150,000 employed in the U.S. supporting the 200,000 who work directly for the oil companies and their suppliers.

Thus, the questions to be answered are: Does the United States—for energy security and international trade reasons, among others—want a U.S. based petroleum industry to be competitive in the global quest for oil and gas reserves? If the answer is "yes," then why would the U.S. government adopt a tax policy that is punitive in nature and lessens the competitiveness of the U.S. petroleum industry? The U.S. tax system already makes it extremely difficult for U.S. multinationals to compete against foreign-based entities. This is in direct contrast to the tax systems of our foreign-based competitors, which actually encourage those companies to be more competitive in winning foreign projects. What we need from Congress are improvements in our system that allow U.S. companies to compete more effectively, not further impediments that make it even more difficult and in some cases impossible to succeed in today's global oil and gas business environment. These improvements should include, among others, the repeal of the plethora of separate FTC baskets, the extension of the carryback/carryover period for foreign tax credits, and the repeal of section 907.

The Administration's FY 1999 budget included these same proposals which would have reduced the efficacy of the FTC for U.S. oil companies. Congress considered these proposals last year and rightfully rejected them. They should be rejected this year as well.

REINSTATEMENT OF EXPIRED SUPERFUND TAXES

The Administration's proposal would reinstate the Superfund excise taxes on petroleum and certain chemicals as well as the Corporate Environmental Tax through October 1, 2009. API strongly opposes this proposal.

It is generally agreed that the CERCLA program, otherwise known as Superfund, has matured to the point that most of the sites on the National Priorities List (NPL) are in some phase of cleanup. Problems, however, remain in the structure of the current program. The program should undergo comprehensive legislative reform and should sunset at the completion of cleanups of the CERCLA sites currently on the NPL. Issues that the reform legislation should address include: liability, remedy selection, and natural resource damage assessments. A restructured and improved Superfund program can and should be funded through general revenues.

Superfund sites are a broad societal problem. Revenues raised to remediate these sites should be broadly based rather than unfairly burdening a few specific industries. EPA has found wastes from all types of businesses and government agencies

at hazardous waste sites. The entire economy benefited in the pre-1980 era from the lower cost of handling waste attributable to standards that were acceptable at the time. To place responsibility for the additional costs resulting from retroactive Superfund cleanup standards on the shoulders of a very few industries when previous economic benefits were widely shared is patently unfair.

The petroleum industry is estimated to be responsible for less than 10 percent of the contamination at Superfund sites but has historically paid over 50 percent of the Superfund taxes. This inequity should be rectified. Congress should substantially reform the program and fund the program through general revenues or other broad-based funding sources.

REINSTATEMENT OF OIL SPILL EXCISE TAX

The Administration proposes reinstating the five cents per barrel excise tax on domestic and imported crude oil dedicated to the Oil Spill Liability Trust Fund through October 1, 2009, and increasing the trust fund limitation (the "cap") from $1 billion to $5 billion. API strongly opposes the proposal.

Collection of the Oil Spill Excise Tax was suspended for several months during 1994 because the Fund had exceeded its cap of $1 billion. It was subsequently allowed to expire December 31, 1994, because Congress perceived there was no need for additional taxes. Since that time, the balance in the Fund has remained above $1 billion, despite the fact that no additional tax has been collected. Clearly, the legislated purposes for the Fund are being accomplished without any need for additional revenues. Congress should reject this proposal.

CORPORATE TAX SHELTERS

In a sweeping attack on corporate tax planning, the Administration has proposed sixteen provisions purported to deal with corporate tax shelters. These proposals are overly broad and would bring within their scope many corporate transactions that are clearly permitted under existing law. Moreover, their ambiguity would leave taxpayers uncertain as to the tax consequences of their activities and would lead to increased controversy and litigation. Business taxpayers must be able to rely on the tax code and existing income tax regulations in order to carry on their business activities. Treasury's proposed rules could cost the economy more in lost business activity than they produce in taxing previously "sheltered" income.

HARBOR MAINTENANCE EXCISE TAX CONVERTED TO COST-BASED USER FEE

The Administration's budget contains a placeholder for revenue from a new Harbor Services User Fee and Harbor Services Fund. This fee would raise nearly $1 billion in new taxes, almost twice what is needed for maintenance dredging. The Administration delayed sending the proposal to the 105th Congress because of the intense and uniform opposition from ports, shippers, carriers and labor. Despite this opposition, the Administration has provided few details about how the new user fee would be structured and has not sought stakeholder input since last September.

API strongly supports the use of such funds for channel maintenance and dredge disposal. We object to the Administration's proposal to use these funds for port construction and other services. The Administration should earmark these funds to address the growing demand for harbor maintenance and dredging. Moreover, we urge Congress to pass H.R. 111 and create an off-budget trust fund for the Harbor Services Fund. Finally, API urges Congress to take the lead in seeking stakeholder input and developing a fair and equitable means of generating the needed revenue.

SUBJECT INVESTMENT INCOME OF TRADE ASSOCIATIONS TO TAX

The Administration's proposal would subject to tax the net investment income in excess of $10,000 of trade associations and other organizations described in section 501(c)(6). API opposes this provision that is estimated to increase taxes on trade associations and other similar not-for-profit organizations by $1.4 billion. We agree with the Tax Council and other groups that subjecting trade association investment income to the unrelated business income tax (UBIT) conflicts with the current-law purpose of imposing UBIT on associations and other tax-exempt organizations to prevent such organizations from competing unfairly against for-profit businesses. The Administration's proposal mischaracterizes the benefit that trade association members receive from such earnings. Without such earnings, members of these associations would have to pay larger tax-deductible dues. There is no tax abuse. Congress should reject this proposal.

Statement of the Bond Market Association

The Bond Market Association is pleased to present this statement on revenue-raising tax proposals in the president's FY 2000 budget. The Bond Market Association represents approximately 200 securities firms and banks that underwrite, trade and sell debt securities, both domestically and internationally. We take an active interest in tax policy that affects the ability of corporations, state and local governments and the federal government to access the capital markets to finance investment. Indeed, capital investment is the engine that powers long-term economic growth, and the federal tax code can have a profound effect on the cost of capital investment. It is in our interest and, we believe, the nation's interest to foster a tax system that encourages capital investment and makes capital available as efficiently as possible.

The president's budget contains a number of proposals that would affect the capital markets. Unfortunately, many of these proposals are recycled versions of the same tax increases that Congress has rejected for years. These proposals represent "revenue grabs" which are not grounded in sound tax policy and which would add complexity to the tax code. As we have in the past, we strongly oppose these tax increases on savings and investment.

INCREASE PRORATION PERCENTAGE FOR PROPERTY AND CASUALTY COMPANIES

In previous letters and statements to the committee, the Association has commented extensively on a variation of this proposal in the administration's FY 1999 budget. Although the administration has tempered the proposal slightly in its current budget, it would still represent a significant tax increase on "tax-exempt" interest earned by property and casualty (P&C) insurance companies.

P&Cs are an extremely important source of demand for municipal securities. In a market dominated by individual investors—approximately 64 percent of outstanding municipal bonds are held by individuals or their proxies, money-market and mutual funds—P&Cs play a vital role in maintaining market stability by providing a steady source of demand. If not for the active participation of P&Cs in the municipal bond market, state and local borrowing rates would be much higher than they are.

So-called "tax-exempt" interest earned by P&Cs on municipal bond transactions is not truly tax-exempt. P&Cs are permitted a deduction for contributions to loss reserves. However, this deduction is reduced by an amount equal to 15 percent of their "proration income," which includes tax-exempt bond interest. P&Cs lose 15 cents of an otherwise allowable deduction for every dollar of tax-exempt interest they earn. This loss of deduction is tantamount to a direct tax of 5.25 percent on their municipal bond interest income.

The administration has proposed raising the loss reserve deduction disallowance from 15 percent of proration income to 25 percent. This would increase the implicit tax rate on municipal bond interest earned by P&Cs from 5.25 percent to 8.75 percent, an increase of 67 percent. (In its FY 1999 budget, the administration proposed a full doubling of the proration tax.) Describing the administration's proposal as a tax increase on P&Cs, however, disguises its true effect. In reality, the burden of this proposed tax increase would fall almost entirely on state and local government bond issuers, not on P&Cs. Under current market conditions, interest rates on tax-exempt securities would not be sufficient to continue to attract P&Cs to the municipal market. Unfortunately, in the market sectors where P&Cs are most active, there are few other ready buyers at current interest rates. If the administration's proposal were enacted, interest rates paid by state and local governments on their borrowing would be higher than under current law. P&Cs will simply be compensated for their additional tax liability through higher returns on their municipal bond portfolios. The effect for state and local governments would be higher borrowing costs. Implicitly, approximately 40–60 percent—perhaps up to 75 percent—of the tax would be borne not by P&Cs but by state and local governments in the form of higher borrowing costs. Of course, higher borrowing costs simply discourage new investment in schools, roads, airports, sewer systems, parks and the many other infrastructure projects that are financed with tax-exempt bonds. The staff of the Joint Committee on Taxation was absolutely correct in its analysis:

> "[P&C] insurers are large holders of tax-exempt bonds. A reduction in demand for these securities by the [P&C] insurers may lead to an increase in borrowing costs for state and local governments. Even a small increase in the interest cost to tax-exempt finance could create a substantial increase in the aggregate financial cost of debt-financed public works projects to state and local governments." [1]

Moreover, the administration has offered little justification for this proposed tax increase. The Treasury Department states only that a 5.25 percent P&C tax on municipal bond interest is too low because it "still allows [P&Cs] to fund a substantial portion of their deductible reserves with tax-exempt or tax-deferred income."[2] This argument fails to draw any parallel between interest earned on municipal bonds and deductions for contributions to loss reserves. The relationship between municipal bond interest and loss reserve deductions is no closer than that between municipal bond interest and any deductible expense, such as that for wages and salaries. The administration also fails to justify the apparent arbitrary proration percentage level contained in its proposal. Why is a 25-percent proration level more appropriate than a 15-percent level? Why in its FY 1999 budget did the administration propose a 30-percent level, but this year's proposal is for a 25-percent level? Both questions are unanswered, and both suggest that the administration's proposal is less an adjustment of tax policy to address changing circumstances and more a pure tax increase proposed solely as a revenue-raiser with little or no tax policy justification.

DISALLOW INTEREST ON DEBT ALLOCABLE TO TAX-EXEMPT OBLIGATIONS

A second proposed tax increase in the administration's budget is also ostensibly targeted at corporations. However, like the "proration" issue discussed above, this tax increase would be borne by state and local government bond issuers who would pay higher interest rates on their borrowing. This proposal would apply the current-law "pro rata" interest expense disallowance that applies to financial institutions to all financial intermediaries.

Currently, all taxpayers, including all corporations, are prohibited from deducting interest expenses associated with purchasing or carrying tax-exempt bonds. Most corporations, including some financial intermediaries, are required to demonstrate that any tax-exempt bond holdings were not financed with the proceeds of borrowing—the so-called "tracing rule." Most corporations are relieved of this burden if their tax-exempt bond holdings do not exceed two percent of their total assets—the so-called "two-percent de minimis rule." Securities firms and banks, however, are subject to stricter treatment; they automatically lose a pro rata portion of their interest expense deduction if they earn any tax-exempt interest. In applying the disallowance, securities firms are permitted to disregard interest expense that is clearly traceable to activities unrelated to municipal bonds. The administration's proposal would apply the pro rata disallowance provision currently applicable to banks to all "financial intermediaries," including securities firms, finance and leasing companies, and certain government-sponsored corporations. The proposal would affect various segments of the municipal bond market differently.

For securities firms, the proposal would apply the current-law pro rata disallowance to a larger portion of a firm's total interest expense deduction, even to interest which is clearly and demonstrably unrelated to holding municipal bonds. A large portion of a securities firm's borrowing is for specific purposes. Securities firms use repurchase agreements—a form of secured borrowing—to finance overnight holdings of Treasury securities bought in the normal course of market-making activity. Or, in another example, firms incur margin loans for stock purchases. In both these examples, the interest expense associated with the borrowing is clearly related to activity unrelated to buying or holding municipal bonds, and so is disregarded in applying the pro rata disallowance of interest expense. In both these examples as well as others, under the administration's proposal, this interest expense would be subject to the disallowance. Securities firms' after-tax costs of carrying municipal bonds would increase.

Securities firms buy and sell municipal bonds in the normal course of doing business. As underwriters, they buy newly issued securities and resell them to investors. When investors seek to sell bonds before their maturity, securities firms quote prices and buy municipal bonds on the secondary market. As a result of the administration's proposal, the after-tax cost of holding municipal bonds in the normal course of business would increase because every time a securities firm bought a bond, it would face a higher after-tax "cost of carry." Firms would be less willing, at least on the margin, to take positions in municipal securities being bought and sold by investors and would consequently bid prices less aggressively. In the end, virtually all the additional tax liability faced by securities firms would ultimately be borne by bond issuers and investors in the forms of higher issuance and transaction costs.

The administration's proposal would affect other market sectors, as well. The proposal would remove government-sponsored corporations from the markets for tax-exempt housing and student loan bonds by repealing the two-percent de minimis rule for these investors. Organizations such as Fannie Mae and Freddie Mac are

major buyers of bonds issued for low- and middle-income owner-occupied and multi-family rental housing. Sallie Mae buys tax-exempt student loan bonds. These investors keep financing costs low for worthwhile state and local housing and student loan programs, and their loss from the market would make it more difficult and more expensive for states and localities to provide these services. Finally, the proposal would dramatically raise costs for firms that finance equipment leases for states and localities. These costs would be passed on to state and local governments in the form of higher leasing costs. Hardest hit would be smaller governments, since they have a more difficult time accessing the conventional capital markets and tend to depend more on leasing as a form of long-term financing.

The administration argues that current law permits securities dealers and other financial intermediaries "to reduce their tax liability inappropriately through double federal tax benefits of interest expense deduction and tax-exempt interest, notwithstanding that they operate similarly to banks." This statement is simply not true. Current law could not be more direct. It is not legal for any corporation to deduct the interest expense associated with holding tax-exempt bonds. It is true that not all corporations are bound to the pro rata disallowance of interest expense deductions as banks are. Equalizing treatment between banks and non-banks, however, could just as easily entail the application of the tracing and two-percent de minimis rules to banks as the application of the pro rata disallowance to non-banks. The administration also argues that "the treatment of banks should be applicable to other taxpayers engaged in the business of financial intermediation, such as securities dealers." And further, "it is difficult to trace funds within the institution and nearly impossible to assess the taxpayer's purpose in accepting deposits or making other borrowings." Both these statements are very misleading. In fact, banks and securities firms are both subject to nearly identical rules under current law. Both are already subject to the pro rata disallowance of interest expense deductions. Securities firms are simply able, in applying the disallowance, to disregard certain interest expense that clearly is traceable. Moreover, of The Bond Market Association's numerous commercial bank members, we are aware of none that have complained about unfair treatment under current law or who have called for anything similar to the administration's proposal.

REQUIRE CURRENT ACCRUAL OF MARKET DISCOUNT BY ACCRUAL METHOD TAXPAYERS

Under current law, market discount occurs when taxpayers buy bonds at a discount to face value (par). Market discount, the difference between a bond's purchase price and its face value, is generally treated as ordinary interest income. The only exception is that tax liability is incurred not annually, but when the bond is sold or redeemed. The administration has proposed that accrual taxpayers would be required to recognize the accrual of market discount—and pay taxes on that accrual—annually.

Much of the problem with the administration's proposed treatment of market discount stems from its mistreatment under current law. On the basis of good tax policy and for purposes of tax symmetry, market discount really should be treated as a capital gain rather than as ordinary income. After all, market discount occurs when, as a result of a decline in market prices, a bond is sold in the secondary market at a price lower than its original issue price (or, in the case of a bond with original issue discount, its adjusted issue price). In such a case, the seller of the bond would incur a capital loss. The buyer of the bond, however, would recognize ordinary income. Such treatment is, at the very least, unfair. This asymmetry is mitigated, however, by the fact that like a capital gain, taxpayers are not required to recognize market discount income until a bond is sold or redeemed. The capital-gain nature of market discount is highlighted in the case of distressed debt. In this case, when an investor buys a bond at a deeply discounted price due to credit deterioration of the issuer and then realizes a gain due to improvements in the issuer's credit condition, the gain is much more in the character of a capital gain than of interest income. The administration recognizes this point in its explanation of its proposal.[3]

The administration has proposed that accrual taxpayers be required to recognize the accrual of market discount as it occurs and to incur tax liability on market discount annually. As a result, the proposal would exacerbate problems and inconsistencies associated with current-law treatment of market discount.

First, the proposal would introduce significant complexity to the treatment of market discount. As the JCT staff recognizes, when the existing market discount provisions were adopted in 1984, Congress purposefully established the current scheme of treatment—incurring tax liability only when a bond is sold or redeemed—in recognition that annual accrual treatment would be too complex.[4] The problem of complexity is compounded, as the JCT staff also recognizes, when a bond carries

both original-issue discount and market discount. The complexity of the market discount rules were highlighted in 1993, when the treatment of market discount on municipal bonds was changed from capital gain to ordinary income. This provision caused significant confusion among municipal bond investors.

Second, the administration's proposal would reduce the attractiveness of bonds trading at a discount to investors who are accrual taxpayers. Unfortunately, the tax treatment of market discount becomes an increasing concern to investors at times of market uncertainty, when bond prices are declining as a result of rising interest rates and when, as a result, market liquidity is hampered. Imposing additional, negative tax consequences on buyers of discounted debt instruments would simply fuel the illiquidity fire. This problem is compounded in times of persistent and severe declines in bond prices. It would be possible in these conditions for certain investors to pay tax annually on the accrual of market discount when, because the value of the bond fails to increase as fast as the discount accrues, little or no real cash income is ever actually earned. In such severe cases, an investor would be forced to recognize the accrual of market discount as ordinary income, even though that income was actually absorbed in a capital loss. Although this mistreatment exists under current law, it would be exacerbated if accrual taxpayers are forced to recognize market discount annually.

DEFER INTEREST DEDUCTION AND ORIGINAL ISSUE DISCOUNT ON CERTAIN CONVERTIBLE DEBT

The administration has proposed to change the tax treatment of original issue discount (OID) on convertible debt securities. OID occurs when the stated coupon of a debt instrument is below the yield demanded by investors. The most common case is a zero-coupon bond, where all the interest income earned by investors is in the form of accrued OID. Under current law, corporations that issue debt with OID may deduct the interest accrual while bonds are outstanding. In addition, taxable OID investors must recognize the accrual of OID as interest income. Under the administration's proposal, for OID instruments which are convertible to stock, issuers would be required to defer their deduction for accrued OID until payment was made to investors in cash. For convertible OID debt where the conversion option is exercised and the debt is paid in stock, issuers would lose the accrued OID deduction altogether. Investors would still be required to recognize the accrual of OID on convertible debt as interest income, regardless of whether issuers took deductions.

The administration's proposal is objectionable on several grounds. First, convertible zero-coupon debt has efficiently provided corporations with billions of dollars in capital financing. The change the administration proposes would significantly raise the cost of issuing convertible zero-coupon bonds, and in doing so would discourage corporate capital investment. Second, the administration's presumptions for the proposal are flawed. The administration has argued that "the issuance of convertible debt instrument[s] is viewed by market participants as a de facto issuance of equity."[5] However, performance does not bear this claim. In fact, of the convertible zero-coupon debt retired since 1985, approximately 70 percent has been retired in cash, and only 30 percent has been converted to stock. Indeed, the market treats convertible zero-coupon bonds more as debt than as equity.

Third, and perhaps most important, the administration's proposal violates the basic tenet of tax symmetry, the notion that the recognition of income by one party should be associated with a deduction by a counterparty. This fundamental principle exists to help ensure that income is taxed only once. Under the proposal, investors would be taxed fully on the accrual of OID on convertible zero-coupon debt, but issuers' deductions would be deferred or denied. The proposal would compound problems associated with the multiple taxation of investment income, thereby raising the cost of corporate capital.

Because the proposal would exacerbate problems of multiple taxation of corporate income and because it would raise the cost of corporate capital investment, we urge the rejection of the administration's proposal.

DENY DRD FOR PREFERRED STOCK WITH CERTAIN NON-STOCK CHARACTERISTICS

Under current law, corporate taxpayers that earn dividends on investments in other corporations are permitted a tax deduction equal to at least 70 percent of those earnings. The deduction is designed to mitigate the negative economic effects associated with multiple taxation of corporate earnings. The administration has proposed eliminating the dividends-received deduction (DRD) for preferred stock with certain characteristics. This proposal would increase the taxation of corporate earnings and discourage capital investment.

The DRD is important because it reduces the effects of multiple taxation of corporate earnings. When dividends are paid to a taxable person or entity, those funds are taxed twice, once at the corporate level and once at the level of the taxpayer to whom the dividends are paid. These multiple levels of taxation raise financing costs for corporations, create global competitiveness problems, and generally reduce incentives for capital formation. The DRD was specifically designed to reduce the burden of one layer of taxation by making dividends largely non-taxable to the corporate owner.

The administration has argued that certain types of preferred stock, such as variable-rate and auction-set preferred, "economically perform as debt instruments and have debt-like characteristics."[6] However, the administration has not proposed that such instruments be formally characterized as debt eligible for interest payment and accrual deductions. The administration has sought to characterize certain preferred stock in such a way as to maximize tax revenue; it would be ineligible for both the DRD and the interest expense deduction.

Eliminating the DRD for these instruments would exacerbate the effects of multiple taxation. The change would be tantamount to a tax increase on corporate earnings since the minimum deduction available to certain investors would fall. This tax increase would flow directly to issuers of preferred stock affected by the proposal who would face higher financing costs as investors demanded higher pre-tax yields. Amplifying the competitive disadvantages of multiple taxation of American corporate earnings would be the fact that many of our largest economic competitors have already adopted tax systems under which inter-corporate dividends are largely or completely untaxed. Eliminating the DRD for preferred stock with certain characteristics would cut U.S. corporations off from an efficient source of financing, thereby discouraging capital investment.

SUMMARY

Government fiscal policy, especially tax policy, can have a profound effect on the ability of governments and corporations to undertake capital investment. Tax increase proposals as seemingly arcane, technical and focused as "increasing the proration percentage for property and casualty companies" or "disallowing interest on debt allocable to tax-exempt obligations" would have effects far beyond what is apparent. By affecting the choices and preferences of investors, these proposals would also have a significant negative effect on the ability of borrowers to finance capital investments at the lowest possible cost. We share the belief of many members of this committee that our tax system ought to encourage and facilitate capital investment. The administration's tax increase proposals outlined above would have the opposite effect. These proposals represent unsound tax policy, and we urge you to oppose them.

We appreciate the opportunity to present our statement, and we look forward to working with Finance Committee members and staff as the budget debate progresses.

ENDNOTES

[1] Staff of the Joint Committee on Taxation, "Description of Revenue Provisions in the President's FY 2000 Budget Proposal" (JCS–1–99), February 22, 1999, pgs. 275–276.

[2] Department of the Treasury, "General Explanations of the Administration's Revenue Proposals, February 1999, page 159.

[3] *Ibid.*, Page 121.

[4] Staff of the Joint Committee on Taxation, Page 207.

[5] Department of the Treasury, page 127.

[6] *Ibid.*, page 132.

STATEMENT OF CLARK/BARDES

[SUBMITTED BY W. T. WAMBERG, CHAIRMAN OF THE BOARD]

INTRODUCTION

Clark/Bardes appreciates the opportunity to present this written statement to the Senate Finance Committee on the revenue-raising proposals included in the Administration's FY 2000 budget submission. Our statement focuses specifically on a proposal that would increase taxes on companies purchasing insurance covering the lives of their employees.

Clark/Bardes is a publicly traded company headquartered in Dallas, Texas, and with offices around the country. We design, market, and administer insurance-based employee benefit financing programs. Our clients, which include a broad range of

businesses, use insurance products as assets to offset the liabilities of employee benefits and to supplement and secure benefits for key executives.

Clark/Bardes strongly opposes the Administration's proposed tax increase on "corporate-owned life insurance" ("COLI"). The same proposal was floated by the Administration in its FY 1999 budget submission and wisely rejected by Congress. Perhaps in recognition of the fact that Congress last year found no coherent tax policy justification for such a change, the Administration this year has branded COLI as a "corporate tax shelter"—an egregious characterization intended to build visceral support for the proposal. Regardless of the Administration's rhetoric, the reasons for rejecting the COLI tax increase remain the same:

- Employer-owned life insurance remains an effective means for businesses to finance their growing retiree health and benefit obligations.
- The Administration's proposal shares none of the same tax policy concerns that drove Congressional action on COLI in 1996 and 1997 legislation.
- The current-law tax treatment of COLI was sanctioned explicitly by Congress in the 1996 and 1997 legislation.
- The Administration's proposal is a thinly disguised attempt to tax the "inside buildup" on insurance policies—i.e., a tax on a long-standing means of savings.
- The Administration's proposal represents yet another move by the Administration—along a slippery slope—to deny deductions for ordinary and necessary business expenses.

USE OF EMPLOYER-OWNED LIFE INSURANCE

Before turning to the Administration's proposal, Clark/Bardes believes it is important to provide background information on employer-owned life insurance—a business practice that does not appear to be well understood.

Many employers, large and small, provide health and other benefits to their retired employees. While ERISA rules generally make "dedicated" funding impossible, employers generally seek to establish a method of financing these obligations. This allows them not only to secure a source of funds for these payments but also to offset the impact of financial accounting rules that require employers to include the present value of the projected future retiree benefits in their annual financial statements.

Life insurance provides an effective means for businesses to finance their retiree benefits. Consultants, like Clark/Bardes, and life insurance companies work with employers to develop programs to enable the employers to predict retiree health benefit needs and match them with proceeds payable under the life insurance programs. A simplified example may help to illustrate:

> ABC Company guarantees its employees a generous health benefits package upon retirement. ABC Company is required to book a liability on its balance sheet for the eventual retirement of its employees, and needs to find ways to fund these obligations.
>
> ABC Company, working with consultants, takes out a series of life insurance policies on its employees. It pays level insurance premiums to the insurance carrier each year. The cash value on the life insurance policy accumulates on a tax-deferred basis. In the event that the contract is surrendered, ABC Company pays tax on any gain in the policy. In the event that employees die, ABC Company receives the death benefit and uses these funds to make benefits payments to its retired employees. Actuaries are able to match closely the amount of insurance necessary to fund ABC Company's liabilities.

The Administration's COLI proposal effectively would take away an employer's ability to finance retiree benefit programs using life insurance, and thus could force businesses to severely limit or discontinue these programs. It is ironic that the President's proposal would hamstring a legitimate means of funding post-retirement benefits when a major focus of Congress is to encourage private sector solutions to provide for the needs of our retirees.

THE ADMINISTRATION'S COLI PROPOSAL

The Administration's proposal to tax employer-owned life insurance should be viewed in light of the basic tax rules governing life insurance and interest expenses and recent changes made by Congress to the tax treatment of COLI.

Since 1913, amounts paid due to the death of an insured person have been excluded from Federal gross income. The present-law provision providing this exclusion is section 101 of the Internal Revenue Code of 1986, as amended (the "Code"). Amounts paid upon the surrender of a life insurance policy are excluded from tax-

able income to the extent of the aggregate amount of premiums or other consideration paid for the policy, pursuant to section 72(e) of the Code.

Section 163 of the Code generally allows deductions for interest paid on genuine indebtedness. However, sections 264(a)(2) and (a)(3) of the Code, enacted in 1964, prohibit deductions if the interest is paid pursuant to (i) a single premium life insurance contract, or (ii) a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract, unless the requirements of an applicable exception to the disallowance rule are satisfied. One of the exceptions to this interest disallowance provision, known as the "four-out-of-seven" rule, is satisfied if no part of four of the annual premiums due during a seven-year period (beginning with the date the first premium on the contract is paid) is paid by means of indebtedness.

The Tax Reform Act of 1986 (the "1986 Act") amended section 264 of the Code to limit generally deductions for interest paid or accrued on debt with respect to COLI policies covering the life of any officer, employee, or individual who is financially interested in the taxpayer. Specifically, it denied deductions for interest to the extent that borrowing levels on corporate-owned policies exceeded $50,000 of cash surrender value per insured officer, employee, or financially interested individual.

Congress in the Health Insurance Portability and Accountability Act of 1996 (the "1996 Act") eliminated deductions for interest paid on loans taken against the tax-free earnings under the life insurance contract. Specifically, the 1996 Act denied a deduction for interest paid or accrued on any indebtedness with respect to any life insurance policies covering an officer, employee, or financially interested individual of the policy owner. The 1996 Act provided a phase-out rule for indebtedness on existing COLI contracts, permitting continued interest deductions in declining percentages through 1998.

The 1996 Act provided an exception for certain COLI contracts. Specifically, the Act continued to allow deductions with respect to indebtedness on COLI covering up to 20 "key persons," defined generally as an officer or a 20-percent owner of the policy owner, subject to the $50,000 indebtedness limit, and further subject to a restriction that the rate of interest paid on the policies cannot exceed the Moody's Corporate Bond Yield Average-Monthly Corporates for each month interest is paid or accrued.

The Taxpayer Relief Act of 1997 (the "1997 Act") added section 264(f) to the Code. This provision generally disallows a deduction for the portion of a taxpayer's total interest expense that is allocated pro rata to the excess of the cash surrender value of the taxpayer's life insurance policies over the amounts of any loans with respect to the policies, effective for policies issued after June 8, 1997. However, section 264(f)(4) provides a broad exception for policies covering 20-percent owners, officers, directors, or employees of the owner of the policy. Thus, the interest deduction disallowance provision in the 1997 Act generally affected only COLI programs covering the lives of non-employees.

The COLI proposal in the Administration's FY 2000 budget, submitted on February 1, 1999, would extend the section 264(f) interest deduction disallowance to COLI programs covering the lives of employees.[1] The proposal therefore would apply a proportionate interest expense disallowance based on all COLI cash surrender values. The exact amount of the interest disallowance would depend on the ratio of the average cash values of the taxpayer's non-leveraged life insurance policies to the average adjusted bases of all other assets.

LACK OF TAX POLICY JUSTIFICATION

The Treasury Department, in its "Green Book" explanation of the revenue proposals in the Administration's FY 2000 budget, implies that the COLI measures taken by Congress in 1996 and 1997 were incomplete in accomplishing their intended goals. A closer inspection of the tax policy considerations that gave rise to the 1996 and 1997 changes would suggest otherwise.

The 1996 Act changes to the tax treatment of COLI focused on leveraged COLI transactions (i.e., transactions involving borrowings against the value of the life insurance policies), which it believed represented an inappropriate and unintended application of the tax rules. The "Blue Book" explanation of the 1996 Act, prepared by the staff of the Joint Committee on Taxation, states that leveraged COLI programs "could be viewed as the economic equivalent of a tax-free savings account owned by the company into which it pays itself tax-deductible interest."[2] The Blue Book further states:

> . . . Congress felt that it is not appropriate to permit a deduction for interest that is funding the increase in value of an asset of which the taxpayer is the ultimate beneficiary as recipient of the proceeds upon the insured person's

death. Interest paid by the taxpayer on a loan under a life insurance policy can be viewed as funding the inside buildup of the policy. The taxpayer is indirectly paying the interest to itself, through the increase in value of the policy of which the taxpayer is the beneficiary.[3]

The 1997 Act COLI provision grew out of concerns over plans by a particular taxpayer, Fannie Mae, to acquire corporate-owned life insurance on the lives of its mortgage holders. The 1997 Act changes, therefore, specifically targeted COLI programs developed with respect to non-employees. Both the House Ways and Means Committee Report and the Senate Finance Committee Report on the 1997 Act discuss an example involving a Fannie Mae-type fact pattern:

> If a mortgage lender can . . . buy a cash value life insurance policy on the lives of mortgage borrowers, the lender may be able to deduct premiums or interest on debt with respect to such a contract, if no other deduction disallowance rule or principle of tax law applies to limit the deductions. The premiums or interest could be deductible even after the individual's mortgage loan is sold to another lender or to a mortgage pool. If the loan were sold to a second lender, the second lender might also be able to buy a cash value life insurance contract on the life of the borrower, and to deduct premiums or interest with respect to that contract.[4]

The COLI proposal in the Administration's FY 2000 budget lacks any similarly compelling tax policy justification. Unlike the 1996 Act provision targeting leveraged COLI programs, the Administration's proposal would apply where there is no link between loan interest and the COLI program.[5] And unlike the 1997 Act provision targeting the use of COLI with respect to non-employees, this proposal does not involve a newly conceived use of COLI.

In explaining the rationale underlying the proposal, the Treasury Department argues that the "inside buildup" on life insurance policies in COLI programs gives rise to "tax arbitrage benefits" for leveraged businesses.[6] Treasury argues that businesses use inside buildup on COLI policies to fund deductible interest payments, thus jumping to the conclusion that COLI considerations govern decisions regarding when businesses incur debt. This view is clearly erroneous. Businesses incur debt for business reasons (e.g., business expansion).

COLI IS NOT A "TAX SHELTER"

Clark/Bardes strongly objects to the Administration's characterization of COLI as a "corporate tax shelter." The penalty provisions of the Internal Revenue Code define a tax shelter as any entity, plan, or arrangement with respect to which tax avoidance or evasion is a significant purpose.[7] A separate proposal in the Administration's FY 2000 budget proposes a new definition of "corporate tax shelter" under section 6662 that would apply to "attempts to obtain a tax benefit" in a "tax avoidance transaction," defined as any transaction in which the reasonably expected pretax profit is insignificant relative to the reasonably expected net tax benefits.[8]

It is difficult to see how traditional COLI programs might reasonably be viewed as meeting any of these "tax shelter" definitions. As discussed above, the Administration's proposal would deny interest deductions on borrowings totally unrelated to COLI, for example, where a company owning life insurance policies on the lives of employees borrows money to construct a new manufacturing plant, or conversely, where a company that borrowed ten years ago to construct a plant now considers purchasing life insurance to help finance retiree benefits. The Administration apparently believes that these disparate actions can be collapsed and viewed as a tax-avoidance transaction or as an attempt to obtain tax benefits. It is difficult to see just what tax might be avoided in this situation or what tax benefit is being sought. Does Treasury seriously suggest that such a company should be hit with the stiff penalties that apply to tax shelter transactions? These are serious questions that do not appear to have thought through completely under the Treasury proposal.

Under a broader view, a "tax shelter" might be thought of as an arrangement involving an unintended application of the tax laws. It is impossible to argue that current COLI programs involve an unintended application of the tax laws. Few other areas of the tax law have received as thorough scrutiny in recent years. In the 1996 Act, Congress explicitly allowed COLI programs to continue in the future so long as they were not leveraged. In the 1997 Act, Congress carefully crafted a specific exception (designed to preserve longstanding use of unleveraged COLI) to the pro rata interest expense disallowance provisions for COLI programs covering employees. In other words, current COLI programs involve an intended application of the tax law.

ATTACK ON "INSIDE BUILDUP," SAVINGS

The Administration's COLI proposal, at its core, is not about "tax shelters" at all. Rather, it is a thinly veiled attack on the very heart of traditional permanent life insurance—that is, the "inside buildup" of credits (or cash value) within these policies that permits policyholders to pay level premiums over the lives of covered individuals. Although couched as a limitation on interest expense deductions, the proposal generally would have the same effect as a direct tax on inside buildup. Thus, the proposal would reverse the fundamental tax treatment of level-premium life insurance that has been in place since 1913.

Congress in the past has rejected proposals to alter the tax treatment of inside buildup, and for good reason. The investment element inherent in permanent life insurance is a significant form of savings. Congress and the Administration in recent years have worked together in the opposite direction, considering new incentives for savings and long-term investment and removing obvious obstacles. It is odd that the Administration at this time would propose making it more difficult to save and invest through life insurance.

INAPPROPRIATE LIMITATION ON BUSINESS DEDUCTIONS

In some respects, Treasury's proposed denial of deductions for interest expenses for companies owning life insurance is not surprising. This proposal comes on the heels of other Clinton Administration proposals to chip away at deductions for expenses that long have been treated as ordinary and necessary costs of doing business. Another recent example is the provision in the Administration's FY 2000 budget to deny deductions for damages paid by companies to plaintiffs groups.

But the proposal is troubling nonetheless, as illustrated by a simple example. The XYX company in 1997 borrows funds to build a new manufacturing facility. The XYZ company in 1997 and 1998 is able to deduct interest paid on these borrowings. In 1999, the XYZ company, responding to concerns over mounting future retiree health obligations, purchases insurance on the lives of its employees. IRS agents tell the XYZ company that it has just entered into a "tax shelter." Suddenly, the XYZ company finds that a portion of the interest on the 1997 loan is no longer viewed by the government as an ordinary and necessary business expense. XYZ therefore is taxed, retroactively, on its 1997 borrowing.

The proposal becomes even more troubling when one considers the logical extensions of the Administration's rationale with respect to COLI. Might the IRS, using the same reasoning, someday deny home mortgage interest deductions for individuals who also own life insurance? Might the government deny deductions for medical expenses for individuals that enjoy tax-preferred accumulations of earnings in 401(k) accounts or IRAs?

CONCLUSION

Clark/Bardes respectfully urges the Senate Finance Committee to reject the Administration's misguided COLI proposal. As discussed above, the Administration once again has failed to articulate a clear or compelling tax policy concern with respect to the current-law rules, and now has sought to couch COLI, altogether inappropriately, as a "tax shelter." If enacted, the Administration's proposal would represent a significant departure from current law and tax policy regarding the treatment of life insurance. It would have a significantly adverse impact on the ability of businesses to solve a variety of needs including the ability to finance meaningful retiree health benefits. It also would provide a disincentive for savings and long-term investment and would represent yet another attack on deductions for ordinary and necessary business expenses.

ENDNOTES

[1] By eliminating the section 264(f)(4) exception that currently exempts COLI programs covering the lives of employees, officers, and directors.

[2] Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 104th Congress (JCS–12–96), December 18, 1996, p. 363.

[3] *Id*, at 364.

[4] H.R. Rep. No. 105–148, 105th Cong., 1st Sess. p. 501; S. Rep. No. 105–33, 105th Cong., 1st Sess., p. 186.

[5] Current law is quite specific that interest deductions resulting from both direct and indirect borrowing, i.e., using the policy as collateral, are disallowed. Sec. 264(a)(3).

[6] General Explanation of the Administration's Revenue Proposals, Department of the Treasury, February 1999, p. 118.

[7] Section 6662(d)(2)(C)(iii).

[8] As a separate matter, Clark/Bardes believes the Administration's proposed new definition of "corporate tax shelter" is unnecessary, ill-advised, and could be broadly applied by IRS agents to attack many legitimate business transactions.

STATEMENT OF THE COALITION FOR THE FAIR TAXATION OF BUSINESS TRANSACTIONS [1]

The Coalition for the Fair Taxation of Business Transactions (the "Coalition") is composed of U.S. companies representing a broad cross-section of industries. The Coalition is opposed to the broad-based "corporate tax shelter" provisions in the Administration's budget because of their detrimental impact on legitimate business transactions. The Coalition is particularly concerned with the broad delegation of authority provided to IRS agents under these proposals, which we believe reverses some of the reforms of the IRS Restructuring and Reform Act, passed just last year.

I. INTRODUCTION

The Administration's Fiscal Year 2000 Budget contains several proposals addressing so-called "corporate tax shelters." The proposals fall into two general categories. The first is a set of broad-based proposals that could result in multiple penalties for any corporation that engages in a transaction that results in any reduction of taxes. The second is a set of specific proposals targeted at specific transactions that Treasury and the IRS view as abusive or inappropriate. These proposals, especially the set of broad-based proposals, appear to be driven by a perception on the part of Treasury and the IRS of a substantial increase in "corporate tax shelter" activity in recent years and that such activity has caused a serious erosion in the corporate tax base.

As a general matter, the Coalition does not believe that there has been a substantial erosion of the corporate tax base. Statistics recently released by the Congressional Budget Office (CBO)[2] demonstrate that, rather than falling, corporate income tax receipts have been steadily rising in recent years. Further, CBO and the Office of Management and Budget ("OMB") both project that revenues from corporate income taxes will continue to rise over the next 10 years. In fact, the average tax rate paid by corporations is approximately 32.5 percent and is projected by CBO to rise to 33.6 percent in 2000. In addition, according to CBO, corporate income tax receipts grew 3.5 percent for fiscal year 1998, while taxable corporate profits grew at a slower rate of only 2.3 percent. In light of the average corporate tax rate remaining relatively constant, there does not appear to be any compelling reason for a radical set of new proposals addressing "corporate tax shelters" when there are only isolated instances of such "tax shelters."

The Coalition also believes that, in addition to being unnecessary, the broad-based proposals could seriously undermine a corporation's ability to undertake legitimate business transactions. The vague, generalized language of the various proposals does not provide sufficient guidance to corporate taxpayers as to what transactions will constitute a "corporate tax shelter." As a result, virtually every transaction, regardless of its purpose, undertaken by a corporate taxpayer that minimizes the corporation's taxes in any way will be potentially subject to the very harsh penalties contained in the tax shelter proposals.

In addition, the Coalition also believes that the broad-based corporate tax shelter proposals would unjustifiably delegate too much authority to the IRS and allow the IRS to impose harsh penalties on activities that represent legitimate business transactions. The tenor and potential effect of these broad-based proposals fly in the face of the Congressional policy underlying enactment of the IRS Restructuring and Reform Act of 1998. In particular, Congress expressed serious concerns about the excessive amount of unrestrained power in the hands of IRS agents and, in response, modified the structure and operations of the IRS and expanded the rights of taxpayers against the intrusiveness of the IRS. The broad grant of authority to IRS agents in the Administration's tax shelter proposals is contrary to the theme of the IRS Restructuring and Reform Act of 1998 to curtail the power that IRS agents have over taxpayers.

Finally, the Coalition believes the level of penalties proposed by the Administration is particularly harsh in light of the overwhelming complexity of the current tax laws. The combination of the proposals would create a cascading of penalties that, both individually and in the aggregate, would be unfair and excessive. Congress has already stated that cascading penalties are unfair and expressed its disapproval of them in the IRS Restructuring and Reform Act.

In sum, Congress should reject these overly broad and unworkable proposals. The proposals transfer excessive and unnecessary authority to the IRS and unfairly impact legitimate business transactions that are not tax-motivated. Moreover, the Ad-

ministration's new definition of corporate tax shelter creates additional uncertainty in a tax code that is already overwhelmed with complexity.

II. DEFINITION OF CORPORATE TAX SHELTER

One need look no further than the proposed new definition of corporate tax shelter[3] to find the genesis of the problems with the Administration's budget proposals. Rather than providing an objective definition of a "corporate tax shelter," the proposal simply defines a corporate tax shelter as any entity, plan, or arrangement in which a corporation obtained a "tax benefit" in a "tax avoidance transaction." Under the proposal, it would no longer be necessary to find that a transaction had a "significant purpose," or indeed any purpose, to avoid taxes for the transaction to be characterized as a corporate tax shelter. As discussed below, these concepts and definitions are overly broad and vague, and are so subjective that they give virtually unlimited discretion to the IRS to determine if a transaction is a corporate tax shelter.

The proposal defines a "tax benefit" as a reduction, exclusion, avoidance or deferral of tax (or an increase in a refund) unless the benefit was "clearly contemplated" by the applicable Code provision. The proposal provides no guidance on how to determine when a tax benefit is clearly contemplated. It appears that a benefit can be an impermissible "tax benefit" even if the benefit was permitted under the actual language of the applicable Code provision. In the absence of any clear guidance, the proposal would apparently provide IRS revenue agents with the power to determine whether a taxpayer's tax benefit was a "clearly contemplated" permissible benefit. This part of the proposal simply grants too much unchecked authority to individual revenue agents, which will inevitably result in increased confrontations between taxpayers and revenue agents and a backlog of litigation in the Tax Court.

The proposal defines a "tax avoidance transaction" as any transaction in which the reasonably expected pre-tax profit (determined on a present value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present value basis) of such transaction. In addition, a tax avoidance transaction is defined to cover certain transactions involving the improper elimination or significant reduction of tax on economic income.

As in the case of the definition of "tax benefit," the Administration's proposal fails to provide any guidance on what transactions would constitute "tax avoidance transactions." For example, the proposal does not provide any guidance as to the amount of expected pre-tax profit that would be "insignificant" relative to the reasonably expected net tax benefits. The proposal also fails to provide guidance as to how a corporate taxpayer is to accomplish the impossible task of present valuing expected net tax benefits. This inflexible, mathematical analysis does not allow for the possibility of legitimate business transactions that do not produce an easily identifiable pre-tax profit. For example, a corporation may need to structure its affairs to conform to regulatory requirements or a company may reorganize its structure to gain access to certain foreign markets. A company may also need to restructure or reorganize to gain economies of scale. In addition, a company may enter into a transaction to obtain funds for working capital at a lower cost.[4] These transactions are motivated by business concerns, even though they do not directly produce a pre-tax economic return by themselves. If these legitimate transactions are done in a tax efficient manner, they apparently will be characterized automatically as a tax shelter because they do not produce a direct economic return. Further, under the proposal, IRS agents could attempt to classify any loss transaction as a tax shelter when the transaction does not provide the expected return.

Under the second part of the proposed definition of tax avoidance transaction, any transaction that results in a significant reduction of tax on economic income could be classified as a corporate tax shelter. The proposal is silent as to what types of transactions would involve the "improper elimination" or "significant reduction" of tax on economic income. The Administration's proposal contains no restraints on the use of this provision by the IRS; therefore, the IRS can classify any legitimate business transaction as a corporate tax shelter if, in the opinion of the IRS, the transaction resulted in a significant reduction of tax on economic income. For example, the IRS could possibly classify such routine business transactions as tax-free reorganizations, tax-free spinoffs, or even check-the-box classification elections as corporate tax shelters. In other words, this proposal would allow the IRS to penalize corporate taxpayers for arranging their transactions in a tax efficient manner. This proposals ignores Judge Learned Hand's observation that:

Anyone may so arrange his affairs that his taxes shall be as low as possible, he is not bound to chose that pattern which will best pay the Treasury, there is not even a patriotic duty to increase one's taxes.[5]

Despite Treasury's claims to the contrary, these proposed broad definitions are not simply a codification of existing judicial doctrines. Current case law views a significant pre-tax profit as a sufficient, but not a necessary, condition for finding that a transaction does not represent a corporate tax shelter. In addition, case law has always considered valid business reasons as part of the evaluation of corporate transactions. For example, the Supreme Court has upheld a transaction "which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached." *Frank Lyon Co.* v. *United States,* 435 U.S. 561, 583–84 (1978). Similarly, cases have held that "when a transaction has no substance other than to create deductions, the transaction is disregarded for tax purposes." *Knetsch* v. *United States,* 364 U.S. 361, 366 (1960). The most recent case applying this analysis examined both the objective economics of a transaction, as well as the subjective business motivations claimed by the parties. *ACM Partnership* v. *Commissioner,* 157 F.3d 231 (3d Cir. 1998). Therefore, adopting a purely mechanical test that compares pre-tax profits to tax benefits, without looking to business reasons for the transaction, goes far beyond the holdings in current case law and is a radical extension of the power of the IRS to control business activities.

III. ANALYSIS OF CORPORATE TAX SHELTER PROPOSALS

A. *Modified Substantial Understatement Penalty*

The Administration's budget proposal would increase the substantial understatement penalty from 20 percent to 40 percent with respect to any item attributable to a corporate tax shelter.[6] A corporation can reduce the 40 percent penalty to 20 percent by fulfilling specific disclosure requirements. Specifically, a taxpayer would be required to disclose a tax shelter transaction to the IRS National Office within 30 days of the closing of the transaction and file a statement with the tax return verifying that the disclosure had been made. This proposal would also eliminate the reasonable cause exception to the imposition of the penalty for any item attributable to a corporate tax shelter.

There is no rationale for increasing the substantial understatement penalty from 20 to 40 percent. The current 20 percent penalty is a powerful incentive for corporate taxpayers to closely analyze any proposed business transaction that results in tax benefits. Moreover, Treasury has failed to provide objective evidence to establish that doubling the substantial understatement penalty will have any incremental behavioral effect. In addition, the proposed definition of "corporate tax shelter" is too vague, and creates too much uncertainty, to justify a 40 percent penalty. Such an increase in penalties is also inconsistent with the intent of the IRS Restructuring and Reform Act to simplify penalty administration and reduce burdens on taxpayers.

If the purpose of increasing the penalty is to gain more disclosure, because the increased penalty would be reduced if the taxpayer discloses, we think a better approach is to eliminate the current 20 percent penalty if the taxpayer discloses and to have the disclosure made on the corporate tax return. The elimination of all penalties is a more powerful incentive than reducing a penalty. Furthermore, we are extremely concerned about the leverage that an IRS agent would have in an audit situation if he were able to threaten a 40 percent penalty on a transaction.

Even less justified is the Administration's proposal to eliminate the reasonable cause exception to the penalty. The reasonable cause exception is an essential function of the penalty regime and is found in virtually every penalty provision of the Code. The rationale for such an exception is simple: in light of the complexity of the Code and the significant uncertainty in its interpretation, it is unfair to automatically impose a penalty upon a taxpayer who has made a good faith effort to comply with the tax law. Without such an exception, taxpayers will be faced with a draconian 40 percent penalty for a misinterpretation of the law, even if there is an honest disagreement on the interpretation of fact and law that is reasonable in light of all the facts and circumstances. In effect, taxpayers will be held to a strict liability standard in interpreting overly complex tax laws.

The elimination of the reasonable cause exception will also have a serious impact on the administration of the tax law. For example, preventing the IRS from waiving penalties for reasonable cause will result in a decline in the number of cases settled administratively. The size of the penalty and the inability on the part of the IRS to waive the penalty will require taxpayers to litigate the underlying issue of whether the transaction was a corporate tax shelter. In addition, the combination of the

elimination of the reasonable cause exception and the creation of a subjective definition of corporate tax shelter will give examining agents an unwarranted and unrestrained opportunity to hold corporate taxpayers hostage during the examination process. Revenue agents, who have no downside, can threaten to propose adjustments based on alleged corporate tax shelter transactions to extract unreasonable concessions by the corporate taxpayer on other issues. Incidents of "rogue" revenue agents abusing their authority in efforts to extort unfair concessions and settlements are not limited to individual taxpayers. In fact, the higher rate of corporate tax audits makes this a particularly worrisome proposal. The use of the increased substantial understatement penalty to obtain concessions from corporate taxpayers is inconsistent with the goals expressed in the IRS Restructuring and Reform Act of 1998.

We understand, however, that Treasury has some concern with respect to some of the professional opinions that taxpayers rely upon as providing reasonable cause. Although the current regulations establish a standard that is sufficiently strict to prevent aggressive tax shelters from satisfying the reasonable cause exception and thereby avoiding the penalty, raising the standard for tax opinions provided by a tax adviser through a clarification of reasonable cause may deter overly aggressive tax planning. As a corrective measure, the reasonable cause exception could be modified to prevent taxpayers from accepting and tax advisers from providing overly aggressive tax opinions. For example, we would support a suggestion made by the Tax Executives Institute (TEI) at the Senate Finance Committee hearing to modify section 6664(c) to provide that obtaining a favorable opinion from a professional tax advisor will not by itself constitute reasonable cause where one of the following exist:

(1) a confidentiality agreement between the taxpayer and the promoter of the tax shelter;

(2) a contingency fee arrangement or unwind clause; or

(3) the opinion has been issued by a practitioner who has been subject to sanction under Circular 230.

B. Deny Certain Tax Benefits to Persons Avoiding Income Tax as a Result of Tax Avoidance Transactions

Currently, under section 269 of the Code, the Secretary of the Treasury has the authority to disallow a tax benefit in certain acquisition transactions where the principle purpose for entering into the transaction is the evasion or avoidance of Federal income tax by obtaining the benefit of a deduction, credit, or other allowance. This provision applies to transactions involving the acquisition of control of a corporation (directly or indirectly), or to transactions where a corporation acquires (directly or indirectly) carryover basis property of another corporation that was not controlled by the acquiring corporation immediately before the transaction. The tax benefits that may be disallowed under section 269 include net operating losses, foreign tax credit carryovers, investment credit carryovers, depreciation deductions, and a wide range of other tax attributes.

The Administration's proposal would dramatically expand section 269 and give the IRS authority to disallow a deduction, credit, exclusion, or other allowance obtained in a "tax avoidance transaction."[7] Thus, the proposal goes well beyond the context of the current section 269 and would represent an inappropriate delegation of authority to Treasury and IRS personnel. Under this proposal, revenue agents could disallow any deduction, credit, exclusion, or other allowance obtained by a corporate taxpayer based on their subjective determination that a transaction falls within the vague definition of a "tax avoidance transaction." This authority could be used to deny a corporate taxpayer a tax benefit provided by the Code merely because the IRS believes that the transaction yielded too much tax savings, regardless of a corporate taxpayer's legitimate business purpose for entering into the transaction. Again, this is giving an IRS agent too much discretion and is inconsistent with the IRS Restructuring and Reform Act.

All the witnesses at the Senate Finance Committee hearing opposed the Administration's expanded section 269 proposal for similar reasons. The American Bar Association (ABA) suggested, as an alternative, codifying the judicial "economic substance doctrine." This suggestion is similarly objectionable. As noted above, Treasury's section 269 proposal grants broad authority to IRS agents. Likewise, codifying the economic substance doctrine would apply a vague standard and give too much discretion to IRS agents. Furthermore, imposing an economic benefit test that measures the pre-tax profit against the value of the tax advantage is inflexible and does not allow for legitimate business transactions that do not produce an easily identifiable pre-tax profit. The economic substance doctrine works best in a judicial setting where the facts and business purpose of a transaction can be appropriately weighed.

C. *Deny Deductions For Certain Tax Advice and Imposition of an Excise Tax on Certain Fees Received.*

The Administration's proposal would deny a deduction for fees paid or incurred in connection with the purchase and implementation, as well as the rendering of tax advice related to, corporate tax shelters and impose a 25 percent excise tax on fees received in connection therewith. This proposal relies on the same vague and faulty definition of "tax avoidance transaction" as the previously discussed proposals. Thus, if in the IRS's view a transaction significantly reduces tax on economic income, or if the transaction does not meet the economic profit test, a tax deduction can be denied for tax advice that represents an ordinary and necessary business expense associated with a legitimate business transaction. An even more absurd result is that a deduction would be disallowed for fees related to tax advice where the advice is to not invest in a particular transaction because it may be considered a tax shelter.

This provision also illustrates the overlapping nature of the corporate tax shelter proposals and the potentially cascading penalties they can impose on a corporate taxpayer. For example, assume that a taxpayer entered into a legitimate business transaction with the advice of its tax adviser that the transaction was not a tax avoidance transaction. If the IRS subsequently determines that the transaction did not have sufficient pre-tax benefits, the transaction could be classified as a tax avoidance transaction. The corporate taxpayer would be subject to at least three penalties: (1) denial of the deduction for fees paid to the tax adviser for what has previously always been considered an ordinary and necessary business expense, (2) the 40 percent modified substantial understatement penalty on the disallowed deduction for the fees paid, and (3) the 40 percent modified substantial understatement penalty on the tax attributed to the tax benefits denied as a result of the IRS characterizing the transaction as a tax avoidance transaction.

Finally, this particular proposal to impose an excise tax on fees received in connection with a tax shelter raises numerous administrative issues. The determination that a transaction falls within the new definition of corporate tax shelters may not be made until years after the payment or the receipt of fees, which raises questions concerning the statute of limitations and the IRS's assessment authority against the "shelter provider." Fairness demands that the fee recipient also be provided an opportunity to challenge the tax shelter determination, which may result in the issue being litigated twice. These are only a few of the practical problems that need resolution in order to implement this vague proposal.

D. *Impose Excise Tax on Certain Rescission Provisions and Provisions Guaranteeing Tax Benefits*

The Administration's budget proposal would impose an excise tax on a "tax benefit protection arrangement" provided to the purchaser of a corporate tax shelter. A tax benefit protection arrangement would include a rescission clause requiring a seller or counterparty to unwind the transaction, a guarantee of tax benefits arrangement, or any other arrangement that has the same economic effect (e.g., insurance purchased with respect to the transaction). The Administration's plan would impose on the purchaser of a corporate tax shelter an excise tax of 25 percent on the maximum payment to be made under a tax benefit arrangement if the tax benefits are denied.

As a practical matter, this proposal fails to consider how rescission clauses or guarantees work. Generally, these agreements put a tax adviser at risk for an agreed-upon percentage of any additional tax that the taxpayer ultimately owes as a result of the transaction. This amount cannot be determined unless and until the Service proposes adjustments to the taxpayer's liability with respect to the transaction and the taxpayer's correct tax liability is either agreed upon by the parties or determined by a court. Until such time, a corporate taxpayer cannot determine the maximum payment possible under the arrangement. Moreover, assessing an excise tax based upon the highest potential benefits that could possibly be obtained in the future under such an agreement is fundamentally unfair and vastly inflates the possibilities for mischief by over-zealous revenue agents.

E. *Preclude Taxpayers From Taking Tax Positions Inconsistent With the Form of Their Transaction*

The Administration's budget proposal would generally provide that a corporate taxpayer is precluded from taking any position that is inconsistent with its form if a "tax indifferent party" is involved in the transaction. This rule would not apply (1) if the taxpayer discloses the inconsistent position on a timely filed original return; (2) to the extent provided in regulations, if reporting the substance of the transaction more clearly reflects income; or (3) to certain transactions (such as pub-

licly-available securities, lending and sale-repurchase transactions) identified in regulations.

This proposal would essentially require a U.S. taxpayer to be bound by the form of a transaction unless it disclosed the inconsistent position to the IRS. Presumably, an IRS agent could then scrutinize the transaction to determine whether it would be considered a tax shelter. This again would place undue authority in the hands of IRS agents to change the tax treatment of a transaction and would result in arbitrary and inconsistent application of the tax law.

For example, a foreign jurisdiction may respect a note as debt even though it would be characterized as equity for U.S. tax purposes. (A 100-year note is generally treated as equity for U.S. tax purposes; however, another country's tax laws may respect the note as debt.) As a result, payments on the note by a foreign subsidiary to its U.S. parent would be treated as deductible interest under the foreign country's tax laws. The U.S. would treat the payment as a dividend that would provide the U.S. parent with a deemed paid foreign tax credit. Because the instrument was formally labeled a note, however, the taxpayer's treatment of the note as equity for U.S. purposes would be inconsistent with the form. Assuming the parent had expiring foreign tax credits, the U.S. parent would be a tax-indifferent party under the proposal. Therefore, an agent on audit might deny the foreign tax credit generated by the dividend payment on the grounds that the taxpayer treated the note as debt for foreign tax purposes and the foreign tax benefit created a tax shelter.

This result is especially harsh for three reasons. First, the appropriate goal of U.S. tax policy should be to determine the proper character of a transaction for federal income tax purposes and then to tax the transaction in accordance with that character. A rule that allows recharacterization based upon inconsistent treatment under foreign law is at odds with this policy because two transactions that are economically indistinguishable will be treated differently. Furthermore, it violates the general principle that U.S. tax principles and not foreign principles should control. Second, the foreign country may have made a conscious policy decision to respect the note as debt. It is inappropriate to give an agent on audit the ability to penalize a taxpayer for using a benefit provided by the foreign tax law; the agent would essentially be substituting the agent's judgment for the judgment of the foreign country's lawmakers. Third, this provision interferes with the consistent application of U.S. tax law because an agent on audit would have tremendous discretion to choose not to follow normal tax principles. The determination of the tax treatment of a transaction would be made by individual agents, not by Congress or by Treasury in its regulatory capacity.

F. Tax Income From Corporate Tax Shelters Including Tax-Indifferent Parties.

The Administration's budget plan would impose a tax on corporate tax shelter transactions involving "tax-indifferent" parties. A "tax-indifferent" party is defined as a foreign person, a Native American tribal organization, a tax-exempt organization, or a domestic corporation with expiring loss or credit carryforwards (generally more than 3 years old). The transactions targeted by this proposal generally result in the tax-indifferent parties having income or gain from the transaction, while taxable corporate participants may have deductions or loss from the transaction. The proposal would impose tax on the tax-indifferent party by recharacterizing the item of gain or income as taxable. For example, a foreign person would be treated as earning taxable effectively connected income; a tax-exempt organization would be treated as earning unrelated business taxable income. All other participants in the corporate tax shelter would be jointly and severally liable for the tax.

As with the other corporate tax shelter provisions, the broad definition of corporate tax shelter does not provide sufficient specificity for taxpayers or tax-indifferent parties to determine what transactions might run afoul of these rules. The vague and subjective definition creates an environment of uncertainty for such parties when making business and investment decisions, and it is likely that many routine business arrangements would fall within this broad definition. For example, taxpayers could be penalized for legitimate attempts to utilize NOLs before the 20-year carryforward period has expired.

The proposal also raises treaty issues because it would provide that tax on income or gain allocable to a foreign person would be determined without regard to applicable treaties. Even though the other parties to a transaction might bear the ultimate liability for the tax under this proposal, the proposal would in essence impose a U.S. tax burden on a transaction that should be exempt from U.S. tax under the treaty, thus changing the economics of the transaction. The imposition of tax on a transaction that should be exempt under a treaty could raise concerns from treaty partners.

IV. CURRENT LEGISLATIVE AND REGULATORY "TAX SHELTER" PROVISIONS

As discussed above, the Administration's broad-based proposals would grant the IRS unfettered authority to determine what is a corporate tax shelter and to subject these transactions to harsh and cascading penalties. We are concerned with Treasury's request for this broad authority when they have not even tried to use some of the tools that Congress has granted within the last few years. A better approach to any perceived problem would be for Treasury to use the tools currently within its arsenal, along with specific legislative or regulatory actions targeted at closing identified loopholes. The broad scope of such current alternatives is illustrated below.

A. Substantial Understatement Penalty

Current law imposes a 20 percent penalty on the portion of an underpayment of tax attributable to a substantial understatement of income tax. For corporations, a substantial understatement of income tax exists if it exceeds the greater of 10 percent of the tax required to be shown on the tax return or $10,000.[8] If a corporation has a substantial understatement of income tax attributable to a tax shelter item, a corporation is liable for the substantial understatement penalty unless it can demonstrate reasonable cause.

As discussed above, Congress expanded the definition of tax shelter for purposes of the substantial understatement penalty in the Taxpayer Relief Act of 1997. Under this expanded definition, a transaction may be a tax shelter if a significant purpose of the transaction was to avoid taxes. (Under the prior provision, a transaction was a tax shelter only if the principal purpose of the transaction was to avoid taxes). This significant expansion of the definition of tax shelter has been in the law for less than two years, and there has not been sufficient time to determine whether this new definition is effective. Before enacting a plethora of new penalties and granting revenue agents larger and more potent weapons, the expanded definition in current law should be given a chance to work.

B. Tax Shelter Registration

The 1997 Act added section 6111(d), which treats certain confidential arrangements as tax shelters that must be registered with the IRS. For purposes of this provision, a "tax shelter" includes any entity, plan, arrangement, or transaction: (1) a significant purpose of the structure of which is tax avoidance or evasion by a corporate participant; (2) that is offered to any potential participant under conditions of confidentiality; and (3) for which promoters may receive fees in excess of $100,000 in the aggregate. An offer is considered to be made under conditions of confidentiality if: (1) the potential participant has an understanding or agreement with or for the benefit of any promoter that restricts or limits the disclosure of the transaction or any significant tax benefits; or (2) any promoter of the tax shelter claims, knows, or has reason to know that the transaction is proprietary to the promoter or any other person other than the potential participant, or is otherwise protected from disclosure or use by others.[9] The penalty for failing to timely register a corporate tax shelter can be severe: the greater of $10,000 or 50 percent of the fees paid to all promoters from offerings prior to the date of registration. If the failure to file is intentional, the penalty is increased to 75 percent of the fees.[10]

This registration requirement was intended to provide Treasury and the IRS with useful information about corporate transactions as early as possible, enabling them to more easily identify these transactions. In addition, this information enables Treasury to make determinations with respect to when administrative or legislative action may be necessary. The committee report explained the need for this corporate tax shelter registration requirement:

> The provision will improve compliance with the tax laws by giving the Treasury Department earlier notification than it generally receives under present law of transactions that may not comport with the tax laws. In addition, the provision will improve compliance by discouraging taxpayers from entering into questionable transactions.[11]

These tax shelter registration provisions apply to any tax shelter offered to potential participants after the date that the Treasury Department issues guidance on registration. As of this date, no guidance has been issued and, therefore, this registration provision is not yet effective. It is premature to propose a new and complex set of measures to deal with a perceived increase in corporate tax shelter activity when powerful provisions have already been enacted, but Treasury has not, almost two years after enactment, implemented them. Rather than enact a number of vague and subjective provisions as proposed, the more prudent course would be to issue the required guidance so that the registration requirements become effective,

then evaluate the registration provisions to determine whether they produce the desired result.

C. Anti-Abuse Rules

Treasury and the IRS have a wide range of general anti-abuse provisions already available to combat the perceived proliferation of corporate tax shelters. For example, if a taxpayer's method of accounting does not clearly reflect income, section 446(b) of the Code authorizes the IRS to disregard the taxpayer's method of accounting and to compute the taxpayer's income under a method of accounting it believes more clearly reflects income. Under section 482 of the Code, the IRS can allocate, distribute, or apportion income, deductions, credits and allowances between controlled taxpayers to prevent evasion of taxes or to accurately reflect their taxable income.

Treasury has promulgated Treas. Reg. § 1.701–2 as a broad anti-abuse rule that permits the IRS to stop perceived abuses with respect to partnerships. Under this anti-abuse regulation, the IRS already has the ability to disregard the existence of a partnership, adjust a partnership's method of accounting, reallocate items of income, gain, loss, deduction or credit, or adjust a partnership's or partner's tax treatment in situations where a transaction meets the literal requirements of a statutory or regulatory provision, but where the IRS believes the results are inconsistent with the intent of the partnership tax rules.

The IRS also has broad authority to stop abuses in the corporate context. For example, the IRS can recharacterize certain stock sales by shareholders as dividends when the purchaser is the issuing corporation or a related corporation under section 302(d) or section 304. Section 338(e)(3) authorizes the IRS to treat certain stock acquisitions as qualified stock purchases in order to prevent avoidance of the requirements of section 338. Section 355(d)(9) gives the IRS the regulatory authority to prevent the avoidance of certain gain recognition requirements under section 355 through the use of related persons, intermediaries, pass-through entities or other arrangements.

D. Case Law

There is a well-established body of case law addressing tax shelters. The principles developed in these cases include the "sham transaction" doctrine, the "business purpose" doctrine, and the "economic substance" doctrine. In applying these principles, the IRS may assert that a transaction should not be respected for tax purposes because it did not have a substantive purpose beyond securing tax benefits. See, e.g., *Gregory* v. *Helvering,* 293 U.S. 465 (1935); *Knetsch* v. *United States,* 364 U.S. 361 (1960); *Rice's Toyota World, Inc.* v. *Commissioner,* 752 F.2d 89 (4th Cir. 1985); *Goldstein* v. *Commissioner,* 364 F.2d 734 (2d Cir. 1966); *Sheldon* v. *Commissioner,* 94 T.C. 738 (1990). These principles have been in existence for many years, and they have not lost their utility. They represent a set of standards that can be applied no matter how sophisticated a transaction might be. As stated above, we believe these judicial doctrines work best in a judicial setting, rather than attempting to codify these standards, because the facts and business purpose of a transaction must be appropriately weighed. Most recently, the IRS successfully litigated two cases in this area, *ACM Partnership* v. *Commissioner,* 157 F.3d 231 (3d Cir. 1998), aff'g, rev'g in part and remanding, 73 TCM 2189 (1997), cert. denied, S. Ct. Dkt. No. 98–1106 and *ASA Investerings* v. *Commissioner,* 76 TCM 325 (1998).

E. IRS Announcements

The IRS has the authority to issue administrative pronouncements to address perceived abusive transactions. These pronouncements may take the form of notices, rulings, or other announcements. In the past few years, the IRS has not hesitated to take advantage of this authority. For example, Notice 97–21 effectively shut down "step-down preferred" transactions. More recently, in fact within the past few weeks, the IRS has attacked certain types of "lease-in lease-out" transactions that it perceived to be abusive through the issuance of Rev. Rul. 99–14. The number of announcements the IRS has issued in the past few years addressing perceived tax shelter activity has been substantial: Notice 98–11 (attacking "hybrid branch arrangements"); Notice 98–5 (attacking transactions that generate foreign tax credits); Notice 96–39 (setting forth the IRS' position on determining whether income from a partnership represented Subpart F income); Notice 95–53 (attacking lease stripping transactions); Notice 94–48 (scrutinizing tax-deductible passthrough debt to buy back stock, or "reverse MIPs"); Notice 94–47 (scrutinizing tax-deductible preferred instruments, or "MIPS"); Notice 94–93 (attacking "corporate inversion" transactions); Notice 94–46 (attacking outbound "corporate inversion transactions").

Note that as part of the IRS Restructuring and Reform Act, Congress expressed its concern and disagreement with the policy direction of Notice 98–11, as well as

their interest in reviewing these issues and taking legislative action they deemed to be appropriate. This controversy demonstrates the need for determinations of what constitutes an abusive transaction to be made in a public manner, through issuance of legislation or an administrative pronouncement, rather than being made by individual IRS agents.

F. Legislation Targeted to Specific Transactions

Another important alternative to the broad-based Administration proposals is specific, targeted statutory changes. Each year Treasury transmits to Congress its suggestions for changes to the tax laws, including targeted proposals to stop abuses and, as a matter of course, Congress has asserted its legislative powers to clarify and amend statutes that are unclear or allow for abuse. On a number of occasions, the Congressional tax writing committees have enacted targeted statutory changes to end specific tax shelter or abusive activity, often with the assistance and consultation of the Treasury Department. For example, in 1998 and 1997 alone, Congress pursued and enacted a number of targeted proposals, including:

- Modification of certain deductible liquidating distributions of regulated investment companies (RIC) and real estate investment trusts (REIT);
- Restrictions on 10-year net operating loss carryback rules for specified liability losses;
- Requirement of gain recognition on certain appreciated financial positions in personal property;
- Election of mark-to-market for securities traders and for traders and dealers in commodities;
- Limitation on the exception for investment companies under section 351;
- Determination of original issue discount where pooled debt obligations are subject to acceleration;
- Denial of interest deduction for on certain convertible preferred stock;
- Requirement of gain recognition for certain extraordinary dividends;
- Anti-Morris Trust provisions;
- Reform of the tax treatment of certain corporate stock transfers;
- Treatment of certain preferred stock as boot;
- Modification of holding period for the dividends-received deduction;
- Inclusion of income from notional principal contracts and stock lending transactions under Subpart F;
- Restriction on like-kind exchanges involving foreign personal property;
- Imposition of holding period requirement for claiming foreign tax credits with respect to dividends;
- Allocation of basis of properties distributed to a partner by a partnership;
- Elimination of the substantial appreciation requirement for inventory on sale of partnership interest; and
- Modification of treatment of company-owned life insurance.

These proposals, which raise nearly $20 billion in tax revenue over 10 years, were targeted at clarifying the statute and/or stopping perceived abuses of the tax law and have been effective in ending certain tax shelter activity. While we believe that many of these items are not abuses, this incomplete list demonstrates that if a statutory provision allows for broader application than Congress may have intended, Congress and the Treasury can statutorily shut them down. Treasury is now essentially asking Congress to short-circuit this well-established legislative approach and provide the IRS with broad authority to characterize a wide range of transaction as "tax shelters" without the need for Congressional oversight or approval.

V. CONCLUSION

The Administration's "corporate tax shelter" proposals go far beyond simply closing unwarranted loopholes: the proposals would have a detrimental impact on legitimate business transactions and could result in the imposition of draconian penalties on taxpayers. The unfettered power transferred to IRS agents would shift the formulation of tax policy from Congress to the tax collector by giving IRS agents unprecedented latitude to reclassify transactions as corporate tax shelters. Congress, not the tax administrator, should make these tax policy decisions. We urge Congress to reject the Administration's far reaching proposals.

ENDNOTES

[1] This testimony was prepared by Arthur Andersen on behalf of the Coalition for the Fair Taxation of Business Transactions.

[2] The Economic and Budget Outlook: Fiscal Years 2000–2009, Congressional Budget Office, January 1999.

[3] For transactions entered into before August 6, 1997, a "tax shelter" is defined as a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement if the principal purpose of the partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax. The Taxpayer Relief Act of 1997 amended section 6662(d)(2)(C)(ii) to provide a new definition of tax shelter for purposes of the substantial understatement penalty. Under this new definition of tax shelter, the tax avoidance purpose of an entity or arrangement need not be its principal purpose. Now a tax shelter is any entity, investment, plan, or arrangement with a significant purpose of avoiding or evading Federal income taxes. The new definition of tax shelter is effective for transactions entered into after August 5, 1997.

[4] The IRS recently issued a Technical Advice Memorandum, TAM 199910046 (November 16, 1998), in which it upheld the taxpayer's interest deduction, ruling that merely because the taxpayer did not earn a profit on the transaction did not imply that the transaction lacked economic substance.

[5] *Helvering* v. *Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935).

[6] Generally, Section 6662(a) of the Internal Revenue Code imposes a 20 percent penalty on the portion of an underpayment of tax attributable to a substantial understatement of income tax.

[7] The definition of "tax avoidance transaction" for purpose of this transaction is the same as is used to define a corporate tax shelter, discussed above.

[8] The Administration has also proposed to treat a corporation's understatement of more than 10 million dollars of income tax as substantial for purposes of the substantial understatement penalty, whether or not it exceeds 10 percent of the taxpayer's total tax liability.

[9] Section 6111(d)(2).

[10] Section 6707.

[11] H.R. Rep. No. 105–148, 105th Cong., 1st Sess. 429.

STATEMENT OF A COALITION OF MORTGAGE REITS

The following comments are offered by a group of mortgage real estate investment trusts (hereinafter referred to as the "Coalition") to the Senate Finance Committee in conjunction with its ~~April 27th~~ hearing on the revenue-raising provisions of the Clinton Administration's FY 2000 budget plan. Coalition members include IndyMac Mortgage Holdings, Inc., Dynex Capital, Inc., IMPAC Mortgage Holdings, Inc., IMPAC Commercial Holdings, Inc., Redwood Trust, Inc., and Capstead Mortgage Holdings. These comments focus on the Administration's proposal to modify the structure of businesses indirectly conducted by real estate investment trusts ("REITs").

IndyMac Mortgage Holdings, Inc., based in Pasadena, California, is the largest publicly traded mortgage REIT [1] in terms of stock market capitalization, and its structure and business activities make it a useful reference point in discussing the impact of the Administration's proposal. IndyMac is a diversified lending company with a focus on residential mortgage products, and is active in residential and commercial construction lending, manufactured housing lending, and home improvement lending. IndyMac is an NYSE-traded company with $6 billion in assets and nearly 1,000 employees. IndyMac Mortgage Holdings participates in the mortgage conduit and securitization business through an affiliated taxable operating company, IndyMac, Inc.

The Coalition has specific concerns over the Administration's proposal to modify the structure of businesses indirectly conducted by REITs. As a result of these concerns, the Coalition's support for this proposal would be contingent on critical modifications being made. Without these modifications, IndyMac and other REITs would be unable to continue to participate in the mortgage conduit or securitization business. The changes requested by the Coalition would be consistent with the Administration's goal not to impede the competitiveness of REITs, while at the same time addressing—more than adequately, we believe—the concerns of the Treasury Department over any potential for tax avoidance by mortgage REITs.

THE MORTGAGE CONDUIT BUSINESS

As one of its most important business activities, IndyMac operates as one of only a small number of private mortgage conduits in this country. While small in number, mortgage conduits play a vital financing role in America's residential housing market, essentially acting as the intermediary between the originator of a mortgage loan and the ultimate investor in mortgage-backed securities (MBSs).

The conduit first purchases mortgage loans made by financial institutions, mortgage bankers, mortgage brokers, and other mortgage originators to homebuyers and others. When a conduit has acquired sufficient individual loans to serve as collateral for a loan pool, it creates an MBS or a series of MBSs, which then are sold to investors through underwriters and investment bankers. After securitization, the conduit acts as a servicer of the loans held as collateral for the MBSs, meaning that the

conduit collects the principal and interest payments on the underlying mortgage loans and remits them to the trustee for the MBS holders.

Perhaps the best-known mortgage conduits are the government-owned Government National Mortgage Association (Ginnie Mae) and the government-sponsored Fannie Mae and Freddie Mac. These government sponsored enterprises (GSEs) act as conduits for loans meeting specified guidelines that pertain to loan amount, product type, and underwriting standards, known as "conforming" mortgage loans.

Private conduits such as IndyMac play a similar role for "nonconforming" mortgage loans that do not meet GSE selection criteria. Mortgage loans purchased by IndyMac include "Alt-A," nonconforming and jumbo residential loans, sub-prime loans, consumer construction loans, manufacturing housing loans, home improvement loans, and other mortgage-related assets. Many of IndyMac's borrowers are low-income and minority consumers who are not eligible for programs currently offered by the GSEs or Ginnie Mae. In sum, IndyMac, through its conduit activities, has helped to fill a significant void in the residential mortgage and mortgage investment industry that the GSEs have been unable to fill.

INDYMAC'S BUSINESS STRUCTURE

IndyMac's mortgage conduit business is conducted primarily through two entities: IndyMac Mortgage Holdings, Inc., which as discussed above is a REIT (hereafter referred to as "IndyMac REIT"), and its taxable affiliate, IndyMac, Inc. (hereafter referred to as "IndyMac Operating"). IndyMac REIT owns all of the preferred stock and 99 percent of the economic interest in IndyMac Operating, which is a taxable C corporation.

IndyMac REIT is the arm of the conduit business that purchases and holds mortgage loans. IndyMac Operating is the arm of IndyMac REIT that acquires loans for IndyMac REIT, pursuant to a contractual sales commitment, and securitizes and services the loans. In order to control the interest rate risks associated with managing a pipeline of loans held for sale, IndyMac Operating also conducts necessary hedging activities. In addition, IndyMac Operating performs servicing for all loans and MBSs owned or issued by it. IndyMac Operating is liable for corporate income taxes on its net income, which is derived primarily from gains on the sale of mortgage loans and MBSs as well as servicing fee income.

Use of this "preferred stock" structure for conducting business is, in part, an outgrowth of the tax laws governing REITs. IndyMac REIT, by itself, effectively is unable to securitize its loans through the most efficient capital markets structure, called a real estate mortgage investment conduit ("REMIC"). This is because the issuance of REMICs by a REIT in effect would be treated as a sale for tax purposes; such treatment in turn would expose the REIT to a 100-percent prohibited tax on "dealer activity."

Similarly, it is well understood that the ability to service a loan is critical to owning a loan, and IndyMac REIT would be subject to strict and unworkable limits on engaging in mortgage servicing activities for third parties. Such activities would generate nonqualifying fee income under the 95-percent REIT gross income test,[2] potentially disqualifying IndyMac REIT from its status as a REIT. It is critical to keep in mind that all net income derived by IndyMac Operating from its business activities is subject to two tiers of taxation at state and federal levels.

In business terms, IndyMac's use of the preferred stock structure aligns its "core competencies," which has allowed it to compete in the mortgage banking and conduit business. This alignment makes available the benefits of centralized management, lower costs, and operating efficiencies, and has allowed IndyMac to respond to market changes, such as trends toward securitization, all to the benefit of homeowners who do not fit within traditional GSE lending criteria.

ADMINISTRATION PROPOSAL

The proposal in the Administration's FY 2000 budget would prohibit use of the REIT preferred stock subsidiary structure. Specifically, the proposal would amend section 856(c)(5)(B) of the Internal Revenue Code to prohibit REITs from holding stock possessing more than 10 percent of the vote or value of all classes of stock of a corporation. This proposal has arisen out of a concern on the part of Treasury that income earned by preferred stock subsidiaries escapes corporate tax as a result of "transmuting of operating income into interest paid to the REIT and other non-arm's length pricing arrangements."[3]

At the same time, Treasury recognizes that many activities conducted by REIT preferred stock subsidiaries represent legitimate business activities that should continue to be available to REIT investors:[4]

Many of the businesses performed by the REIT subsidiaries are natural outgrowths of a REIT's traditional operations, such as third-party management and development businesses. While it is inappropriate for the earnings from these non-REIT businesses to be sheltered through a REIT, it also is counterintuitive to prevent these entities from taking advantage of their evolving experiences and expanding into areas where their expertise may be of significant value.

In light of these concerns, the Administration proposal would allow a REIT to establish a "taxable REIT subsidiary" ("TRS") to perform certain activities that cannot be conducted directly by a REIT. These TRSs would be subject to a number of restrictions, including a provision that a TRS could not deduct any interest incurred on debt funded directly or indirectly by the REIT. Other restrictions would place limits on the value of TRSs that could be owned by REITs; impose an excise tax on any excess payments made by the TRS to the REIT; and limit intercompany rentals between the REIT and the TRS.[5]

It is not clear that the Treasury proposal ever contemplates mortgage REIT preferred stock subsidiaries like IndyMac Operating.[6] If not, the inability of mortgage REITs to utilize the "taxable REIT subsidiary" structure would have a severe negative impact on IndyMac and the housing industry. If mortgage REITs are intended to be permitted to establish TRSs, it is still the case that the Administration's current proposal contains unworkable restrictions that effectively would end the synergies between mortgage REITs and taxable entities that have so benefited homeowners and the housing industry.

In allowing REITs to conduct otherwise disqualifying business activities through taxable subsidiaries, the Administration's FY 2000 budget proposal represents a significant improvement over a similar proposal included in last year's Administration budget submission. Like the current proposal, last year's proposal would have prohibited use of the REIT preferred stock subsidiary structure. However, last year's proposal, rather than allowing REITs to convert preferred stock subsidiaries into a taxable subsidiary, would have "grandfathered" existing preferred stock structures, but under an overly restrictive set of rules that was viewed as unworkable by industry.

IMPACT ON MORTGAGE REITS

If the Administration's FY 2000 budget proposal were enacted, IndyMac REIT would be forced to end its preferred stock affiliation with IndyMac Operating. In order to continue in the mortgage conduit business, IndyMac REIT and other mortgage REITs would have to consider converting their affiliates into a TRS under the terms outlined by the Administration in its proposal, assuming that the Administration's proposal contemplates this provision applying to mortgage REIT subsidiaries.

At least in concept, IndyMac would be willing to entertain a conversion of IndyMac Operating from a preferred stock affiliate into a taxable subsidiary. As discussed above, IndyMac Operating does not engage in the type of income shifting activities that have prompted Treasury's concerns.

However, certain restrictions proposed by the Treasury Department with respect to the operation of the TRS would be completely unworkable for IndyMac and other mortgage REITs. Most significant, by far, is the Administration's proposed disallowance of interest deductions on debt funded directly or indirectly by the REIT.

This proposed restriction overlooks the fundamental element of debt in the day-to-day business operations of finance companies, like mortgage conduits. IndyMac Operating borrows extensively to finance its operations, such as the purchase of mortgages. These loans can come from outside third parties, such as banks or investment banks, with the sponsoring REIT as effective guarantor, or from loans directly from the sponsoring REIT.

Direct loans from the sponsoring REIT clearly would be impacted by the Administration's proposal, and it is possible that guaranteed loans would also be covered as "indirect" loans. To the extent that any or all of these types of loans are considered direct or indirect loans subject to the interest expense disallowance, the inability to deduct a finance company's core and largest business expense would make it impossible for IndyMac Operating to compete with all other finance companies which are entitled to deduct such expenses. This exposure would be sufficient to force an end to IndyMac Operating's ability to conduct its business activities in conjunction with IndyMac REIT, thus divorcing the two critical elements of IndyMac's mortgage conduit business. If IndyMac and the other mortgage REITs were unable to conduct their business, it would have a severe impact on the housing market, because IndyMac and other mortgage REITs provide a vital link between investors and borrowers in the non-conforming and jumbo markets who are not served by the GSEs.

The taxable preferred stock subsidiaries of IndyMac and other mortgage REITs operate in the same manner as a finance company that makes loans and securitizes or sells them to investors. All finance companies that are not depository institutions require external debt to fund loan originations. All operate at relatively high leverage because loan assets typically are saleable and thus relatively liquid.

Through their affiliation with a REIT, these taxable preferred stock subsidiaries are able to access capital to fund operations at lower rates than would be the case if they tried to access public debt markets directly. Compared to the taxable entity, the REIT is generally better capitalized and larger, in terms of assets and borrowings, and thus can borrow at lower rates than the preferred stock subsidiary. Lenders generally lend to the REIT and the taxable entity on a combined basis, and require credit support from the larger entity.

Without credit support, the taxable subsidiaries would have higher borrowing costs, which ultimately would be passed on to borrowers served through the mortgage conduit businesses operated by IndyMac and others as higher interest rates and costs.[7] The proposal would operate, therefore, like a tax on these homeowner/borrowers. There is no reason to impose this tax—there are specific rules already in the Code that could be adopted to prevent the potential for tax abuse that has given rise to the Administration's proposal. These rules are described in the following section.

NECESSARY MODIFICATIONS

The Administration's proposed interest deduction disallowance is intended to prevent excessive interest charges by a sponsoring REIT to its taxable subsidiary, or TRS. As opposed to the TRS interest expense disallowance proposed by the Treasury Department, the Coalition strongly believes that the "earnings stripping" limitations imposed under section 163(j) of the Internal Revenue Code for interest paid to or accrued by tax-exempt entities and foreign persons would adequately, and more fairly, prevent any perceived abuses resulting from direct or indirect lending between a REIT and a TRS. At the same time, adoption of this rule would preserve the TRS's ability to conduct its business and serve its customers.

Enacted in 1989, section 163(j) was crafted specifically to prevent the siphoning of earnings from a corporation by a related person that is exempt from U.S. tax, e.g., a foreign company. Those rules extend both to direct lending activities as well as to guarantees by a related person of loans obtained by the corporation from unrelated persons. Under these rules, a corporation's interest deductions for a taxable year may be denied if the corporation has excess interest expense for a year *and* its ratio of debt to equity exceeds 1.5 to 1.

Substitution of this earnings stripping rule for the complete interest deduction disallowance under the Administration's proposal would guard against true abuse while accommodating legitimate mortgage conduit business activities. The purpose of section 163(j) was to limit interest deductions for leveraged companies that generate a *negative* spread in view of the likelihood that the *negative* spread was attributable to earnings stripping. In contrast, the companies affiliated with IndyMac and other mortgage REITs in the mortgage conduit business generally generate excess interest income—i.e., they generate a *positive* spread on interest income. IndyMac Operating has never incurred negative spread in its six years of operation. In fact, IndyMac's taxable affiliate has incurred tax liability for positive spread it has earned in each year since its founding in 1993.

It is a fundamental fact in the finance industry that companies operating in the mortgage banking and conduit business, like IndyMac Operating, operate at relatively high leverage ratios. The same is true for GSEs like Ginnie Mae and Fannie Mae, as it is for Merrill Lynch, Bank of America, and other well-known industry names. The presence of this debt is inherent in the business of a finance company and is not, in and of itself, any indication of a situation where earnings are being stripped. In enacting the rules under section 163(j), Congress made clear that an earnings stripping situation involves the combination of high leverage *and* a negative interest spread. The Coalition agrees.

In sum, the Coalition believes that adoption of the section 163(j) rules would allow IndyMac and other mortgage REITs to continue to participate in the mortgage conduit business and provide financing to segments of the housing industry not currently served by the GSEs. At the same time, we believe the section 163(j) rules would guard effectively against true earnings stripping situations. It would be unreasonable to subject REITs and their affiliates to the Administration's complete disallowance of interest deductions, a rule that would be more stringent than those currently applied with respect to transactions between U.S. and related foreign companies.

CONCLUSION

Congress enacted the REIT rules in 1960 to give small investors the same access to dynamic real estate markets that are available to larger investors. Working with the National Association of Real Estate Investment Trusts ("NAREIT"), Congress has amended the REIT statute many times since to respond to dramatic changes in the real estate industry. The Administration's proposal to modify the structure of businesses that may be conducted indirectly by REITs may be viewed, and commended, as a further effort to modernize the REIT rules.

However, as discussed above, the Administration proposal must be modified to address the concerns of an important sector of the REIT industry, namely mortgage REITs. Specifically, the proposed restrictions on the operation of the taxable REIT subsidiaries under the Administration's proposal would fundamentally impede the business practices of REITs like IndyMac involved in the mortgage conduit business. The proposed outright elimination of deductions for interest on intercompany debt or REIT-guaranteed debt would lead IndyMac and other mortgage REITs to sever themselves from the core competencies of servicing and securitizing mortgage loans. Thus, IndyMac's individual investors no longer would be able to participate effectively in the mortgage conduit business, contrary to Congressional intent to give these REIT investors access to the real estate mortgage markets.

If the Administration's proposal is to receive serious consideration, it will be paramount to replace the proposed wholesale interest deduction disallowance with the earnings stripping rules under section 163(j). The Coalition also believes that the intended applicability of the TRS provisions to mortgage REITs should be made explicit. In addition, we believe it will be necessary to apply these rules over an appropriate transitional period. The Coalition is prepared to work with Congress, the Treasury, and NAREIT to develop solutions in this regard.

ENDNOTES

[1] A mortgage REIT invests primarily in debt secured by mortgages on real estate assets. An equity REIT, by contrast, invests primarily in equity or ownership interests directly in real estate assets.

[2] The 95-percent test generally limits REITS to receiving income that qualifies as rents from real property and portfolio income.

[3] *General Explanations of the Administration's Revenue Proposals*, Department of the Treasury, February 1999, p. 140. IndyMac believes Treasury's income-shifting argument is significantly overstated. The REIT rules strictly regulate the types and amount of income that may be earned by a REIT. IndyMac REIT and others in the REIT industry are strongly discouraged from taking aggressive tax positions, given the severity of potential tax penalties, including loss of REIT status and the 100-percent prohibited transactions tax.

[4] *Id*, at 140.

[5] The proposal would allow REITs to convert preferred stock subsidiaries into TRSs on a tax-free basis within a window period, as yet unspecified.

[6] For example, the Treasury explanation of the proposal discusses activities of a TRS by reference to "tenant" and "non-tenant" activities.

[7] These higher borrowing costs would translate into increased deductible interest expenses for the taxable subsidiaries, which would reduce the amount of revenues that would be collected as a result of the proposal.

STATEMENT OF THE COALITION TO PRESERVE EMPLOYEE OWNERSHIP OF S CORPORATIONS

[SUBMITTED BY ARTHUR ANDERSEN, LLP]

This statement is respectfully submitted on behalf of the Coalition to Preserve Employee Ownership of S Corporations ("Coalition") in connection with the Committee's hearings on revenue provisions included in the President's fiscal year 2000 budget. The Coalition appreciates the Committee's interest in public comments on the Administration's budget proposals and welcomes the opportunity to express its strong opposition to one of these proposals in particular—the proposal to repeal the recently-enacted provision of The Taxpayer Relief Act of 1997 ("1997 Act") that exempts S corporation income that flows through to an ESOP shareholder from the unrelated business income tax ("UBIT"). As explained below, we believe that the 1997 Act provision is furthering the goal Congress intended of facilitating employee ownership of closely-held businesses and should not be repealed; that it is inappropriate as a matter of tax policy to keep changing tax laws upon which businesses rely; that the Administration's tax proposal is inconsistent with the general intent of Congress underlying Subchapter S, is overly complex, and would impose a new tax burden on employees; and that the proposal cannot be justified on "anti-tax shel-

ter" grounds. Therefore, we respectfully request this Committee to reject the Administration's proposal and to keep in place the law the Congress enacted not two years ago.

BACKGROUND

ESOPs provide an opportunity for millions of Americans to own a piece of the businesses for which they work. They not only provide greater incentives for employees to help the companies grow, but also play a critical role in the employees' retirement planning strategies. As explained below, Congress recently has taken important steps to remove some of the barriers to employee ownership that existed for closely-held businesses. The Coalition commends the Congress for its recognition of the value of employee ownership and hopes that this Committee will continue to support employee ownership in the future.

In the Small Business Job Protection Act of 1996 (the "1996 Act"), Congress allowed ESOPs to be shareholders of S corporations, in recognition of the fact that the previous-law "prohibition of certain tax-exempt organizations being S corporation shareholders may have inhibited employee-ownership of closely-held businesses." Joint Committee on Taxation's *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS–12–96). The 1996 Act, however, included a number of restrictive tax rules with respect to ESOPs of S corporations that generally made employee ownership of an S corporation unattractive. For example, the 1996 Act provided that:

1. The income of the S corporation that flowed through to the ESOP shareholder, as well as any gain on the sale of S corporation stock, would be treated as unrelated business taxable income ("UBTI") and would be subject to tax at the ESOP level. Thus, the S corporation income would be subject to tax twice—once to the ESOP and once to the participants upon distribution.

2. The increased deduction limitation under Section 404(a)(9) of the Internal Revenue Code of 1986, as amended ("Code"), would not apply to S corporations. As a result, even though a C corporation generally can deduct contributions to an ESOP that are made to allow the ESOP to pay interest and principal on the loan it incurred to acquire the corporation's stock, up to an amount equal to 25 percent of the compensation paid or accrued to employees under the plan, an S corporation generally is limited to a deduction for contributions equal to 15 percent of the compensation paid or accrued to such employees.

3. The deduction for dividends paid on certain employer securities under Code Section 404(k)(1) would not be available to S corporations. As a result, even though a C corporation may deduct the amount of certain cash dividends that ultimately are passed through to the participants of the ESOP, an S corporation is not entitled to such a deduction.

4. The special "rollover" rules of Code Section 1042 that are designed to encourage the contribution of employer stock to ESOPs would not apply to S corporation stock. As a result, even though shareholders may be able to defer gain on the sale of C corporation stock to an ESOP if they reinvest the proceeds in certain qualifying securities, such deferral is not available on the sale of S corporation stock.

In the 1997 Act, Congress decided to repeal the first of these restrictions, such that S corporation income or loss that passes through to an ESOP shareholder, and any gain or loss on the sale by the ESOP of S corporation stock, would not be subject to UBIT. The legislative history indicates that this change was made because the Congress believed "that treating S corporation income as UBTI is not appropriate because such amounts would be subject to tax at the ESOP level, and also again when benefits are distributed to ESOP participants." S. Rept. 105–33 (105th Cong., 1st Sess.), at p. 80. This change became effective for taxable years beginning after December 31, 1997. In reliance on this law change, many employee-owned businesses have elected S corporation status, in some cases increasing the amount of stock owned for the benefit of their employees. Further, some existing S corporations have established ESOPs. Finally, some corporations are in the process either of establishing ESOPs or restructuring so that they will be eligible to elect S corporation status. These companies are furthering the goal of increasing employee ownership that Congress was trying to advance in enacting the 1997 Act provision.

Now, barely a year after the 1997 Act provision became effective, the Administration is asking the Congress to reject the decision it made in the 1997 Act. In particular, the Administration has included in the "corporate tax shelter" section of its budget a proposal to repeal the 1997 Act provision and, instead, to allow an S corporation ESOP a deduction for distributions to participants and beneficiaries to the extent of the S corporation income on which it has paid UBIT. The proposal also would modify net operating loss rules in effect to allow for the carryback of "excess"

distribution deductions for 2 years, and the carryforward of such deductions for 20 years. The proposal would be effective for tax years beginning after the date of first committee action. Thus, it would apply to income and gain of corporations that already have ESOPs and/or that already have converted to S corporation status, as well as to corporations that are in the process of establishing ESOPs or converting to S corporation status.

PROBLEMS WITH THE ADMINISTRATION'S PROPOSAL

The Coalition believes that the Administration's proposal is fundamentally flawed for the reasons set forth below.

1. The 1997 Act Provision Is Furthering the Laudable Goal of Increasing Employee Ownership and Should Not Be Repealed

As indicated above, Congress enacted the 1996 and 1997 Act provisions regarding S corporation ESOPs in order to remove obstacles that had deterred employee ownership of closely-held corporations. Thus far, these provisions have been successful in achieving this objective of facilitating employee ownership. As a direct result of the law changes, employees have increased their ownership of closely-held businesses, shareholders have decided to transfer more stock to ESOPs, and S corporations that previously could not have had ESOPs have been able to give their employees an ownership interest in the business. It is virtually certain that Congress's decisions in 1996 and 1997 will encourage even greater employee ownership in the future. It makes no sense to repeal a provision which is doing exactly what Congress intended it to do and which is furthering a valuable policy goal.

2. It Is Inappropriate as a Matter of Tax Policy to Change a Tax Law on Which Businesses Have Relied in Making Costly Business Decisions

The Coalition also believes it would be grossly inappropriate as a matter of tax policy to encourage ESOP ownership of S corporations in 1997 and, not two years later, to fundamentally alter the tax consequences of such ownership. As explained further below, converting to S corporation status, selling more stock to an ESOP, and establishing an ESOP are all important decisions that have real economic consequences. Businesses that are considering these actions should be able to make their decisions based on a relatively stable set of tax rules, rather than to have to suffer from tax laws that become effective in one tax year and are repealed in the next.

Corporations that converted to S corporation status in reliance on the 1997 Act provision (or that are in the process of converting) have had to weigh the costs and benefits of their decision in order to determine whether it was (or is) prudent. As indicated above, for a company with an ESOP, converting to S corporation status involves losing certain benefits (such as Code Sections 404(a)(9) and 404(k)(1)) that are available to C corporations, but not to S corporations. Further, converting to S corporation status in many cases involves eliminating the economic interests of "ineligible" shareholders; restructuring debt, options and other arrangements that could be recharacterized as a "second class of stock;" implementing new shareholders' agreements; paying a "LIFO recapture tax," etc. Companies that also elected to treat subsidiaries as "Qualified Subchapter S Subsidiaries" will have lost forever their basis in the stock of such subsidiaries, which could have significant negative consequences in the event of a future sale of those businesses. If the 1997 Act provision had not been enacted, these companies likely would not have incurred the costs, or accepted the consequences, associated with becoming S corporations. It would be improper from a tax policy perspective to encourage conversions in 1997 and to fundamentally change the consequences thereof not more than two years later.

Similarly, companies that have increased the extent to which they are employee owned, or that are in the process of establishing ESOPs, have relied on the 1997 Act provision in determining whether the costs of establishing ESOPs are outweighed by the benefits. In this regard, it is critical to understand that establishing an ESOP is a very costly process. It typically involves, among other things, conducting a feasibility study; obtaining valuations; making comprehensive changes to the overall compensation arrangements; and making difficult decisions about the extent to which employees should have access to information about, and be involved in, the business. ESOPs also are subject to numerous regulatory and disclosure requirements by the Department of Labor. In addition, in the case of a leveraged ESOP, significant financing costs may be incurred. Companies that undertake actions with such significant consequences and costs should be able to rely on a relatively stable set of tax laws.

3. The Administration's Proposal Not Only Is Complex, But Also Could Result in S Corporation Income Being Subject to Two Levels of Tax and in Employees Bearing a New Tax Burden

As a general matter, Congress has recognized throughout Subchapter S that, subject to limited exceptions, S corporation income should only be subject to one level of tax. However, as explained below, the Administration's proposal in some situations improperly would result in S corporation income being subject to two levels of tax—one at the ESOP level and one at the participant level. Such a result not only would be inconsistent with the general Congressional intent underlying Subchapter S, but also would create an untenable new tax burden on the employee-owners of ESOP-owned companies.

The Administration's proposal apparently attempts to ensure that S corporation income is subject to only one level of tax by introducing a new deduction mechanism. However, this deduction mechanism not only introduces needless complexity into an already overly complex tax law, but also is fundamentally flawed. For example, assume an ESOP had S corporation income in excess of distributions for a number of years prior to the termination or revocation of the corporation's S election. Under the Administration's proposal, the S corporation earnings would be subject to immediate tax at the ESOP level. However, if the ESOP distributed those earnings to participants more than two years after the corporation terminated or revoked its S corporation election, neither the carryback nor carryforward provisions of the proposal likely would be useful because the ESOP would be unlikely to have earnings subject to UBTI at that time (i.e., after the corporation has become a C corporation). Thus, the S corporation earnings in effect would be subject to tax at both the ESOP level (when earned) and the participant level (when distributed), with the employees bearing the burden of the double-level tax.

By contrast, the Congressional decision in the 1997 Act to exempt S corporation income from UBIT at the ESOP level is simple and ensures that S corporation income properly is subject to tax only once—when the income is distributed to participants. The Coalition strongly endorses this decision and encourages this Committee not to entertain the introduction of a complex deduction mechanism that is technically flawed, can engender tax results inconsistent with the general intent underlying Subchapter S, and would produce a new tax burden on employees.

4. Repealing the 1997 Act Provision Cannot Be Justified on "Anti-Tax Shelter" Grounds

As indicated above, the Administration included its proposal to repeal the 1997 Act provision as part of the "corporate tax shelter" section of its budget. As should be apparent from the above, the 1997 Act provision is playing a valuable role in fostering employee ownership of closely-held businesses and enabling people to enhance their retirement savings. Members of this Coalition that have converted to S corporation status, established ESOPs, or given ESOPs greater stakes in the business are doing exactly what the Congress intended when it enacted the 1997 Act provision—they are not engaging in a tax shelter, taking advantage of a loophole, or otherwise engaging in an abusive transaction.

The Coalition understands that there may be some concern about particular transactions in which taxpayers may be using ESOPs in a manner not intended by the Congress in 1997. The Joint Committee on Taxation, in its Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal, suggested that there may be concerns regarding S corporation ESOPs in cases where there are only one or two employees. In addition, it referenced a technique described by Prof. Martin Ginsburg in which the 1997 Act provision can be used to create a "tax holiday" for other shareholders of an S corporation.[1] If Congress is concerned about particular transactions, the appropriate response is to craft narrow solutions targeting those transactions, rather than to reject wholesale the decision made in the 1997 Act to further employee ownership of closely-held companies.

RECOMMENDATIONS

For the reasons set forth above, the Coalition strongly urges the Committee not to approve the Administration's proposal. The Coalition appreciates the Committee's interest in its views on this significant issue.

ENDNOTE

[1] Ginsburg, "The Taxpayer Relief Act of 1997: Worse Than You Think," 76 *Tax Notes* 1790 (September 29, 1997).

Statement of the Committee of Annuity Insurers

The Committee of Annuity Insurers is composed of forty-one life insurance companies that issue annuity contracts, representing approximately two-thirds of the annuity business in the United States. The Committee of Annuity Insurers was formed in 1981 to address Federal legislative and regulatory issues affecting the annuity industry and to participate in the development of Federal tax policy regarding annuities. A list of the member companies is attached at the end of this statement. We thank you for the opportunity to submit this statement for the record.

All of the Administration's proposal~ relating to the taxation of life insurance companies and their products are fundamentally flawed. However, the focus of this statement is the Administration's proposal to increase the so-called "DAC tax" imposed under IRC section 848 and, in particular, the increase proposed with respect to annuity contracts used for retirement savings outside of pension plans ("non-qualified annuities"). The Administration's proposal reflects unsound tax policy and, if enacted, would have a substantial, adverse effect on private retirement savings in America. As was the case last year, the Administration has demonstrated that it does not understand the important role that annuities and life insurance play in assuring Americans that they will have adequate resources during retirement and adequate protection for their families.

Annuities are widely owned by Americans. At the end of 1997, there were approximately 38 million individual annuity contracts outstanding, nearly three times the approximately 13 million contracts outstanding just 11 years before. The premiums paid into individual annuities—amounts saved by individual Americans for their retirement—grew from approximately $34 billion in 1987 to $90 billion in 1997, an average annual increase of greater than 10 percent.

Owners of non-qualified annuities are predominantly middle-income Americans saving for retirement. The reasons for this are obvious. Annuities have unique characteristics that make them particularly well-suited to accumulate retirement savings and provide retirement income. Annuities allow individuals to protect themselves against the risk of outliving their savings by guaranteeing income payments that will continue as long as the owner lives. Deferred annuities also guarantee a death benefit if the owner dies before annuity payments begin.

The tax rules established for annuities have been successful in increasing retirement savings. Eighty-four percent of owners of non-qualified annuities surveyed by The Gallup Organization in 1998 reported that they have saved more money than they would have if the tax advantages of an annuity contract had not been available. Almost nine in ten (88%) reported that they try not to withdraw any money from their annuity before they retire because they would have to pay tax on the money withdrawn.

As discussed below, the proposal contained in the Administration's FY 2000 budget to increase the DAC tax is in substance a tax on owners of non-qualified annuity contracts and cash value life insurance. It would make these products more expensive and less attractive to retirement savers. It would also lower the benefits payable to savers and families. Furthermore, as also discussed below, the DAC tax is fundamentally flawed and increasing its rate would simply be an expansion of bad tax policy.

1. The Administration's DAC proposal is in substance a tax on the owners of annuities and life insurance.

Last year, the Administration's budget proposals included several direct tax increases on annuity and life insurance contract owners, including imposition of tax when a variable contract owner changed his or her investment strategy and a reduction in cost basis for amounts paid for insurance protection. The proposals were rightly met with massive bipartisan opposition and were rejected. This year's budget proposal on DAC is simply an attempt to increase indirectly the taxes of annuity and life insurance contract owners. We urge this Committee to reject the Administration's back door tax increase on annuity and life insurance contract owners in the same decisive manner in which the Committee rejected last year's proposed direct tax increases.

IRC section 848 denies life insurance companies a current deduction for a portion of their ordinary and necessary business expenses equal to a percentage of the net premiums paid each year by the owners of certain types of contracts. These amounts instead must be capitalized and then amortized over 120 months. The amounts that currently must be capitalized are 1.75 percent of non-qualified annuity premiums, 2.05 percent of group life insurance premiums, and 7.70 percent of other life insurance premiums (including noncancellable or guaranteed renewable accident and health insurance). Under the Administration's proposal, these categories of contracts

would be modified and the percentages would be dramatically increased. Specifically, the rate for annuity contracts would almost triple to 5.15 percent while the rate for individual cash value life insurance would almost double to 12.85 percent.

The tax resulting from the requirements of section 848 is directly related to the amount of premiums paid by the owners of the contracts. Thus, as individuals increase their annuity savings (by paying more premiums), a company's taxes increase—the higher the savings, the higher the tax. It is clear that since the enactment of DAC in 1990, the DAC tax has been passed through to the individual owners of annuities and life insurance. Some contracts impose an express charge for the cost of the DAC tax, for example, while other contracts necessarily pay lower dividends or less interest to the policyholder. Still other contracts impose higher general expense charges to cover the DAC tax. (See *The Wall Street Journal*, December 10, 1990, "Life Insurers to Pass Along Tax Increase.")

According to the Joint Committee on Taxation, the increased capitalization percentages proposed in the Administration's FY 2000 budget will result in increased taxes of $3.73 billion for the period 1999—2004 and $9.48 billion for the period 1999—2009. This tax increase will largely come from middle-income Americans who are purchasing annuities to save for retirement and cash value life insurance to protect their families. According to a Gallup survey conducted in April 1998, most owners of non-qualified annuities have moderate annual household incomes. Three-quarters (75%) have total annual household incomes under $75,000. Eight in ten owners of non-qualified annuities state that they plan to use their annuity savings for retirement income (83%) or to avoid being a financial burden on their children (82%).

The Administration's proposal will discourage private retirement savings and the purchase of life insurance. Congress in recent years has become ever more focused on the declining savings rate in America and on ways to encourage savings and retirement savings in particular. As described above, Americans have been saving more and more in annuities, which are the only non-pension retirement investments that can provide the owner with a guarantee of an income that will last as long as the owner lives. Life insurance contracts can uniquely protect families against the risk of loss of income. Increasing the cost of annuities and cash value life insurance and reducing the benefits will inevitably reduce private savings and the purchase of life insurance protection.

2. *Contrary to the Administration's claims, an increase in the DAC tax is not necessary to reflect the income of life insurance companies accurately.*

The Administration claims that the increases it proposes in the DAC capitalization percentages are necessary to accurately reflect the economic income of life insurance companies. In particular, the Administration asserts that "life insurance companies generally capitalize only a fraction of their policy acquisition expenses." In fact, as explained below, life insurance companies already more than adequately capitalize the expenses they incur in connection with issuing annuity and life insurance contracts. The Administration's proposal would further distort life insurance company income simply to raise revenue.

As a preliminary matter, the Administration cites certain data that life insurance companies report to state insurance regulators as a basis for its claim that only a fraction of policy selling expenses are being capitalized. In particular, the Administration points to the ratio of commissions to net premiums during the period 1993—1997, and notes that the ratio is higher than the current DAC capitalization percentage. The Administration's ratios present an inaccurate and misleading picture of the portion of commissions being capitalized under current law.

The Administration's ratios apparently treat expense allowances paid on reinsured contracts as commissions and in doing so effectively count those amounts twice. As a result, the numerators in the Administration's ratios are significantly overstated. If expense allowances paid in connection with reinsurance are accounted for properly, the ratio of commissions to net premiums is significantly lower than described by the Administration.

More importantly, the current tax rules applicable to life insurance companies capitalize policy selling expenses not only through the section 848 DAC tax, but also by requiring (in IRC section 807) reserves for life insurance and annuity contracts to be based on a "preliminary term" or equivalent method. It is a matter of historical record that preliminary term reserve methods were developed because of the inter-relationship of policy selling expenses and reserves. Since the early 1900's, when preliminary term reserve methods began to be accepted by state insurance regulators, the relationship between policy reserves and a life insurance company's policy selling expenses has been widely recognized. See, e.g., K. Black, Jr. and H.

Skipper, Jr, *Life Insurance* 565—69(12th ed. 1994); *McGill's Life Insurance* 401—408 (edited by E. Graves and L. Hayes, 1994).

Under a preliminary term reserve method, the reserve established in the year the policy is issued is reduced (from a higher, "net level" basis) to provide funds to pay the expenses (such as commissions) the life insurer incurs in issuing the contract. The amount of this reduction is known as the "expense allowance," i.e., the amount of the premium that may be used to pay expenses instead of being allocated to the reserve. Of course, the life insurance company's liability for the benefits promised to the policyholder remains the same even if a lower, preliminary term reserve is established. As a result, the amount added to the reserve in subsequent years is increased to take account of the reduction in the first year.

In measuring a life insurance company's income, reducing the first year reserve deduction by the expense allowance is economically equivalent to computing a higher, net level reserve and capitalizing, rather than currently deducting, that portion of policy selling expenses. Likewise, increasing the reserve in subsequent years is equivalent to amortizing those policy selling expenses over the subsequent years. Thus, under the current income tax rules applicable to life insurance companies, policy selling expenses are capitalized both under the section 848 DAC tax and through the required use of preliminary term reserves. The Administration's FY 2000 budget proposal completely ignores this combined effect.

This relationship between policy selling expenses and preliminary term reserves has been recognized by Congress. In accordance with the treatment mandated by the state regulators for purposes of the NAIC annual statement, life insurance companies have always deducted their policy selling expenses in the year incurred in computing their Federal income taxes. Until 1984, life insurance companies also computed their tax reserves based on the reserve computed and held on the annual statement. However, under the Life Insurance Company Income Tax Act of 1959 (the "1959 Act"), if a company computed its annual statement reserves on a preliminary term method, the reserves could be recomputed on the higher, net level method for tax purposes. Because companies were allowed to compute reserves on the net level method and to deduct policy selling expenses as incurred, life insurance companies under the 1959 Act typically incurred a substantial tax loss in the year a policy was issued.

When Congress was considering revisions to the tax treatment of life insurance companies in 1983, concern was expressed about the losses incurred in the first policy year as a result of the interplay of the net level reserve method and the current deduction of first year expenses. In particular, there was concern that a mismatching of income and deductions was occurring. As a consequence, as those who participated in the development of the Deficit Reduction Act of 1984 (the "1984 Act") know, Congress at that time considered requiring life insurance companies to capitalize and amortize policy selling expenses.

Congress chose not to change directly the tax treatment of policy selling expenses, however. Rather, recognizing that the effect of the use of preliminary term reserve methods is economically identical to capitalizing (and amortizing over the premium paying period) the expense allowance by which the first year reserve is reduced, Congress decided to alter the treatment of selling expenses indirectly by requiring companies to use preliminary term methods, rather than the net level method, in computing life insurance reserves.

Although the published legislative history of the 1984 Act does not explicitly comment on this congressional decision to address the treatment of selling expenses through reduction of the allowable reserve deduction, the legislative history of the Tax Reform Act of 1986 does. In 1986, Congress became concerned that there was a mismatching of income and deductions in the case of property and casualty insurers. In particular, some thought that allowing a property and casualty company a deduction for both unearned premium reserves and policy selling expenses resulted in such a mismatching.

Again, recognizing the relationship between the treatment of reserves and selling expenses, Congress chose to reduce the unearned premium reserve deduction of property and casualty insurers by 20 percent, while allowing selling expenses to remain currently deductible. See I.R.C. section 832(b)(4). The legislative history of this rule noted that "this approach is equivalent to denying current deductibility for a portion of the premium acquisition costs." Jt. Comm. on Taxation, *General Explanation of the Tax Reform Act of 1986,* at p. 595 ("1986 Act Bluebook"). Moreover, Congress specifically excluded life insurance reserves that were included in unearned premium reserves from the 20 percent reduction. See I.R.C. section 832(b)(7). It did so, according to the legislative history, because under the 1984 Act life insurance reserves "are calculated . . . in a manner intended to reduce the

mismeasurement of income resulting from the mismatching of income and expenses." See *1986 Act Bluebook* at p. 595 (emphasis added).

In summary, life insurance companies are already over capitalizing policy selling expenses for income tax purposes because of the combination of the current DAC tax and the mandated use of preliminary term reserves. In these circumstances, increasing the DAC capitalization percentages will not result in a clearer reflection of the income of life insurance companies. To the contrary, increasing the percentages as the Administration proposes would further distort life insurance company income simply to raise revenue.

3. Contrary to the Administration's suggestion, an increase in the DAC tax is inconsistent with GAAP accounting.

The Administration's explanation of the DAC proposal implies that increases in the DAC percentages are consistent with generally accepted accounting principles (GAAP). The Administration states that "[l]ife insurance companies generally capitalize only a portion of their actual policy acquisition costs. In contrast, when preparing their financial statements using [GAAP], life companies generally capitalize their actual acquisition costs." What the Administration's explanation fails to note is that, while it is correct that under GAAP accounting actual acquisition costs are capitalized, GAAP accounting does not mandate the use of preliminary term reserves. In fact, no system of insurance accounting "doubles up" on capitalization by requiring a combination of capitalization of actual policy acquisition costs combined with the use of preliminary term reserves.

It is clear from the legislative history of the Omnibus Budget Reconciliation Act of 1990 (the "1990 Act") that Congress expressly considered and rejected GAAP as a basis for accounting for life insurance company policy selling expenses. The Chairman of the Senate Budget Committee inserted in the Congressional Record the language submitted by the Senate Finance Committee describing the section 848 DAC tax. 136 Congressional Record at S15691 (Oct. 18, 1990). In this explanation, the Finance Committee recognized that, while there were some potential benefits to the GAAP approach, there were a number of drawbacks to it. As a result, the Finance Committee chose a proxy approach of amortizing a percentage of premiums over an arbitrary 10 year period, rather than capitalizing actual selling expenses and amortizing them over the actual life of the contracts. In doing so, the Finance Committee observed that

> The Committee recognizes that this approach to the amortization of policy acquisition expenses does not measure actual policy acquisition expenses. However, the Committee believes that the advantage of retaining a theoretically correct approach is outweighed by the administrative simplicity of this proxy approach. Further, the Committee believes that the level of amortizable amounts obtained under this proxy approach should, in most cases, understate actual acquisition expenses. . . . Id.

The House legislative history contains similar explanatory material. See Legislative History of Ways and Means Democratic Alternative (WMCP 101-37), October 15, 1990, at 27-28.

In short, when Congress enacted the DAC tax in 1990, it knew that the proxy percentages did not capitalize the full amount of acquisition expenses as does GAAP accounting. However, as discussed above, the combination of the current DAC percentages with the mandated use of preliminary term reserves already results in two different capitalization mechanisms. If GAAP accounting is the appropriate model for taxing life insurance companies, as the Administration suggests, then the DAC tax should be repealed, not increased.

In conclusion, the Committee of Annuity Insurers urges the Committee to reject the Administration's proposal to increase the section 848 DAC tax. The proposal is simply a disguised tax on the owners of annuities and life insurance contracts. Furthermore, the proposal lacks any sound policy basis and further distorts the income of life insurance companies.

THE COMMITTEE OF ANNUITY INSURERS

Aetna Inc., Hartford, CT
Allmerica Financial Company, Worcester, MA
Allstate Life Insurance Company, Northbrook, IL
American General Corporation, Houston, TX
American International Group, Inc., Wilmington, DE
American Investors Life Insurance Company, Inc., Topeka, KS
American Skandia Life Assurance Corporation, Shelton,
Conseco, Inc., Carmel, IN

COVA Financial Services Life Insurance Co., Oakbrook Terrace, IL
Equitable Life Assurance Society of the United States, New York, NY
Equitable of Iowa Companies, DesMoines, IA
F & G Life Insurance, Baltimore, MD
Fidelity Investments Life Insurance Company, Boston, MA
GE Life and Annuity Assurance Company, Richmond, VA
Great American Life Insurance Co., Cincinnati, OH
Hartford Life Insurance Company, Hartford, CT
IDS Life Insurance Company, Minneapolis, MN
Integrity Life Insurance Company, Louisville, KY
Jackson National Life Insurance Company, Lansing, MI
Keyport Life Insurance Company, Boston, MA
Life Insurance Company of the Southwest, Dallas, TX
Lincoln National Corporation, Fort Wayne, IN
ManuLife Financial, Boston, MA
Merrill Lynch Life Insurance Company, Princeton, NJ
Metropolitan Life Insurance Company, New York, NY
Minnesota Life Insurance Company, St. Paul, MN
Mutual of Omaha Companies, Omaha, NE
Nationwide Life Insurance Companies, Columbus, OH
New York Life Insurance Company, New York, NY
Ohio National Financial Services, Cincinnati, OH
Pacific Life Insurance Company, Newport Beach, CA
Phoenix Home Mutual Life Insurance Company, Hartford, CT
Protective Life Insurance Company, Birmingham, AL
ReliaStar Financial Corporation, Seattle, WA
Security First Group, Los Angeles, CA
SunAmerica, Inc., Los Angeles, CA
Sun Life of Canada, Wellesley Hills, MA
Teachers Insurance & Annuity Association of America—College Retirement Equities Fund (TIAA-CREF), New York, NY
The Principal Financial Group, Des Moines, IA
Travelers Insurance Companies, Hartford, CT
Zurich Kemper Life Insurance Companies, Chicago, IL

Statement of the Committee to Preserve Private Employee Ownership

INTRODUCTION

This statement is submitted on behalf of the Committee to Preserve Private Employee Ownership ("CPPEO"), which is a separately funded and chartered committee of the S Corporation Association. To date, 29 employers have joined CPPEO and over 40,000 employees across the country are represented by companies that belong to CPPEO.

CPPEO welcomes the opportunity to submit this statement to the Finance Committee for the written record regarding two of the proposals in the President's Fiscal Year 2000 Budget. CPPEO strongly opposes the proposal to effectively repeal the provision in the Taxpayer Relief Act of 1997 (the "1997 Act")[1] that allowed S corporations to create ESOPs in order to promote employee stock ownership and employee retirement savings for S corporation employees. CPPEO urges the Finance Committee to reject the Administration's S corporation ESOP proposal and continue to allow S corporations to have ESOP shareholders as contemplated in the 1997 Act. CPPEO also strongly opposes the Administration's proposal to tax "large" C corporations and their shareholders upon a conversion to S corporation status. CPPEO urges the Finance Committee to reject this proposal, which has been included in the President's budget for the past three years and has been rejected each year, on the grounds that it would inhibit the ability of S corporations to acquire C corporations, would impose burdensome complexity, and may represent a first step in an attempt to eliminate S corporations as a form of doing business.

LEGISLATIVE HISTORY OF S CORPORATION ESOPs

In the early 1990s, efforts began to enact legislation that would allow S corporation employees to enjoy the benefits of employee stock ownership that were already conferred on C corporation employees. Finally, in 1996, Congress included a provision in the Small Business Jobs Protection Act of 1996 (the "1996 Act")[2] that allowed S corporations to have ESOP shareholders, effective for taxable years beginning after December 31, 1997, so that S corporation employees could partake in

some of the benefits of employee ownership that were already afforded to employees of C corporations. This provision, which was added just prior to enactment, did not result in a viable method to allow S corporation ESOPs, though it clearly expressed Congress' intent that S corporations should be allowed to have employee stock ownership plans.

The 1996 Act did not provide S corporation ESOPs with all of the incentives that are provided to encourage C corporation ESOPs. For example, under Internal Revenue Code section 1042,[3] shareholders that sell employer stock to a C corporation ESOP are allowed to defer the recognition of gain from such sale, while S corporations cannot do so. In addition, under section 404(a)(9), C corporations are allowed to make additional deductible contributions that are used by an ESOP to repay the principal and interest on loans incurred by the ESOP to purchase employer stock, though this is also not permissible for S corporations. C corporations are also allowed deductions under section 404(k)—deductions for which S corporations are ineligible—for dividends paid to an ESOP that are used either to make distributions to participants or to repay loans incurred by the ESOP to purchase employer stock. In addition, as a practical matter, S corporation ESOP participants are unable to use a substantial tax break—the "net unrealized appreciation" exclusion in section 402(e)(4)—because this benefit applies only to distributions of employer stock, which S corporations typically cannot do, as described below.

Because these incentives provided to C corporation ESOPs were not provided to S corporation ESOPs, a major relative disincentive was imposed on S corporation ESOPs by the 1996 Act. Furthermore, a 39.6 percent tax (the unrelated business income tax of section 511, or "UBIT") was imposed on employees' retirement accounts with respect to the ESOP's share of the income of the sponsoring S corporation and any gain realized by the ESOP when it sold the stock of the sponsoring S corporation. The imposition of UBIT on S corporation ESOPs meant that the same income was being taxed twice, once to employees' ESOP accounts and a second time to the employees' distributions from the ESOP. Accordingly, owning S corporation stock through an ESOP would subject employees to double tax on their benefits, while individuals holding S corporation stock directly would be subject to only a single level of tax.

The 1996 Act had another defect that made ESOPs an impractical choice for providing employee retirement benefits to S corporation employees—the right of ESOP participants to demand their distributions in the form of employer securities. By law, S corporations cannot have more than 75 shareholders and cannot have IRAs or certain other qualified retirement plans as shareholders. Therefore, S corporations generally could not adopt ESOPs without taking the risk that the future actions of an ESOP participant—such as rolling over his or her stock into an IRA—could nullify the corporation's election of S corporation status.

In 1997, as part of the Taxpayers Relief Act ("the 1997 Act"), Congress reaffirmed its policy goal of making ESOPs available to the employees of S corporations and addressed the problems with the ESOP provisions in the 1996 Act. Congress did not provide S corporation ESOPs with all the advantages and incentives provided to C corporation ESOPs (such as the favorable tax treatment for shareholders selling stock to the ESOP and increased deductions and contribution limits for the sponsoring employer discussed above) but it did fix the critical problems. The double tax on S corporation stock held by an ESOP was eliminated by exempting income attributable to S corporation stock held by the ESOP from UBIT. Thus, only one level of tax was to be imposed, and it would be on the ESOP participant when he or she received a distribution from the ESOP. S corporation ESOPs also were given the right to distribute cash to participants in lieu of S corporation stock in order to address the problems of ineligible S corporation shareholders and the numerical limit on S corporation shareholders.

In 1997 it was clear that a key feature of the legislation was that S corporation ESOPs would not have the same incentives afforded to C corporation ESOPs. The incentives provided to C corporation ESOPs that were not allowed to S corporation ESOPs under the 1996 Act, as described above, would continue to be allowed only to C corporation ESOPs. However, S corporation ESOPs would enjoy two benefits not available to C corporation ESOPs.

First, the income of S corporation ESOPs under the 1997 Act is subject to only a single level of tax. This is an inherent attribute of the way S corporations and their shareholders are taxed, and in fact is the *fundamental* characteristic of the S corporation tax regime. No one, including the Administration, disputes that only one level of tax should be imposed on S corporations and their shareholders. The second benefit provided to S corporation ESOPs is that the one level of tax is *deferred* until benefits are distributed to ESOP participants. Considerable thought was given in 1997 to whether this *deferral* of tax should be allowed. Various ways of tax-

ing S corporation ESOPs and their participants were considered in 1997, including ways essentially the same as the Administration's proposal, and were rejected as too complex, burdensome, and unworkable. In order to achieve a workable S corporation ESOP tax regime with incentives that were roughly commensurate with those available to C corporation ESOPs, Congress determined that the deferral of the one level of tax, in lieu of the special incentives afforded to C corporation ESOPs, was appropriate. The Administration is rejecting this determination just 18 months after Congress has acted.

THE ADMINISTRATION'S S CORPORATION ESOP PROPOSAL

The Administration proposes to reimpose UBIT on S corporation ESOPs, both new and old. The specific provisions relating to UBIT adopted in the 1997 Act would be repealed. Assistant Treasury Secretary Donald Lubick agreed, in his testimony before this Committee, that S corporations should be allowed to have ESOPs and that there should be only one level of tax imposed on the S corporation income of an ESOP and its participants. Assistant Secretary Lubick explained, however, that under the Administration's proposal the benefit of tax deferral on the S corporation income of an ESOP would be eliminated by reimposing UBIT on S corporation ESOPs. As an acknowledgment that *double taxation* of S corporations and their shareholders is not appropriate, the Administration's proposal would provide S corporation ESOPs with a special deduction when distributions are made to ESOP participants. As discussed below, however, CPPEO does not believe that the special deduction can prevent the double taxation of S corporation ESOPs and employee participants.

THE ADMINISTRATION'S S CORPORATION ESOP PROPOSAL WOULD UNDERMINE CONGRESSIONAL POLICY

The Administration's S corporation ESOP proposal would undermine the Congressional policy of allowing S corporations to establish ESOPs for their employees principally because it will not only end deferral, but also will reinstate double taxation. The Administration's proposal to allow a deduction to the ESOP for distributions to participants will not prevent double taxation.

S corporation ESOPs will be required to pay UBIT for all the years that they hold S corporation stock, but will not be allowed any way to recover those taxes until distributions are made to participants. The rules limiting the timing of distributions by an ESOP to its employee participants, like the rules for all qualified retirement plans, encourage long-term retirement savings and are intended to produce the result that distributions to an employee will occur many years, even decades, after the employee first becomes a participant in the ESOP. A 2-year carryback and a 20-year carryforward of excess deductions will not ensure that the taxes paid by the ESOP over many years, even decades, will be recovered. Thus, there is no assurance that the deduction will prevent double taxation of employee benefits. *In fact, the estimated revenue to be raised by the Administration's proposal is the same as the revenue cost of the 1997 Act, demonstrating that the Administration's proposal is simply an attempt to repeal the provisions of the 1997 Act and is not aimed at preventing what it claims are unintended uses of current law.*

The Administration's proposed scheme for eliminating tax deferral and attempting to prevent double taxation has another substantial defect. That is, any tax refunds to the ESOP for the tax deductions allowed to the ESOP cannot be fairly allocated and paid to the employee participants. Assume, for the sake of illustration, that employees A and B are the participants in an S corporation ESOP, each owning an equal number of shares of S corporation stock through the ESOP. A and B work for the next 20 years and the ESOP pays tax on the income of the S corporation attributable to their shares of stock. Then A decides to retire and the ESOP sells the shares of stock in A's account to the S corporation and pays A the proceeds. The ESOP receives a deduction for the distribution to A and is able to reduce its UBIT liability for the year it makes a distribution to A. In this example, there would be no way the ESOP could use the full amount of the deduction for the year it makes a distribution to A, nor would it be able to fully use the excess amount when it carries the excess deduction back two years. Thus, the ESOP would not be able to realize the full benefit of the deduction, which was intended to allow the ESOP to recoup the taxes it paid over the past 20 years with respect to the stock in A's account and, presumably, give A that benefit to offset the second level of taxes A will pay. By the time the ESOP realizes all the benefits of the deduction, A will have long ceased to be a participant in the ESOP and those benefits will be allocated to the remaining participant, namely B.

In addition, it is not clear how the ESOP could properly allocate the benefits that it can immediately realize. The deduction is allowed for distributions to participants. After the proceeds from the sale of the stock in A's account are distributed to A, A ceases to be a participant. The ESOP cannot make any additional allocations or distributions to A. As the sole remaining participant, B will receive the benefit of those deductions.

The Administration's proposal also resurrects a problem under ERISA that the 1997 Act eliminated. The imposition of UBIT on S corporation ESOPs raises concerns about fiduciary obligations under ERISA for potential ESOP plan sponsors and trustees. The potential for double taxation and the inequitable allocation of benefits among plan participants will make the establishment of S corporation ESOPs unpalatable to anyone who would be subject to ERISA. In addition, qualified plan trustees typically avoid investments that give rise to UBIT because it obligates the trustee to file a federal income tax return for the plan's UBIT liability. Under the Administration's proposal, the establishment of an S corporation ESOP would *necessarily* involve making investments that give rise to UBIT liability because ESOPs are *required* to invest primarily in employer securities.

The Administration's proposal attempts to characterize the treatment of S corporation ESOPs as a corporate tax shelter. The beneficiaries of S corporation ESOPs are the *employees,* not the S corporation. Moreover, in his testimony before this Committee, Assistant Secretary Lubick made it clear that the Administration's only valid concern is that there may be attempts by some persons to use the S corporation ESOP provisions as a device to gain tax deferral rather than to provide retirement savings benefits to employees. CPPEO notes that the IRS already has an arsenal of anti-abuse tools to deal with any *unintended* benefits from creating an S corporation ESOP. Current law was enacted to do just what it is doing—encouraging employee ownership of S corporations. *Indeed, advocating the repeal of a successful retirement program directly contradicts the Administration's stated objective of increasing retirement savings, as reflected in the 17 retirement savings proposals included in its fiscal year 2000 budget.*

CPPEO'S S CORPORATION ESOP ANTI-ABUSE PROPOSAL

As stated above, the IRS already has an arsenal of anti-abuse tools to deal with any unintended benefits from creating an S corporation ESOP and CPPEO believes there is no need to provide additional anti-abuse rules that deal specifically with S corporation ESOPs. If, however, it is determined that an anti-abuse rule dealing specifically with the potential misuse of S corporation ESOPs is required, CPPEO strongly urges that such an anti-abuse rule be narrowly targeted to penalize only the persons who misuse the ESOP for their own advantage, or the advantage of members of their families, and not S corporation employees. To this end, CPPEO proposes that such an anti-abuse rule apply to persons who *control* an S corporation which has misused its ESOP and who are consequently *responsible* for the misuse of the ESOP to defer tax on their income from the S corporation. Accordingly, persons who individually benefit from the deferral of a substantial portion of the S corporation's income and who collectively have control of the S corporation would be denied the retirement benefits of an S corporation ESOP. The penalty for such persons' misuse of an S corporation ESOP to gain deferral of tax on S corporation income would be the loss of tax deferral for such persons and *not the disqualification of the ESOP.* Disqualification of the ESOP would unfairly harm the retirement savings of non-controlling S corporation employees, who Congress has clearly intended to be the intended beneficiaries of the S corporation ESOP provisions, and whose interests in the ESOP reflect the allocation of retirement benefits in accordance with the requirements that apply to qualified retirement plans.

To implement this approach, CPPEO urges that Congress direct the Treasury Department to add a rebuttable presumption to Treas. Reg. § 1.269–3(b) to the effect that, in the absence of proof to the contrary, the acquisition of "control" of an S corporation by one or more "20-percent employee-owners" is indicative of a purpose to avoid or evade tax. If the presumption is not rebutted, the controlling employee-owners would be taxed currently on S corporation income attributable to S corporation stock held by them through the ESOP, and on S corporation income attributable to their holdings of "synthetic equity" (such as options, restricted shares, stock appreciation rights, or similar instruments) in the S corporation. In this manner, the benefit of tax deferral on S corporation income attributable to the use of an ESOP would be denied to the controlling shareholders who improperly employ the ESOP (alone or in combination with synthetic equity) to gain such tax deferral for themselves or their families, but would not be denied to non-controlling employees who participate in the ESOP.

The anti-abuse provision described above preserves the use of S corporation ESOPs to provide retirement benefits to S corporation employees as Congress intended, and explicitly prevents the misuse of S corporation ESOPs by those persons who, through their control of the S corporation, might otherwise seek to use an ESOP simply to defer tax on the S corporation income of themselves and their families rather than provide retirement savings benefits to their S corporation employees.

CONVERSIONS FROM C CORPORATION STATUS TO S CORPORATION STATUS

Under current law, the conversion of a C corporation into an S corporation (whether by electing S corporation status or by merging the C corporation into an existing S corporation) generally does not result in the recognition of gain or loss by either the C corporation or its shareholders. Current law limits the potential for using the tax-free conversion to S corporation status to shift appreciated assets from a C corporation to an S corporation in order to avoid the corporate level tax on the sale of the assets. Under current law, a corporate level tax is imposed on an S corporation if it sells appreciated assets within ten years of acquiring the assets in a conversion from C corporation status. S corporation shareholders are also taxed on the gain, reduced by the amount of tax paid by the S corporation.

THE ADMINISTRATION'S PROPOSAL TO TAX CONVERSIONS TO S CORPORATION STATUS IS BAD TAX POLICY

Under the Administration's proposal, a C corporation and its shareholders would be taxed on a conversion of the C corporation to S corporation status (whether by electing S corporation status or by merger into an existing S corporation) if the value of the corporation on the date of conversion is more than $5 million. By imposing a tax on the merger of C corporations into existing S corporations (and mergers preceded by the election of S corporation status by an existing C corporation), the Administration's proposal would unfairly inhibit the ability of S corporations to expand their businesses through corporate acquisitions. C corporations are allowed to make tax-free corporate acquisitions, but S corporations would be denied that privilege.

This unfair result would, moreover, come at the price of burdensome complexity. The $5 million threshold value for imposing tax on S corporation conversions would create a "cliff" effect causing disputes over valuation that would be difficult to resolve for corporations that are not publicly traded. In addition, more rules would be needed to address the murky issues of whether conversions below the $5 million threshold were "abusive" transactions structured merely to avoid the conversion tax.

Perhaps most troubling is that the Administration's proposal may represent a first step toward the repeal of the S corporation tax regime. The restrictions on S corporations (primarily the "one class of stock" rule and limitations on the number and type of shareholders) already do not compare favorably with the flexibility afforded limited liability companies, which have expanded the availability of corporate limited liability combined with a single level of tax. Therefore, the desirability of S corporation status for newly-formed businesses has been decreased. The Administration's proposal would decrease the desirability of C corporations converting to S corporation status. Enactment of the Administration's proposal would confine S corporation status principally to existing S corporations, at which point the opponents of the S corporation tax regime would challenge the need to preserve a separate tax regime for the benefit of only existing S corporations and their shareholders. The S corporation tax regime has served entrepreneurial businesses well for the past 40 years, and there is no good reason to dismantle that regime now.

CONCLUSION

Current law encourages employee ownership of S corporations and promotes employee retirement savings. Current law is working *exactly* as it was intended to work when Congress amended the ESOP rules for S corporations in the 1997 Act. Accordingly, CPPEO urges this Committee to reject the Administration's S corporation ESOP tax proposal. The tax and retirement policies reflected in the 1997 Act, resolved just a few months ago, should not now be undone. If, however, a specific "anti-abuse" rule is considered appropriate, we urge this Committee to adopt the rule described herein, so that only those persons who individually benefit from the deferral of a substantial portion of the S corporation's income and who collectively have control of the S corporation would be denied the otherwise intentional retirement savings benefits of S corporation ESOPs.

In addition, current law fairly treats corporate acquisitions by S corporations the same as corporate acquisitions by C corporations. Accordingly, CPPEO urges this

Committee to reject the Administration's proposal to tax conversions to S corporation status. The Administration's proposal is not needed, would unfairly discriminate against S corporations, would add burdensome complexity to the tax law, and would threaten the continued existence of the S corporation tax regime.

ENDNOTES

[1] P.L. 105–34.
[2] P.L. 104–188.
[3] All "section" references are to the Internal Revenue Code of 1986, as amended.

STATEMENT OF THE EMPLOYER-OWNED LIFE INSURANCE COALITION

[SUBMITTED BY ELAINE K. CHURCH, PRICEWATERHOUSECOOPERS, LLP]

This statement presents the views of the Employer-Owned Life Insurance Coalition, a broad coalition of employers concerned by the provision in the Administration's fiscal year 2000 budget that would increase the taxes of leveraged owners of life insurance policies.

CONGRESS SHOULD REJECT THE ADMINISTRATION'S LIFE INSURANCE PROPOSALS

The Administration's fiscal year 2000 budget proposal would increase taxes of highly-leveraged taxpayers that purchase life insurance. Businesses purchasing insurance on the lives of their employees would be denied a portion of the deduction to which they are otherwise entitled for ordinary and necessary interest expenses unrelated to the purchase of life insurance. The Administration's characterization of this proposal as eliminating a "tax shelter" obscures the real goal of this proposal, which is to tax the accumulated cash value, commonly known as "inside buildup," within these policies.

Congress has consistently refused to tax inside buildup and, for the reasons set forth below, we urge Congress to reject this ill-conceived proposal as well.

DISGUISED ATTACK ON HISTORICAL TREATMENT OF TRADITIONAL LIFE INSURANCE

The Administration's proposal drives at the heart of permanent life insurance. Although the Treasury Department has characterized the proposal as preventing "tax arbitrage," *the proposal in reality targets the very essence of traditional permanent life insurance:* the inside buildup. The Administration's proposal would impose a new tax on businesses based on the cash value of their life insurance policies.

The Administration's proposal would deny a portion of a business's otherwise allowable interest expense deductions based on the cash value of insurance purchased by the business on the lives of its employees. Though thinly disguised as a limitation on interest expenses deductions, the proposal generally would have the same effect as a tax on inside buildup. Similar to a tax on inside buildup, the interest disallowance would be measured by reference to the cash values of the business's insurance policies—as the cash values increase the disallowance would increase, resulting in additional tax. So while not a direct tax on inside buildup, the effect would be similar—accumulate cash value in a life insurance policy, pay an additional tax.

HISTORICAL TAX TREATMENT OF PERMANENT LIFE INSURANCE IS SOUND

The Administration's proposal would change the fundamental tax treatment of traditional life insurance that has been in place since the federal tax code was first enacted in 1913. Congress has on a number of occasions considered, and each time rejected, proposals to alter this treatment. In fact, just last year, Congress rejected a number of proposals, including the proposal now under consideration, to tax inside build up. Nothing has changed that would alter the considered judgment of prior Congresses that the historical tax treatment of traditional life insurance is grounded in sound policy and should not be modified.

Among the reasons we believe that these latest attacks on life insurance are particularly unjustified, unnecessary and unwise are——

Cash Value is Incidental to Permanent Life Insurance Protection

The cash value of life insurance is merely an incident of the basic plan called "permanent life insurance" whereby premiums to provide protection against the risk of premature death are paid on a level basis for the insured's lifetime or some other extended period of years. In the early years of a policy, premiums necessarily exceed the cost of comparable term insurance. These excess premiums are reflected in the

"cash value" of the policy. As fairness would dictate, the insurance company credits interest to the accumulated cash value, which helps finance the cost of coverage in later years, reducing aggregate premium costs.

Thus, while a permanent life insurance policy in a sense has an investment component, this feature is incidental to the underlying purpose of the policy. The essential nature of the arrangement is always protection against the risk of premature death. For businesses, life insurance protects against the economic devastation that can occur with the death of an invaluable employee or the business owner. Life insurance is a cost-effective way to obtain this protection because the costs for life insurance do not increase as the covered individual ages.

While some might conclude that only small businesses need the stability provided by permanent life insurance, this is not in fact true. All corporations are susceptible to catastrophic economic losses resulting from the death of an invaluable employee. Large corporations use permanent life insurance to protect against, and level out the costs associated with, the economic uncertainty the possibility of such future losses creates. The United States Court of Appeals for the Seventh Circuit,[1] discussing why corporations purchase liability insurance, noted that:

> Corporations . . . do not insure to protect their wealth and future income, as natural persons do, or to provide income replacement or a substitute for bequests to their heirs (which is why natural persons buy life insurance). Investors can "insure" against large risks in one line of business more cheaply than do corporations, without the moral hazard and adverse selection and loading costs: they diversify their portfolios of stock. Instead corporations insure to spread the costs of casualties over time. Bad experience concentrated in a single year, which might cause bankruptcy (and its associated transaction costs), can be paid for over several years.

A regular, level, predictable life insurance premium replaces the uncertainty of large, unpredictable losses caused by the death of such an employee. This predictability frees all corporations to make long term plans for business development and growth.

The Tax Code Already Strictly Limits Cash Value Accumulations

The Administration's proposal ignores the major overhauls of life insurance taxation made by Congress over the past 20 years. These reforms have resulted in a set of stringent standards that ensure that life insurance policies cannot be used to cloak inappropriate investments.

The most significant reforms occurred in the 1980's, when Congress and the Treasury undertook a thorough study of life insurance. It was recognized that while all life insurance policies provided protection in the event of death, some policies were so heavily investment oriented that their investment aspects outweighed the protection element. After much study, Congress established stringent statutory guidelines, approved by the Administration, that limit life insurance tax benefits at both the company and policyholder levels to those policies whose predominant purpose is the provision of life insurance protection.

- In 1982, Congress first applied temporary "guideline premium" limitations to certain flexible premium insurance contracts;
- In 1984, Congress revised and tightened these limitations and extended them to all life insurance products;
- In 1986, the Congress again reviewed these definitional guidelines, making additional technical and clarifying changes;
- Finally, in 1988, the Congress again addressed these issues, developing still more restrictive rules for certain modified endowment contracts and modifying the rules applicable to life insurance contracts to require that premiums applicable to mortality charges be reasonable, as defined by Treasury regulation.

Today, these guidelines (set forth in sections 7702 and 7702A of the Internal Revenue Code) significantly limit the investment element of any policy by requiring specific relationships between death benefits and policy accumulations under complicated technical rules (the so-called cash value test or the guideline premium/cash value corridor tests). *Policies that cannot meet these limitations were deemed "investment oriented" in the judgment of Congress and are not eligible for tax treatment as life insurance.*

On the other hand, Congress and the Administration clearly intended that inside buildup within policies *satisfying* the new criteria would *not* be subject to taxation. In fact, policymakers concluded that with the tightening of the definition of life insurance and the placing of narrower limits on the investment orientation of policies,

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[1] *Sears, Roebuck and Co.* v. *Commissioner*, 972 F.2d 858, 862 (7th Cir., 1992).

there was all the more reason for continuing an exemption for inside buildup. Buck Chapoton, then Assistant Secretary of the Treasury for Tax Policy testified on this point before a Ways & Means subcommittee in 1983, explaining that:

> the treatment of [inside buildup bears] an important relationship to the definition of life insurance; that is, to the extent the definition of life insurance is tightened, thereby placing narrower limits on the investment orientation of a life insurance policy, there is more reason for allowing favorable tax treatment to the [inside buildup] under policies that fall under a tighter definition. [Tax Treatment of Life Insurance; Hearings Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, May 10, 1983, 98th Cong., 1st Sess. 16 (1983).]

Congress proceeded on this basis and, as noted above, in 1984 established a tighter and narrower definition of life insurance.

In addition to blessing the continuation of tax benefits for inside buildup within life insurance contracts when it considered these issues in the 1982, 1984, 1986 and 1988 legislation described above, Congress did so on numerous other occasions by failing to enact Treasury proposals to tax inside buildup. For example, notwithstanding Treasury proposals to tax inside buildup contained in the 1978 Blueprints for Tax Reform, the November, 1984 Treasury Tax Reform proposals, the 1985 Tax Reform Proposals and various budget proposals in the 90's, Congress consistently refused to tax inside buildup within life insurance policies.

The Tax Code Already Prevents Abusive Leveraging of Life Insurance

Businesses purchasing life insurance policies that satisfy the rigorous life insurance qualification tests are still further restricted in the funding and use of those policies. Since 1964, the Internal Revenue Code has denied interest deductions on Loans traceable to the acquisition or holding of a life insurance policy. However, Congress has always distinguished between the perceived abuses of life insurance and the legitimate use of life insurance.

Congress has implicitly endorsed continuation of inside buildup in each of the past three years while addressing specific perceived abuses. In 1996 it considered and addressed certain perceived problems with policy loans by repealing the deduction for interest on policy loans. However, no attempt was made to tax inside buildup generally.

In 1997, Congress became concerned that Fannie Mae intended to use its quasi-federal status and preferred borrowing position to purchase coverage for its customers (denying a portion of Fannie Mae's otherwise applicable interest deductions). When drafting the interest disallowance, Congress distinguished its concerns regarding what was considered to be Fannie Mae's inappropriate efforts to exploit its preferred borrowing position from the typical situation involving employer-owned policies. As a result, Congress provided a clear exemption for policies purchased by a business on employees, officers, directors and 20-percent owners.

Finally, just last year Congress rejected the same indirect attack on inside buildup the Administration proposes again this year. In the same year, however, Congress again demonstrated its commitment to preserving tax-favored status for employer policies by enacting additional technical corrections to clarify the scope of the exemption enacted in 1997 (e.g. to cover former employees, group contracts, etc.).

In 1998, the Administration's fiscal year 1999 budget also contained direct assaults on the tax preferred status of inside buildup in proposals designed to tax inside buildup in certain policy changes and transactions involving insurance company separate accounts as well as through adjustments to annuity basis rules. These proposals were widely criticized, and Congress rejected all of them. This year, the Administration has abandoned this direct attack in favor of an indirect taxation of inside buildup.

In each of the past three years, Congress was asked to address concerns over perceived exploitation of certain tax benefits related to life insurance. It had the opportunity to impose sweeping, across the board changes to the traditional taxation of life insurance policies. Congress rejected this course, choosing instead to pursue a reasoned middle course. Legislation was crafted to narrowly address specific concerns without trimming any of the core tax benefits afforded with respect to inside buildup.

Given this detailed review of life insurance policies, employers reasonably relied on the continued availability of inside buildup with respect to the policies they previously held, as well as in subsequent policy purchases. Similarly, carriers reasonably relied on the continued availability of inside buildup in developing and marketing insurance policies. Treasury's attempt, once again, to reverse Congress's well reasoned decision is unconscionable. For yet another year, policyholders and carriers

made business decisions in reliance on congressional decisions and are again thrown into turmoil as a result of the Administration's thinly disguised attack on inside buildup. Consistent with every prior, Congressional decision on this issue, this proposal must AGAIN be summarily rejected.

Purchase of Life Insurance Has Recognized, Legitimate Business Purposes

In re-proposing this disallowance, the Administration has attempted to shift Congressional attention away from the proposal's unstated goal of taxing the inside buildup by labeling the proposal, not as a proposed insurance tax modification as it did last year, but as a corporate tax shelter. Nothing has changed in the proposal from last year to this year except the packaging. The proposal is still just an attack on inside buildup—it is not an attempt to eliminate a tax shelter because no tax shelter exists.

The Administration would have you believe that every business purchasing life insurance is engaging in tax arbitrage if that business is or becomes leveraged. It is irrelevant under the Administration's proposal that the debt was acquired at a different time, or that the business had distinctly separate, but equally valid, non-tax business reasons for acquiring a life insurance policy and incurring debt. The purchase of a life insurance policy will "taint" previously, legitimately acquired debt, and the existence of a life insurance policy will "taint" any debt acquired after the life insurance policy is purchased.

Legitimate business purposes exist for purchasing life insurance. Similarly, businesses incur debt for equally valid business reasons. But there is no room in the Administration's proposal to recognize the potentially valid reasons for engaging in two unrelated transactions. This approach completely disregards Congress's longstanding respect for and support of, debt-financed transactions and the purchase of life insurance by businesses.

APPRECIATION IN CASH VALUE SHOULD NOT BE TAXED

Long-Term Investment Should be Encouraged, Not Penalized

Permanent life insurance provides significant amounts of long-term funds for investment in the U.S. economy. These funds are attributable to *permitted* levels of policy investment. Businesses acquire life insurance policies to provide protection against the death of a valued employee or owner as well as a funding vehicle for many employee benefits, often including retiree benefits. These reasons for purchasing and maintaining life insurance policies benefit the U.S. economy. By ensuring that fewer businesses fail due to the death of an invaluable individual other employees are still employed. By funding employee benefits, more active employees and retirees are provided for, which reduces the strain on public benefits.

The incidental investment element inherent in permanent life insurance should, if anything, be encouraged, not penalized. Congress and the Administration have repeatedly emphasized the need to increase U.S. savings, especially long term and retirement savings. Recent efforts have used the tax code to *encourage* savings, not penalize them. Consider, for example, the recent expansion of IRAs, the introduction of Roth IRAs and education IRAs, as well as small employer savings vehicles like the SIMPLE. Given these savings goals, the Administration proposal to significantly reduce or eliminate business's efforts to fund long-term employee benefits and retirement savings programs for their employees appears especially misguided.

Unrealized Appreciation Should Not be Taxed

There is another, more fundamental, reason why the incidental investment inherent in permanent life insurance should not be taxed currently: accumulating cash values represent unrealized appreciation. Taxing a business currently on the increase in the cash value of a life insurance policy would be like taxing a homeowner each year on the appreciation in value of the home even though the home has not been sold. This would be inconsistent with historical and fundamental concepts of the federal income tax and contrary to the traditional principle that the government should not tax unrealized amounts which taxpayers cannot receive without giving up important rights and benefits. Taxing life insurance policyholders on accumulating cash values would single out life insurance by withdrawing the protection generally provided against taxation of an amount the receipt of which is subject to substantial restrictions. Given that much of this "investment" actually reflects a prepayment of premiums designed to spread costs levelly over the insured's life, this would be especially inappropriate.

ORDINARY AND NECESSARY INTEREST EXPENSES SHOULD BE DEDUCTIBLE

The Administration's proposal to disallow otherwise deductible interest expenses is inconsistent with fundamental income tax principles.

Interest Payments are an Ordinary and Necessary Business Expense

It is difficult to comprehend how an otherwise ordinary and necessary business expense loses its status as such solely because a business purchases life insurance on its employees. For example, few would argue that if Acme Computer borrows funds to help finance the cost of a new supercomputer assembly plant, the interest Acme pays on the debt is a legitimate business expense that is properly deductible. How can it be that if Acme decides it is prudent to purchase life insurance on the leader of the team that developed the supercomputer—to help offset the inevitable transition costs that would follow the team leader's unexpected death—that a portion of the interest payments is suddenly no longer considered a legitimate business expense? This is precisely the effect of the Administration's proposal.

To fully appreciate this provision, apply the underlying rationale to an individual taxpayer: Should any homeowner who purchases or holds life insurance be denied a portion of the otherwise applicable deduction for mortgage interest? Or, carrying the analogy a bit further, should any homebuyer who contributes to an IRA or a section 401(k) plan (thereby receiving the tax benefits of tax deferral or, in the case of a Roth IRA, tax exemption) be denied a portion of the otherwise applicable deduction for mortgage interest?

The Treasury Department asserts that the deduction denial would prevent tax arbitrage in connection with cash value policies. However, the proposal does not apply to debt directly or even indirectly secured by cash values; interest on such amounts is nondeductible under current law. Section 264 of the Internal Revenue Code disallows a deduction for interest on policy loans from the insurer as well as on loans from third parties to the extent the debt is traceable to the decision to purchase or maintain a policy. Thus, the only interest deductions that would be affected by the proposal would be those attributable to unrelated business debt—loans secured by anything but life insurance. The arbitrage concern is a red herring; the real target is inside buildup.

If the Administration has concerns about the insurance policy purchased on the life of the team leader, then it should say so—and it should address the issue directly. It is inappropriate to deny instead a legitimate business expense deduction as an indirect means of taxing inside buildup. Congress, for sound policy reasons, has steadfastly refused to enact proposals that more directly attack inside buildup; it should similarly refuse to enact this proposal.

Disproportionate Impact on Similar Businesses

The Administration's proposal to impose a tax penalty on businesses that purchase life insurance on their employees would have a disproportionate impact on highly-leveraged businesses. For financial institutions that are generally highly-leveraged because assets of their customers are generally viewed as debt of the institution, the effects of the proposal would be disproportionately harsh. This is inconsistent with a fundamental tenet of the tax laws that, to the extent possible, taxation should be neutral with respect to core business decisions such as the appropriate degree of debt. It is also patently unfair and without policy justification.

To illustrate the disproportionate burden on highly-leveraged businesses, take the following example: Assume two competing companies, each with $50 million in assets. Company A has $2 million in outstanding debt, with an annual interest expense of $150,000. Company B has $20 million in outstanding debt, with an annual interest expense of $1.8 million.

> If Company A purchases an insurance policy on the life of its resident genius, Company A would be required to forego a portion of the interest expense on its outstanding debt. For example, if the cash value of the policy were $5 million, one-tenth of the annual interest expense, or $15,000, would not be deductible.
>
> If Company B buys the same policy for its resident genius, it too would be required to forego one-tenth of its interest expense deduction. However, for Company B, this amounts to a foregone deduction of $180,000—*12 times the amount foregone by Company A.*

The deduction disallowances illustrated above would occur *each year,* compounding the disproportionate impact on Company B. Over a span of 30 years, Company B could lose interest deductions in excess of $5.4 million—while Company A might lose closer to $450,000.

Whatever one's beliefs about the proper tax treatment of life insurance policies, what possible justification exists for imposing a tax penalty associated with the purchase of such a policy that varies with the level of a company's outstanding debt?

CONCLUSION

For the reasons explained above, we believe the Congress, consistent with its long-standing interest in preserving tax benefits for inside buildup within life insurance contracts, should reject the Administration's insurance proposal, which would effectively subject inside buildup to current taxation.

STATEMENT OF THE EQUIPMENT LEASING ASSOCIATION

INTRODUCTION

The Equipment Leasing Association is submitting this statement for the record to express our concerns regarding the proposed "corporate tax shelter proposals" included in the Clinton Administration's proposed FY 2000 Budget. ELA has over 800 member companies throughout the United States who provide financing for all types of businesses in all types of markets. Large ticket leasing includes the financing of transportation equipment such as aircraft, rail cars and vessels. Middle market lessors finance high-tech equipment including main frame computers and PC networks, as well as medical equipment such as MRIs (magnetic resonance imaging) and CT (computed tomography) systems. Lessors in the small ticket arena provide financing for equipment essential to virtually all businesses such as phone systems, pagers, copiers, scanners and fax machines.

WHAT TYPE OF COMPANY LEASES?

More companies, particularly small businesses, acquire new, state of the art equipment through leasing than through any other type of financing. Eighty percent of all U.S. companies lease some or all of their equipment. Companies that lease tend to be smaller, growth-oriented and focused on productivity—these are companies long on ideas, but often, short on capital.

WHY COMPANIES LEASE

Companies choose lease financing for several reasons:

- Leasing permits 100% financing;
- Leasing permits a close matching of rental payments to the revenue produced by the use of the equipment;
- Leasing allows companies to keep their debt lines open for working capital rather than tying it up in capital expenditures;
- Companies that lease know that they make money by using the equipment, not owning it;
- Leasing allows a company to focus on its core business—they don't have to worry about maintenance, upgrading or asset disposition;
- Leasing minimizes concerns about the technological obsolescence of the company's equipment;
- Leasing shifts asset management risk to the lessor, away from the user.

Leasing by commercial enterprises increases productivity and stimulates economic growth. While the federal and state tax codes provide various incentives to invest in new equipment, many companies find they are not in a financial position to utilize the incentives. However, through leasing, the intended incentives to invest can be passed through to the company using the equipment in the form of lower rental payments because the leasing company utilizes the intended investment incentives. The use of leasing in this manner has long been intended by Congress.

LEASING CREATES JOBS

It is estimated that each increase of $1 billion in equipment investment creates approximately 30,000 jobs (Brimmer Report). According to the U.S. Department of Commerce, in 1998 alone, the equipment leasing industry financed over $183 billion in equipment acquisition and it is anticipated that equipment lessors will finance over $200 billion in new equipment acquisition in 1999.

STATE AND LOCAL GOVERNMENTS LEASE, TOO

It is not only commercial enterprises that lease equipment. Tax-exempt entities such as states, cities, counties and other subdivisions around the U.S. often lease

various types of equipment in an effort to keep taxpayer costs down. Equipment leased by local governments includes 911 emergency phone systems, computers, school buses and police vehicles. Tax-exempt hospitals often lease their emergency vehicles and high-cost, sophisticated diagnostic medical equipment, in an effort to keep health care costs down.

Lessors also lease equipment to other tax-exempt entities such as foreign corporate enterprises or individuals. Examples include automobile fleet leasing, leases of tractors and trailers, and leases of aircraft (both commercial and corporate). Further, many domestic lessees have the right to sublease assets into foreign markets in times when the equipment may be surplus. Very often, these subleases are to entities in foreign markets which have the need for the asset

THE ADMINISTRATION'S "CORPORATE TAX SHELTER" PROPOSALS REPRESENT A SIGNIFICANT CHANGE IN U.S. TAX POLICY

An analysis of the Administration's sweeping and vague corporate tax shelter proposals raises the concern that leasing transactions which conform to long standing tax policy and Congressional intent could be negatively impacted by the Administration's proposals. If this were the case, these proposals would represent a significant change in longstanding U.S. tax policy. Treasury officials have advised us that it is generally not their intent to negatively impact lease finance structures, and that this would be clarified in their anticipated "white paper". Without this clear exclusion of leasing transactions that meet the standards of current law from the sweeping new corporate tax shelter proposals, ELA must oppose these proposals and urges Congress to reject them.

ELA has long supported two fundamental principles of federal tax policy. First, the form of financing chosen to facilitate the acquisition of assets, whether loans or leases, should be respected as long as economically valid. Second, the principle that the tax treatment of an owner of an asset should not differ whether the asset is used directly by the owner or leased to another end-user. Again, in their current form, the Administration's proposals appear to violate these two principles and have already had a chilling effect on equipment acquisition in certain markets. Therefore, ELA opposes them and urges Congress to reject them.

FURTHER LIMITING LESSORS' TAX BENEFITS IN TAX-EXEMPT USE PROPERTY TRANSACTIONS IS WRONG!

ELA has grave concerns regarding the scope of the Administration's proposal to "Limit Inappropriate Tax Benefits For Lessors of Tax-Exempt Use Property". While Treasury has expressed concerns regarding one specific type of cross-border financing structure—the "lease-in/lease-out" ("LILO") structure—the Administration's legislative proposal would impact virtually every cross-border transaction with a tax-exempt entity. The proposal may also impact domestic lease transactions wherein the lessee may be able to sublease the equipment to a foreign user at some point during its life. (A tax-exempt entity includes the United States, State or local governments, tax-exempt organizations, and any foreign person or entity (Section 168(h)(2))).

Under current law, lessors of "tax-exempt use property" are already penalized, as they are limited in their ability to claim certain tax benefits. Lessors of tax-exempt use property are prohibited from using either an accelerated method of depreciation or economic depreciation if the lease term is equal to or greater than an asset's class life. Instead, they are required to use a straight-line method over a recovery period that is not less than 125% of the lease term.

The Administration's proposal would further inhibit lease financing, as it would generally prohibit a lessor of property leased to a foreign lessee (as well as other tax-exempt persons) from currently utilizing net losses from a leasing transaction. Instead, to the extent a lessor of tax-exempt use property realizes in any year a net loss, the net loss would be suspended and carried forward to offset the future income from the transaction. This proposal would eliminate all of the tax deferral benefits that underpin the economics of cross-border leasing.

Every lease transaction generates deductions in the early years of the transaction, which are offset by the taxable income in the later years. It is the U.S. lessor's ability to use these deductions against its other business income that allows it to provide the lessee with a lease rate that is lower than a straight borrowing. If enacted, this proposal will have a devastating impact on U.S. companies currently involved in selling assets to foreign entities where lease financing has been a significant feature of the marketplace, for example, manufacturers of aircraft and aircraft engines. As such, the proposal is contrary to long-established policies of promoting U.S. ex-

ports. (The proposal could also negatively impact U.S. domestic leasing by inhibiting flexibility of use and subleasing of the asset).

Clearly, the Administration's proposal goes far beyond what is necessary to prevent perceived abusive transactions as it encroaches upon non-abusive transactions that are permitted under current law. In fact, in light of the 1986 depreciation rules providing for straight-line depreciation over the class-life of foreign use property (which were intended to replicate economic depreciation), we believe that the Pickle depreciation rules, insofar as they relate to foreign lessees, are no longer necessary or appropriate and do not reflect sound tax policy. Consequently, we urge Congress to reject this proposal and encourage the Treasury Department to support a depreciation rule which does not discriminate between property owned by a U.S. taxpayer that is used outside the U.S. and property owned by a U.S. taxpayer that is leased to a foreign person. In both cases the income is fully taxable.

TREASURY HAS SUFFICIENT AUTHORITY UNDER CURRENT LAW TO ADDRESS FINANCING STRUCTURE CONCERNS

It is clear that Treasury has authority under current law to shut down the "lease-in/leaseout" ("LILO") transactions that it opposes (see Revenue Ruling 99-14). Instead of advancing an overly broad legislative proposal which will disrupt efficient, economic-based transactions, we once again call upon Treasury to exercise its existing authority under current law to address its specific concerns and issue final 467 regulations, which have been pending in proposed form for over two years.

The Administration's proposal is also overly broad in that it could inappropriately affect legitimate business deductions that may be tangentially related to a leasing transaction but are not generated to shelter income. This legislation is not needed. A much narrower solution for addressing Treasury's concerns regarding "LILOs" is available—the issuance of final Section 467 regulations.

We also believe that the Administration's proposal is in direct conflict with the Congressional objective of developing a U.S. trade policy which will provide U.S. companies with the ability to compete on a level playing field with their foreign competitors. If enacted, this legislation will severely inhibit the ability of U.S. exporters and financial institutions to compete effectively on a global scale. If U.S. companies are not able to compete on cross-border leases, tax revenues currently going to the U.S. Treasury will be lost to foreign Treasuries, as all leases, including cross-border leases, generate more taxable income than deductions over the life of the lease agreement.

PROPOSAL TO "DISALLOW INTEREST ON DEBT ALLOCABLE TO TAX-EXEMPT OBLIGATIONS" WILL INCREASE STATES' AND MUNICIPALITIES' COST OF CAPITAL

ELA opposes the Administration's proposal to "disallow interest on debt allocable to tax-exempt obligations", as the elimination of the 2% de minimis rule will impair the ability of state and local governments to raise capital. While non-financial corporations may not account for a large percentage of total municipal securities outstanding, these corporate buyers do play a vital role in three important market segments: (1) short term municipal investments, (2) state and local government housing and student loan bonds, and (3) municipal leasing transactions.

CONCLUSION

The uncertainty caused by the Administration's proposals has already had a chilling effect on equipment acquisitions in various markets. For over three decades, ELA members have provided lessees with various lease financing options which conform to long standing tax policy and Congressional intent. Taxpayers ask, "at what point did Congressionally-intended incentives for investment and economic growth become 'abusive corporate tax shelters'?"

Congress, the Treasury Department and the courts have long recognized that companies financing the acquisition of equipment through a loan are the recipients of various tax incentives. These same bodies also have long recognized that equipment acquired through leasing involves the transfer of tax benefits from the user of the equipment to the owner-lessor. As a direct result of these sound tax policies, American citizens are the beneficiaries of the most modern and productive economy in the world. While equipment lessors would undoubtedly be negatively impacted by the proposed changes discussed above, the ultimate impact will be to drive up the cost of capital equipment acquisitions for U.S. businesses, particularly small businesses.

STATEMENT OF GENERAL MOTORS CORPORATION

The Clinton Administration proposes to tax the issuance of tracking stock, a type of stock that tracks the economic performance of less than all the assets of the issuing corporation. General Motors Corporation ("GM") has a unique perspective on this proposed legislation. GM was the first publicly-traded company to issue tracking stock (GM's Class E Common Stock), in connection with its acquisition of Electronic Data Systems Corporation ("EDS") in 1984. In total, GM has issued more than $10 billion in tracking stocks and has nearly $5 billion in such stock outstanding currently.

GM believes that it would be beneficial for the Committee to understand (1) the business circumstances that caused GM to create tracking stock in the first instance and (2) GM's experience with this stock since it was first issued. GM's experience demonstrates that tracking stock is an exceedingly valuable business mechanism that cannot reasonably be used for tax avoidance. GM strongly urges this Committee to reject the Administration's proposal to tax the issuance of tracking stock.

GM'S EXPERIENCE WITH TRACKING STOCK

GM is the world's largest manufacturer and distributor of motor vehicles. In 1998, GM had worldwide sales of more than $160 billion and provided employment to more than 600,000 workers.

A. Acquisitions of EDS and Hughes Aircraft Company

In the mid-1980's, GM was concerned that the company needed to be better prepared for the cyclical downturns in the U.S. automotive market. The company was primarily a manufacturer of automobiles and automotive components, which made GM vulnerable to the periodic recessions that occur in the automotive industry. At the same time, GM was attempting to implement cost-effective data processing systems across its worldwide operations. GM also believed that it had to increase its high technology expertise as a means to accelerate the application of electronics in its automotive products.

GM thought the best way to diversify its earnings base to withstand economic downturns, reduce its cost structure, and address the need for increased electronic content in its automotive products was to make significant acquisitions in the computer servicing, data processing, and high-technology electronics industries. Toward that end, GM began to investigate the acquisition of two companies, EDS and Hughes Aircraft Company ("Hughes"). EDS was then a rapidly growing data processing and computer company located in Dallas, Texas. GM believed that the integration of GM's automotive business with EDS's computer expertise would provide GM an "electronic backbone," increase GM's marketing efficiencies and reduce its cost structure. Hughes was one of the leading defense electronics companies in the world, with expertise in engineering, electronics and science. GM believed a combination of its automotive manufacturing business with Hughes' engineering and electronics expertise would dramatically improve GM's products. Moreover, the ownership of EDS and Hughes would make GM a more diversified company and thus reduce the cyclicality of GM's earnings.

GM negotiated the acquisition of EDS with EDS's top executives, principally Ross Perot and Morton Meyerson. EDS's executives were intrigued by the growth potential that could result from a merger with GM, but they had many concerns about receiving ordinary GM common stock as the merger consideration. EDS perceived itself as a nimble, high-growth, high-technology company, and the company's executives worried about the consequences of merging into GM and staking their economic fortunes with those of a slower-growth, mature automotive company. In particular, EDS's executives were concerned that GM's enormous size would render EDS's successes immaterial to GM and would suppress EDS's entrepreneurial spirit. EDS was also concerned that its employees would not be motivated by holding stock and stock options in a company whose stock price they could not meaningfully influence by their efforts.

GM tracking stock was the key to persuading EDS to merge with GM. GM's Class E Common Stock had liquidation and bankruptcy rights on an equal footing with GM's existing common stock and represented a full integration of GM's assets with EDS's assets. Class E Common Stock voted in the election of GM's Board of Directors, and had no voting rights in the election of EDS directors. However, the dividends on the Class E Common Stock would be payable by GM based on the earnings of EDS. GM anticipated that the Class E Common Stock's value would reflect primarily the performance of EDS. The idea for this stock was not driven or motivated by tax considerations (the acquisition was fully taxable to EDS's shareholders), but instead was created by business people seeking to solve a business problem.

The creation of this stock in fact solved the problems identified by EDS's executives and permitted the merger to go forward. The creation of Class E Common Stock created a separately-traded equity that could be separately valued, and in turn this equity could be made available to EDS employees to provide direct incentives for them to improve and grow their distinct business. As a service business, it was critical to EDS's stability and growth that it retain its key employees. At the same time, GM was able to acquire all of EDS and integrate EDS's expertise into GM's automotive business.

Shortly after GM completed its acquisition of EDS, GM began negotiations with the Howard Hughes Medical Institute ("HHMI") for the acquisition of Hughes. Hughes was a premier high-technology company. Whereas EDS's expertise was in computer software and data processing, Hughes' line of business was high-technology electronics and engineering. But the HHMI expressed concerns similar to those heard from EDS executives about receiving GM automotive stock as the merger consideration. HHMI perceived GM's automotive stock as a relatively unattractive investment. By offering HHMI a GM tracking stock whose dividends were based on the earnings of Hughes' business, the merger proposal became more attractive to HHMI. GM was thus able to complete this acquisition in 1985.

The acquisitions of Hughes and EDS undeniably played an important role in the resurgence of GM. EDS and Hughes brought new engineering and scientific expertise, managerial focus, high technology, capital and growth to GM. At the same time, being owned by GM benefitted both EDS and Hughes. The value of Class E Common Stock and Class H Common Stock both experienced significant growth. And with the increased capital that GM was able to provide Hughes, Hughes (i) made technological advances that have markedly improved the technological content of GM vehicles (such as "head-up" displays), and (ii) created new nonautomotive products that have benefitted the U.S. economy, including well-known consumer goods such as DirecTV and pay-at-the-pump fuel stations.

B. Funding GM's Defined Benefit Pension Plan

While the acquisitions of Hughes and EDS helped reenergize GM, the economic downturn in the early 1990's adversely affected GM's financial position. At that time, GM's defined benefit pension plan for its U.S. automotive workers became severely underfunded, and the company did not have the cash to alleviate that underfunding. The underfunding of the GM plan was estimated to represent approximately 50% of the entire contingent underfunding liability of the Pension Benefit Guaranty Corporation ("PBGC"), which generated substantial controversy and concern at that government agency and in the media.

In order to fund its pension plans, GM began working with the PBGC and the Departments of Labor and Treasury to make a substantial contribution of Class E Common Stock to the GM pension plans. In general, the PBGC does not favor a corporation's pension plan being funded with traditional employer company stock, since any downturns in that company's business will reduce the company's ability to make future contributions and at the same time cause the company's underfunding to increase as its stock price declines. In this case, however, the PBGC reacted positively to GM's suggestion of a contribution of Class E Common Stock since the fortunes of this stock were less tied to GM's automotive business. Working with the PBGC and the Departments of Labor and Treasury, GM successfully completed in March 1995 a contribution of approximately $7 billion of Class E Common Stock to the GM plans. This contribution dramatically reduced the level of GM's underfunding (and in turn the PBGC's contingent liability), in a way that would not have been possible without the use of tracking stock.

GM's use of tracking stock to fund its pension plan did not constitute any form of tax avoidance and was not motivated by tax reasons. Indeed, GM made this contribution only after extensive collaboration with the Treasury Department, the Labor Department, and the PBGC. Each government agency supported GM's issuing Class E Common Stock to fund GM's pension plan.

C. Recent Experiences with Tracking Stock

GM ultimately spun off EDS to GM's shareholders in 1996, nearly 12 years after GM had acquired EDS. The spin-off was accomplished tax-free under Code § 355, with GM receiving a ruling from the IRS that the spin-off met all relevant requirements of the Internal Revenue Code. GM spun off EDS because GM concluded that it could continue to enjoy the benefits of EDS's expertise through a long-term supply agreement. At the same time, EDS's business had progressed to the point where EDS concluded that being owned by GM was detrimental to its ability to attract new business from customers or enter into strategic alliances with third parties. A spin-off with a long-term supply agreement thus benefitted both parties.

As GM was considering the strategic alternatives available to it regarding EDS, one alternative that was briefly considered was to sell a substantial block of Class E Common Stock to a company interested in purchasing a controlling interest in EDS. While GM believes that it had strong business reasons for such a transaction, such a sale arguably might have been the type of transaction that the Clinton Administration finds objectionable about tracking stock, i.e., a sale of tracking stock in lieu of a sale of subsidiary stock. But when it negotiated with potential strategic purchasers, none of them was willing to invest in EDS without acquiring a direct ownership in EDS's assets or having a significant voice in EDS management. Each potential strategic purchaser also noted that if GM were to have gone bankrupt or had trouble paying creditors, the assets of EDS would have been available to satisfy the claims of GM creditors. Consequently, every potential strategic purchaser of a substantial portion of EDS rejected any suggestion that it simply acquire Class E Common Stock. This reluctance demonstrates why the Clinton Administration's concerns about tracking stock are hypothetical, not real. There is no practical way to dispose of a subsidiary through the sale of tracking stock. Potential strategic purchasers are unwilling, for substantial business reasons, to purchase tracking stock instead of the underlying subsidiary's stock.

In 1997, GM also disposed of the defense electronics business of Hughes. This transaction was accomplished by spinning off the Hughes Defense business to all classes of GM shareholders, with Hughes Defense then merging with Raytheon Corporation. GM's Class H Common Stock remained outstanding, with such stock continuing to track the earnings of Hughes' remaining businesses (principally telecommunications and satellites). This transaction was tax-free under Code §355, with GM receiving a favorable ruling from the IRS. The existence of Class H Common Stock in no way facilitated this transaction. Indeed, the existence of GM tracking stock was, if anything, a complicating factor, since it required GM, among other things, to weigh the relative interests of its different classes of common stock, determine that the spin off and related transactions were fair to all classes of GM stockholders, and condition the transactions on approvals by each class of GM common stock.

LESSONS LEARNED FROM THE GM EXPERIENCE

GM's experience with tracking stock demonstrates conclusively why tracking stock is a valuable business tool and not a tool for tax avoidance. The lessons from the GM experience include the following:

A. Compelling Business Purposes

The stated concern of the Clinton Administration is that corporations will issue tracking stock in order to dispose of a business without paying the tax that would normally be owed after a taxable sale. We are aware of no case where this has ever occurred. Corporations generally issue tracking stock when they *acquire* (not sell) a new business or when they need to raise additional capital to expand or preserve a business. For example:

- GM issued tracking stock when it acquired EDS and Hughes
- Genzyme issued tracking stock in order to obtain funding for its research and development activities
- Sprint issued tracking stock when it acquired all of the stock of Sprint PCS
- USX issued tracking stock when it needed additional capital to restore its steel business
- GM issued tracking stock in order to alleviate the underfunding in its pension plan

GM could not have acquired EDS or Hughes without the ability to issue tracking stock, nor could it have funded its underfunded pension plan without tracking stock. The prior owners of EDS and Hughes did not view GM's automotive stock as an attractive investment and steadfastly refused to accept GM's automotive common stock as merger consideration. Similarly, a large block of GM automotive stock was not an appropriate mechanism to fund the GM pension plans.

B. Investor Choice

Tracking stock permits greater investor choice. Investors can choose the business operations of a corporation in which they wish to invest, as opposed to investing in a corporate conglomerate. In today's specialized financial markets, many mutual funds and other investors invest only in certain types of companies, such as sector funds that only invest in computer or technology companies. Most sector funds do not invest in the stock of corporate conglomerates. By issuing tracking stock, GM created separately traded stocks that were purchased by investors who otherwise would not have been willing to invest in the GM group as a whole.

This element of investor choice continues to reflect itself in GM's shareholder base even today. GM's automotive stock is an attractive investment for so-called value investors, i.e., investors who prefer equities with a lower price-to-earnings ratio that pay a reasonable dividend. GM's Class H Common Stock, on the other hand, is a growth stock with a high price-to-earnings ratio that does not currently pay dividends. If GM had only one class of equity outstanding, the GM story would be confusing to the marketplace, and, for example, investors in growth stocks would not be attracted to invest in the GM group.

C. Raising Capital

Tracking stock provides an efficient mechanism to raise capital. Many of the corporations that have issued tracking stock are mature businesses whose stocks trade at relatively low price-to-earnings ratios, such as GM (autos), USX (steel), Pittston (coal), and Georgia Pacific (forestry), but who own subsidiaries that are in different businesses. If these corporations were to issue their own stock in a tax-free public offering, the proceeds received in exchange for the equity surrendered would reflect the low price-to-earnings ratio of the core business. By issuing tracking stock that tracks the business of a higher-growth subsidiary, the issuing corporation is able to raise more capital with less dilution to existing shareholders. And by doing so, the issuing company's ability to invest and grow its own business is enhanced.

This value disparity can clearly be seen in GM's experience with tracking stock. GM's automotive stock has typically traded at a price-to-earnings multiple of approximately 8–10. GM's Class E Common Stock typically traded, however, at a multiple of from 20–30; GM's Class H Common Stock also trades at very high multiples, currently above 60. When GM needed to fund its pension plan in the early 1990's, GM was able to provide approximately $7 billion to the plan by issuing high-multiple Class E Common Stock. If GM had been required to issue its automotive stock to the plan, a much greater amount of shareholder dilution would have been required in order to provide $7 billion of funding.

D. Executive Accountability and Employee Incentives

Corporate officers invariably are more focused on shareholder value when they know that their actions will directly affect equity valuations. In the absence of tracking stock, executives at Hughes and EDS would have known that their actions would have had only minimal influence on GM's stock price, since the equity markets invariably have valued GM's business based on the performance of GM's automotive business.

By creating separate tracking stocks, employees at EDS and Hughes knew that their actions had a more direct impact on stock values. From a shareholder perspective, a tracking stock much more closely aligned the financial incentives of EDS and Hughes' employees with those of GM's shareholders. The existence of tracking stock also permitted employees to receive stock in their 401(k) plans and stock options whose value was tied to the business at which they worked. It was these types of issues that principally caused GM to propose tracking stock when it acquired EDS in 1984.

E. Shareholder Value

Tracking stock is a powerful generator of shareholder value. Equity markets tend to discount conglomerates, valuing an entire business at less than its component parts are worth. Tracking stock permits each distinct business to be separately valued on its own fundamentals and earnings, while at the same time allowing corporate groups to obtain operating synergies and economies of scale.

The value enhancement possible through tracking stock was clearly seen on March 10, 1999, when DuPont Corporation announced that it would issue a class of DuPont tracking stock to track DuPont's life sciences business. DuPont's stock rose nearly 8% in value upon this announcement. Moreover, DuPont's stated reasons for issuing this stock were the textbook case for tracking stock. DuPont's mature chemical business traded at a relatively low price-to-earnings ratio, masking the value of DuPont's high-value pharmaceuticals and life sciences business. By issuing tracking stock, DuPont intends to unlock the value of its life sciences business, while also creating an acquisition currency that it can use to make acquisitions in the life sciences business.

F. Tracking Stock Not Used for Tax Avoidance Purposes

The Clinton Administration proposes to tax tracking stock based on the assumption that such stock can be used for tax avoidance. However, tracking stock carries none of the indicia of tax avoidance. The hallmark of corporate tax avoidance transactions is that such transactions are effected without public disclosure, without any business purpose or economic substance, in order to generate artificial tax losses.

In contrast, tracking stock issuances have all been fully disclosed to shareholders and have been completed only when the use of tracking stock made compelling business sense.

The Administration also is apparently concerned that a corporation will simply sell tracking stock in order to dispose of a subsidiary, in lieu of selling the subsidiary's stock in a taxable sale. This concern ignores what has actually happened in the marketplace with tracking stock. GM issued both Class E Common Stock and Class H Common Stock for business reasons to consummate important acquisitions for the company. GM believes that the other public corporations that have issued tracking stock have also done so for strong business reasons. Tracking stock is an effective business tool for making acquisitions and raising capital, but it cannot realistically be used for dispositions.

In the early 1990's, GM considered selling a substantial block of Class E Common Stock to potential strategic purchasers of EDS. GM quickly learned that it was just not possible to effect such a transaction. No potential strategic purchaser was willing to purchase any significant amount of tracking stock, because tracking stock does not carry with it any rights to manage and control the underlying assets. Moreover, the strategic purchaser's economic investment would have remained linked to the economic fortunes of GM, a scenario that was unacceptable to any potential purchaser. Based on its experience with tracking stock, GM believes that tracking stock cannot realistically be used in the way that the Clinton Administration apparently fears, i.e., tracking stock offers no reasonable avenue for tax avoidance and cannot be used to effect an otherwise taxable sale.

Another impediment to using tracking stock for tax purposes is that such stock is complex and cannot be issued or sold without substantial public disclosure and explanation to shareholders. When corporations have sought to issue tracking stock without a compelling business reason, shareholders have rejected it (as, for example, K-Mart's shareholders did in 1994). In the fifteen years since tracking stock was first issued, we are aware of only fifteen public companies that have issued such stock.

G. Congress Has Already Enacted, and Treasury Can Adopt, Provisions to Ensure that Tracking Stock Cannot Be Used for Tax Avoidance

The concerns of the Clinton Administration appear to be based on a fear that a taxpayer might use tracking stock to sell off its interest in a subsidiary to a third party without paying tax on any gain realized from appreciation in that subsidiary. Fifteen years of history with tracking stock shows, however, that such stock has not been used for tax avoidance. The fears of the Administration thus are premised on hypothetical tax avoidance, as opposed to a response to any past abuses involving tracking stock.

The Administration proposal also ignores two important facts: Congress has already enacted legislation to ensure that tracking stock is not used as a substitute for selling the subsidiary itself, and Treasury has the authority under Code § 337(d) to enact regulations if any taxpayer in fact creates some as-yet-unidentified way to use tracking stock for tax avoidance purposes.

In 1990, Congress enacted Code § 355(d)(6)(B)(iii). This statute prevents a parent corporation from selling a large block of tracking stock to a third party and then later distributing the stock of the tracked subsidiary to that third party in a tax-free split-off under Code § 355. This statute thus addresses the exact situation that the Clinton Administration is apparently concerned about—the sale of tracking stock to a third party as a substitute for a taxable divestiture. Code § 355(d) is premised on the assumption that no third party would ever agree to purchase a business via the use of tracking stock unless that third party knew that ultimately the tracking stock would be unwound and the third party would receive the underlying business via a tax-free spin-off. Code § 355(d)(6)(B)(iii) prevents this technique.

In addition, Code § 337(d) provides Treasury with the authority to issue regulations to carry out the purposes of so-called "*General Utilities* repeal," i.e., to ensure that corporations cannot sell the stock of a subsidiary at a gain without incurring a tax liability. If Treasury had any specific concerns that tracking stock was being used to avoid *General Utilities* repeal, this statute gives Treasury full authority to issue regulations to prevent that avoidance. Since Code § 337(d) was enacted in 1986, Treasury has not adopted any regulations to address any perceived tracking stock abuses, because, we believe, there have been no abuses. In the event Treasury becomes concerned that tracking stock is being used in some specified tax-avoidance manner, Treasury should use the authority already given it to implement a targeted response, instead of simply asking Congress to effectively eliminate the use of tracking stock altogether (as the Clinton Administration proposal would surely do).

CONCLUSION

GM recognizes that both the Clinton Administration and the Congress have a real and substantial interest in curtailing the use of tax avoidance mechanisms and tax shelters by corporations. GM believes that corporate use of inappropriate shelters merits this Committee's attention and remediation. However, we are aware of no circumstance where any corporation has used tracking stock as a tax avoidance mechanism.

Corporations that have issued tracking stock have done so for compelling business reasons. The proposed new rules for taxing tracking stock would have the effect of virtually eliminating a legitimate and valuable business mechanism, hurting shareholder value, restraining capital formation and job creation, and giving rise to marketplace and employee confusion, while doing nothing to eliminate tax avoidance.

GM strongly urges this Committee to reject the Administration's proposal to tax the issuance of tracking stock. Thank you.

STATEMENT OF THE INVESTMENT COMPANY INSTITUTE

The Investment Company Institute (the "Institute") [1] submits for the Committee's consideration the following comments regarding proposals to (1) require mandatory accrual of market discount, (2) increase the penalties under section 6721 of the Internal Revenue Code [2] for failure to file correct information returns, (3) tax partial liquidations of partnership interests, and (4) modify section 1374 to require current gain recognition on the conversion of a large C corporation to an S corporation.

I. MANDATORY ACCRUAL OF MARKET DISCOUNT

Background

Market discount generally is defined as the excess of the principal amount of a debt instrument (or the adjusted issue price in the case of a debt instrument issued with original issue discount [3]) over a holder's basis in the debt instrument immediately after acquisition. A bond typically will trade in the secondary market at a price below its principal amount (and hence with market discount) because an increase in interest rates after the date the bond was issued has reduced its value.[4] Assuming no further changes in interest rates or in the creditworthiness of the issuer, the market value of a bond purchased with market discount would increase on a consistent yield basis until its maturity date.

Current law generally does not require any taxpayer—whether the taxpayer determines income on a cash or an accrual basis—to take market discount accruals into taxable income until the date the bond matures or is sold.[5] Upon disposition, the amount of gain on a market discount bond, up to the amount of the accrued market discount, is taxed as ordinary income; any excess amount is treated as capital gain. Among the reasons for not taking market discount accruals into income on a current basis are that market discount (1) arises from market changes that affect the yield of a bond rather than from the terms of the bond itself, (2) may not be realized in part or in whole by any holder disposing of a bond prior to maturity,[6] and (3) can be difficult to compute.

Proposal

Under the President's Fiscal Year 2000 budget proposal, accrual basis taxpayers would be required to include market discount in income currently, i.e., as it accrues.[7] The holder's yield for market discount purposes would be limited to the greater of (1) the original yield-to-maturity of the debt instrument plus five percentage points or (2) the applicable Federal rate (at the time the holder acquired the debt instrument) plus five percentage points. Importantly, the proposal would not apply to cash basis taxpayers, such as individuals.

Recommendation

The Institute urges the Committee to reject the proposed requirement that accrual basis taxpayers, such as RICs, currently include in taxable income their market discount accruals. First, the proposal would accelerate the inclusion of market discount in the RIC's taxable income without the receipt of any cash that could be used by the RIC to meet its distribution obligations to its shareholders.[8] Second, the proposal would result in over-inclusions of taxable ordinary income to the extent that a bond purchased with market discount is sold for an amount that is less than the purchase price plus accrued market discount. These results are particularly inappropriate for RIC's individual shareholders, who would experience neither income

acceleration nor over-inclusion of market discount if they were to make comparable investments directly.

Example

To illustrate these effects, assume a bond with a principal amount of $10,000 and a five percent coupon payment that has five years to maturity. Further assume that a RIC acquires this bond for $9,000 and holds it for three years. Finally, assume that interest rate fluctuations between the date the bond was acquired by the RIC and the date the bond was sold were such that the value of the bond, at disposition, was only $9,500.

Under current law, the RIC accrues $200 of market discount each year, but need not include the accruals in income until the year of sale.[9] Upon disposition, the RIC would treat the $500 gain ($9,500 proceeds less $9,000 basis) as ordinary income.

As the proposal would not apply to cash basis taxpayers, an individual that held the market discount bond directly would continue to receive the same tax treatment that the RIC receives under current law; prior to disposition, no amounts would be includible in taxable income.

In contrast, the proposal would require the RIC to treat the $200 accrual in each of the three years as ordinary income, which must be distributed currently by the RIC to its shareholders. Upon disposition, at which time the RIC's cost basis has been increased to $9,600 (to reflect the $600 of market discount included in income), the RIC would have a $100 capital loss. This loss could be used by the RIC to offset capital gain at the RIC level, but could not be "flowed through" to the RIC's shareholders.[10]

The proposal also should be rejected because of the potential negative impact on the liquidity of bonds (tax-exempt bonds, in particular) in any interest rate environment in which existing bonds would trade at a significant discount to principal amount. Because of the potential negative tax consequences of purchasing market discount bonds (e.g., accelerated inclusion of ordinary income and capital losses in the event of subsequent interest rate increases), RICs and other accrual basis taxpayers might have strong incentives to buy only newly-issued bonds.

II. INCREASED PENALTIES FOR FAILURE TO FILE CORRECT INFORMATION RETURNS

Background

Current law imposes penalties on payers, including RICs, that fail to file with the Internal Revenue Service ("IRS") correct information returns showing, among other things, payments of dividends and gross proceeds to shareholders. Specifically, section 6721 imposes on each payer a penalty of $50 for each return with respect to which a failure occurs, with a maximum penalty of $250,000.[11] The $50 penalty is reduced to $15 per return for any failure that is corrected within 30 days of the required filing date and to $30 per return for any failure corrected by August 1 of the calendar year in which the required filing date occurs.

Proposal

The President's Fiscal Year 2000 budget contains a proposal that would increase the $50-per-return penalty for failure to file correct information returns to the greater of $50 per return or five percent of the aggregate amount required to be reported correctly but not so reported.[12] The increased penalty would not apply if the total amount reported for the calendar year was at least 97 percent of the amount required to be reported.

Recommendation

The Institute urges the Committee to reject the proposal to increase the penalty for failure to file correct information returns. Information reporting compliance is a matter of serious concern to RICs. Significant effort is devoted to providing the IRS and RIC shareholders with timely, accurate information returns and statements. As a result, a high level of information reporting compliance is maintained within the industry.

The Code's information reporting penalty structure was comprehensively revised by Congress in 1989 to encourage voluntary compliance. Information reporting penalties are not designed to raise revenues.[13] The current penalty structure provides adequate, indeed very powerful, incentives for RICs to promptly correct any errors made.

III. PARTIAL LIQUIDATIONS OF PARTNERSHIP INTERESTS

Background

Under current law, a partial liquidation of a partnership interest is taxable only to the extent that any cash distributed exceeds the partner's adjusted basis in its partnership interest immediately before the distribution. Thus, in the case of a "master/feeder fund structure," [14] a RIC feeder fund partner typically may liquidate a portion of its interest in the master fund partnership in the ordinary course of its business without incurring capital gain on its underlying investment in the partnership. A RIC feeder fund will partially liquidate its interest in the master fund partnership on any day in which it needs to generate cash to meet shareholder redemptions.[15]

Proposal

Under the President's Fiscal Year 2000 budget proposal, a partial liquidation of a partner's interest in a partnership would be taxed as a complete liquidation of that portion of the partner's interest.[16] Gain or loss on the partial liquidation would be determined by allocating the distributee partner's basis ratably over the portions of the partnership interest that are liquidated and retained. The rationale for the proposed change, according to the Treasury Department's "General Explanations of the Administration's Revenue Proposals," is that the current law rules "provide for an inappropriate deferral of gain."

Recommendation

Should the Committee decide to expand the circumstances in which partial liquidations of partnership interests are taxed, the Institute urges the Committee not to apply the change to RIC feeder fund investments in master funds. This exception should be made because the rationale for the proposal—to prevent deferral—simply does not apply.

Under current law, the shareholder in a RIC feeder fund whose redemption request triggers the RIC's need for cash, and hence the partial liquidation of the RIC's interest in the master fund partnership, already is required to take into account currently any gain—attributable to appreciation in the value of the shareholder's investment, through the RIC, in the master fund partnership—on the shares redeemed. The existing basis calculation rules of section 1012 and share redemption rules of section 302 apply to prevent deferral.

The only impact of applying this proposal to master/feeder funds would be to require a taxable distribution by a RIC feeder fund of gains to its *non-redeeming* shareholders, who did not trigger the partial liquidation.[17] This result would be unfair and presumably is unintended. Consequently, should the Committee determine to pursue the Administration's proposal, an exception for the master/feeder fund structure should be adopted.

IV. CONVERSIONS OF LARGE C CORPORATIONS TO S CORPORATIONS

Background

Section 1374 generally provides that when a C corporation converts to an S corporation, the S corporation will be subject to corporate level taxation on the net built-in gain on any asset that is held at the time of the conversion and sold within 10 years. In Notice 88–19, 1988–1 C.B. 486, the IRS announced that regulations implementing repeal of the so-called General Utilities doctrine would be promulgated under section 337(d) to provide that section 1374 principles, including section 1374's "10-year rule" for the recognition of built-in gains, would be applied to C corporations that convert to regulated investment company ("RIC") or real estate investment trust ("REIT") status.

Notice 88–19 was supplemented by Notice 88–96, 1988–2 C.B. 420, which states that the regulations to be promulgated under section 337(d) will provide a safe harbor from the recognition of built-in gain in situations in which a RIC fails to qualify under Subchapter M for one taxable year and subsequently requalifies as a RIC. Specifically, Notice 88–96 provides a safe harbor for a corporation that (1) immediately prior to qualifying as a RIC was taxed as a C corporation for not more than one taxable year, and (2) immediately prior to being taxed as a C corporation was taxed as a RIC for at least one taxable year. The safe harbor does not apply to assets acquired by a corporation during the C corporation year in a transaction that results in its basis in the assets being determined by reference to a corporate transferor's basis.

Proposal

The President's Fiscal Year 2000 budget proposes to repeal section 1374 for large corporations.[18] For this purpose, a corporation is a large corporation if its stock is valued at more than five million dollars at the time of the conversion to an S corporation. Thus, a conversion of a large C corporation to an S corporation would result in gain recognition both to the converting corporation and its shareholders. The proposal further provides that Notice 88–19 would be revised to provide that the conversion of a large C corporation to a RIC or REIT would result in the immediate recognition of the corporation's net built-in gain. Thus, the Notice, if revised as proposed, no longer would permit a large corporation that converts to a RIC or REIT to elect to apply rules similar to the 10-year built-in gain recognition rules of section 1374.

Recommendation

Because the safe harbor set forth in Notice 88–96 is not based upon the 10-year built-in gain rules of section 1374, the repeal of section 1374 for a large C corporation should have no effect on Notice 88–96. The safe harbor is based on the recognition that the imposition of a significant tax burden on a RIC that requalifies under Subchapter M after failing to qualify for a single year would be inappropriate. Moreover, the imposition of tax in such a case would fall directly on the RIC's shareholders, who typically are middle-income investors.

The Institute understands from discussions with the Treasury Department that the proposed revision to section 1374 and the related change to Notice 88–19 are not intended to impact the safe harbor provided by Notice 88–96.

Should this proposal be adopted, the Institute recommends that the legislative history include a statement, such as the following, making it clear that the proposed revision to section 1374 and the related change to Notice 88–19 would not impact the safe harbor set forth in Notice 88–96 for RICs that fail to qualify for one taxable year:

> This provision is not intended to affect Notice 88–96, 1988–2 C.B. 420, which provides that regulations to be promulgated under section 337(d) will provide a safe harbor from the built-in gain recognition rules announced in Notice 88–19, 1988–1 C.B. 486, for situations in which a RIC temporarily fails to qualify under Subchapter M. Thus, it is intended that the regulations to be promulgated under section 337(d) will contain the safe harbor described in Notice 88–96.

ENDNOTES

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 7,546 open-end investment companies ("mutual funds"), 457 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $5.730 trillion, accounting for approximately 95% of total industry assets, and have over 73 million individual shareholders.

[2] All references to "sections" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").

[3] Original issue discount ("OID") is defined generally as the excess of a debt instrument's stated redemption price at maturity over its issue price. The total amount of OID on a debt instrument generally does not change over the period the debt instrument is outstanding.

[4] A decline in the creditworthiness of an issuer also may cause a bond to trade in the secondary market at a discount.

[5] Partial principal payments on a market discount bond are included as ordinary income to the extent of accrued market discount. Holders also may elect to take market discount accruals into income currently.

[6] The amount that ultimately will be received upon the sale of a bond depends, among other things, upon future changes in interest rates. If interest rates increase, bonds purchased with market discount may be sold at a loss; in this case, none of the accrued market discount ever is realized.

[7] The proposal would apply to debt instruments acquired on or after the date of enactment.

[8] Under section 852(a), a RIC must distribute at least 90 percent of its ordinary income with respect to its fiscal year to qualify for treatment under Subchapter M of the Code. In addition, under section 4982, a RIC will incur an excise tax unless it distributes by December 31 essentially all of its calendar year ordinary income (and capital gain through October 31).

[9] Alternatively, a RIC could elect to accrue the market discount on a "constant yield" basis under section 1276(b)(2).

[10] RICs may not flow through capital losses to their investors, pursuant to Subchapter M of the Code. Capital losses may be carried forward for eight years, pursuant to section 1212(a)(1)(C)(i). In recent years, some RICs investing in bonds have been unable to generate sufficient capital gains to offset losses carried forward before they expired.

[11] Failures attributable to intentional disregard of the filing requirement generally are subject to a $100 per failure penalty that is not eligible for the $250,000 maximum.

[12] The proposal would be effective for returns the due date for which (without regard to extensions) is more than 90 days after the date of enactment.

[13] In the Conference Report to the 1989 changes, Congress recommended to IRS that they "develop a policy statement emphasizing that civil tax penalties exist for the purpose of encouraging voluntary compliance." H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 661 (1989).

[14] The master/feeder structure has developed as a vehicle pursuant to which RICs (known as "feeder funds") generally invest substantially all of their assets in one partnership (known as the "master fund"). On occasion, institutional investors or other entities also may be feeder funds.

[15] RIC feeder funds typically are structured as open-end investment companies, the shares of which are redeemable upon shareholder demand pursuant to the Investment Company Act of 1940. On occasion, RIC feeder funds also may be structured as "interval funds," which issue shares that are redeemable on a periodic, rather than daily, basis.

[16] The proposal would apply to certain partial liquidations made after date of enactment. From a discussion with a Treasury Department official, we understand that the proposal is not intended to be applied on a daily basis.

[17] The distribution requirements applicable to RICs require that dividends be declared ratably to all RIC shares outstanding on the date the dividend distribution is declared. Unlike the rules applicable to partnerships, no ability exists to specially allocate the gain to the redeeming RIC shareholder.

[18] The proposal to repeal section 1374 for large corporations would apply to Subchapter S elections first effective for a taxable year beginning after January 1, 2000 and to acquisitions (e.g., mergers) after December 31, 1999.

Statement of the Large Public Power Council

I. INTRODUCTION

We appreciate the opportunity to submit this written statement for the record of the Committee on Finance hearing on the revenue provisions in the President's FY 2000 Budget. We are the Large Public Power Council (the "LPPC"), an organization composed of 21 of the nation's largest locally-owned and controlled power systems. A list of our members is attached as an appendix to this statement. LPPC members directly and indirectly provide reliable, high-quality, low-cost electricity to more than 40 million people. This includes tens of thousands of large and small businesses located in some of the faster-growing urban and rural residential and commercial markets in America. Like their approximately 2000 smaller public power counterparts located in every state but Hawaii, LPPC's members are not-for-profit entities committed only to the people and communities they serve.

We are pleased to see that the President's FY 2000 Budget includes the proposals that the Administration originally made last year relating to the tax aspects of electricity deregulation. As we stated last year both when the temporary regulations on private use were issued and when the comprehensive electricity restructuring proposal was unveiled, the LPPC supports the Administration's efforts to address, in a rational and equitable way, the tax issues raised by electricity deregulation.

We believe, however, that improvements can be made to the President's approach to resolving these tax issues. In this statement, we will outline the tax issues created for publicly-owned utilities in a deregulated environment, discuss the President's solution to these problems, and propose an alternative bipartisan compromise that may better address those problems.

II. TAX ISSUES IN ELECTRICITY DEREGULATION

Publicly-owned utilities have operated up to now under a strict regime of Federal tax rules governing their ability to issue tax-exempt bonds. Under current Federal tax law, interest on state and local government bonds generally is excluded from income if the bonds are issued to finance governmental activities. Facilities for electric generation, transmission, and distribution are eligible for financing with tax-exempt bonds when the financed facilities are used by or paid for by a state or local governmental entity. Generally, bond-financed facilities are used for a governmental purpose even when the electricity they generate or transmit is sold to private persons provided those persons are purchasing the electricity as members of the general public. The so-called "private use" rules limit the amount of power that publicly-owned utilities may sell to private entities through facilities financed with tax-exempt bonds.

For years, the private use rules were cumbersome but manageable. These rules, however, were enacted in an era that did not contemplate electricity deregulation. As states deregulate, the private use rules are threatening many communities that are served by public power with significant financial penalties as they adjust to the changing marketplace. While Federal deregulation legislation has yet to be enacted,

eighteen states have already gone forward and begun to deregulate electricity at the state and local level. The era of competition has already begun in those states.

With competition, publicly-owned utilities face some difficult choices. In order to develop efficient nondiscriminatory transmission services, publicly-owned utilities may be required to turn operation of their transmission facilities over to independent systems operators or otherwise use those facilities in a manner that may violate the private use rules. As traditional service areas of both investor-owned and publicly-owned facilities are opened to retail competition, publicly-owned utilities may find it necessary to enter into contracts with private users of electricity in order to prevent their generation facilities from becoming stranded costs and to be able to pay debt service on their bonds. For instance, when electricity is sold under long-term contracts to private persons, the private use restrictions of the Internal Revenue Code may render the interest on outstanding bonds taxable.

In effect, publicly-owned utilities face the prospect of violating the private use rules, or walling off their customers from competition: in either case consumers would experience higher rates—the precise opposite of what deregulation is supposed to achieve. The consumer can only lose when this happens.

III. THE PRESIDENT'S PROPOSALS ON THE TAX ISSUES RELATED TO ELECTRICITY RESTRUCTURING

A. Treasury regulations

In January 1998, the Treasury and the Internal Revenue Service ("IRS") issued temporary and proposed regulations relating to the rules for generation, transmission, and distribution of electricity with facilities financed with tax-exempt bonds. These rules provide limited relief, within the context of present law, from the application of the private use rules in a deregulated environment. Because these regulations are temporary, they expire three years after publication unless the IRS finalizes or reissues them.

We applaud the Administration's efforts to afford publicly-owned utilities some opportunity to participate in a deregulated market. However, the regulations fail to address some serious problems, including the ability of publicly-owned utilities to meet the needs of existing customers. Further, as noted above, they are temporary, and unless finalized, will expire in less than two years (January 22, 2001). Thus, we concur with the Administration that legislative action is needed to address the private use problem facing publicly-owned utilities.

B. The Administration's FY 2000 budget proposals

On March 24, 1998, the Department of Energy announced the Administration's Comprehensive Electricity Competition Plan. Included in the plan were revisions to the tax rules governing private use of tax-exempt bond-financed electric facilities. The President has included these tax proposals in his FY 2000 Budget submission. The Administration resubmitted its comprehensive deregulation plan to Congress on April 15, 1999.

These proposals are several. First, the Administration proposal would bar the use of tax-exempt bonds for new facilities for electric generation and transmission. Distribution facilities could continue to be financed with tax-exempt bonds subject to the existing private use rules.

Second, the Administration proposal would grandfather existing tax-exempt bonds from the private use rules if the bonds were used to finance: (1) transmission facilities the private use of which results from a FERC order requiring non-discriminatory open access to those facilities; or (2) generation or distribution facilities the private use of which results from retail competition or a contract effective after implementation of retail competition. The proposal would permit current, but not advance, refunding, of bonds issued before date of enactment of The Administration's Comprehensive Electricity Competition Plan.

In addition, the Administration includes a proposal to accommodate the need in a deregulated environment of investor-owned utilities with nuclear facilities for modification of the treatment of contributions to nuclear decommissioning funds.

LPPC applauds these proposals as rational and equitable attempts to address the problems faced by utilities in a deregulated environment. In the case of publicly-owned utilities, the Administration would provide relief from the application of the private use rules; in the case of certain investor-owned utilities, it would make workable the provision governing the treatment of contributions to nuclear decommissioning funds. We believe, however, that there is an alternative approach that better addresses the different situations in which the various publicly-owned utilities may find themselves.

IV. THE BOND FAIRNESS AND PROTECTION ACT: AN ALTERNATIVE BIPARTISAN COMPROMISE APPROACH

The LPPC urges the Committee to consider an alternative approach to the private use issue, one that is supported by a bipartisan group of Senators and Members, the Bond Fairness and Protection Act of 1999 (S. 386 in the Senate and H.R. 721 in the House). This legislative proposal would provide publicly-owned utilities with an option: they can continue to issue tax-exempt bonds for generation transmission and distribution facilities under a set of private use rules clarified to provide a modest set of changes to deal with deregulation, or they can elect to forego the ability to issue tax-exempt bonds for new generation facilities, but with a grandfather of their existing tax-exempt bonds from the adverse application of the private use rules.

The clarifications to the private use rules proposed in the legislation are intended to accommodate the reality of operating in a deregulated market, nearly all of which were recognized by Treasury in the relief provided in its temporary regulations. Private use would not include certain "permitted open access transactions." The bill lists the following activities as permitted open access transactions: (1) providing open access transmission service consistent with FERC Order No. 888 or with state open transmission access rules; (2) joining an FERC-approved ISO, regional transmission group (RTG), power exchange, or in accordance with an ISO, RTG, or power exchange tariff; (3) providing open access distribution services to competing retail sellers of electricity; or (4) if open transmission or distribution services are offered, contracting for sales of power at non-tariff rates with on-system purchasers or existing off-system purchasers.

Only the last of these clarifications is new and would merely permit publicly-owned utilities to enter into long-term contracts with their existing customers, a change that is essential if these utilities are to compete with other electric providers for these customers. In fact, this change would merely give publicly-owned utilities the same ability to contract with their customers as the investor-owned "two county" utilities that benefit from tax-exempt bonds have. Moreover, given the changing nature of how electricity is being sold, a publicly-owned utility should not have to give up the ability to issue tax-exempt bonds merely in order to contract or to provide service to its historic customers.

The advantage of this approach is that it provides needed flexibility to public utilities; if a public utility wants to participate in the competitive market generally it will need to give up its ability to issue tax-exempt bonds in the future, thereby mitigating any perception of a competitive advantage. If a public utility is not interested in competing in the open market or has little outstanding debt, it need not make the election. Moreover, this approach links the availability of relief from the retroactive application of the private use rules to outstanding tax-exempt bonds with a willingness to forego the ability to issue tax-exempt debt in the future for generation facilities.

The Bond Fairness and Protection Act of 1999 has attracted the support of a diverse group of organizations including, for example, from the private sector, the Independent Energy Producers, and from the public sector, the National League of Cities. Similarly, the Government Finance Officers Association has endorsed the need for private use relief of the type contained in this bill. In addition, the Bond Market Association has indicated that this bill "represent[s] the most attractive approach to problems faced by public power utilities under deregulation."

V. CONCLUSION

Again, Mr. Chairman, we appreciate this opportunity to present our views on the electricity restructuring provisions in the President's FY 2000 Budget. We urge the Committee to act this year to provide much needed relief from the unintended application of the private use restrictions of the Internal Revenue Code to publicly-owned utilities struggling to adapt to the changing marketplace while continuing to serve their customers by providing cheap and reliable electricity. The marketplace is not waiting for Federal legislation to force deregulation; it is happening now in numerous states and localities around the country. But only Congress can change the Federal tax rules that are hampering the ability of publicly-owned and controlled utilities to provide the services on which consumers depend.

We would be happy to assist the Committee in any way possible as you consider the tax issues related to electric deregulation.

Statement of the Leasing Coalition

[SUBMITTED BY PRICEWATERHOUSECOOPERS]

I. INTRODUCTION

On behalf of a group of companies in the leasing industry (hereinafter the "Leasing Coalition"), PricewaterhouseCoopers appreciates the opportunity to present this written statement to the Senate Finance Committee in conjunction with its April 27, 1999, hearing on the revenue proposals in the Administration's FY 2000 budget.

Our comments center on tax increases proposed by the Administration that would overturn the carefully constructed body of law, built over decades, governing the tax treatment of leasing transactions. These proposals include a leasing-industry specific measure targeting what Treasury refers to as "inappropriate benefits"[1] for lessors of tax-exempt use property. The Leasing Coalition also has strong concerns over the impact on leasing transactions of several general Administration proposals relating to "corporate tax shelters," including a proposal empowering IRS agents to "deny tax benefits" in "tax-avoidance transactions."[2]

In these comments, the Leasing Coalition discusses the rationale underlying the present-law tax treatment of leasing transactions and examines the impact of the Administration's proposals on commonplace leasing arrangements. We also discuss the potentially adverse impact of these proposals on the competitiveness of American businesses, on exports, and on the cost of capital.

We conclude by urging Members of the Senate Finance Committee to reject the Administration's tax proposals that would adversely affect the leasing industry. These proposals inappropriately would overturn the longstanding body of tax law governing common leasing transactions, branding these legitimate business transactions as "corporate tax shelters." Instead of considering proposals at this time that would impair the competitiveness of the leasing industry, we respectfully would suggest that the Administration and Congress consider ways to help U.S. companies that use leasing as a form of financing expand in the global marketplace.

II. THE LEASING INDUSTRY

Leasing is an increasingly common means of financing investment in equipment and other property. In 1998, the U.S. Department of Commerce estimated that approximately 31 percent of all domestic equipment investment was financed through leasing rather than outright acquisition.[3] Approximately 80 percent of U.S. companies lease some or all of their equipment.[4] The leasing industry in 1998 financed more than $180 billion in equipment acquisitions, an amount expected to exceed $200 billion in 1999.

Lessees, or the users of the property, find leasing an attractive financing mechanism for a number of reasons. Because a lease allows 100-percent financing, the lessee is able to preserve cash that would be necessary to buy or make a downpayment on a piece of equipment. Moreover, lessees generally are able to secure financing under a lease at a lower cost than under a loan. A lessee also may wish to use the asset only for a short period of time, and may not want to risk having the value of the equipment decline more quickly than expected—or become obsolete—during this period of use. For financial statement purposes, leasing can be preferable in that it allows the lessee to avoid booking the asset (and the accompanying liability) on its balance sheet. Finally, the lessee may find rental deductions for lease payments more beneficial, from a timing perspective, than depreciation deductions taken over a certain schedule (e.g., double-declining balance).

Leasing also provides a number of business advantages to lessors. Manufacturing companies (e.g., automobile, computer, aircraft, and rolling stock manufacturers) may act as lessors through subsidiary companies as a means of providing their wares to customers. Financial institutions like banks, thrifts, and insurance companies engage in leasing as a core part of their financial intermediation business. As the owner of the equipment, the lessor is able to take full deductions for depreciation. In 1998, between 2,000 and 3,000 companies acted as equipment lessors.

Leasing also promotes exports of U.S. equipment, and thus helps U.S. companies compete in the global economy. Many lease transactions undertaken by U.S. lessors are cross-border leases, i.e., leases of equipment to foreign users. These involve all types of equipment, including tankers, railroad cars, machine tools, computers, copy machines, printing presses, aircraft, mining and oil drilling equipment, and turbines and generators. Many of these leases are supported in one form or another by the Export-Import Bank of the United States, which insures the credit of foreign lessees.

III. TAX TREATMENT OF LEASES

A. Present Law

A substantial body of law has developed over the last forty years regarding the treatment of leasing transactions for federal income tax purposes. At issue is whether a transaction structured as a lease is respected as a lease for tax purposes or is recharacterized as a conditional sale of the property. If the transaction is respected as a lease for tax purposes, the lessor is treated as the owner of the property and therefore is entitled to depreciation deductions with respect to the property. The lessor also is entitled to interest deductions with respect to any financing of the property, and recognizes income in the form of the rental payments it receives. The lessee is entitled to a business deduction for the rental payments it makes with respect to the property. On the other hand, if the transaction is recharacterized as a conditional sale, the purported lessee is treated as having purchased the property in exchange for a debt instrument. The purported lessee is treated as the owner of the property and is entitled to depreciation deductions with respect to the property. In addition, the purported lessee is entitled to interest deductions for a portion of the amount it pays under the purported lease. The purported lessor recognizes gain or loss on the conditional sale and recognizes interest income with respect to a portion of the amount received under the purported lease. The purported lessor is entitled to interest deductions with respect to any financing of the property.

Guidance regarding the determination whether a transaction is respected as a lease for tax purposes is provided pursuant to an extensive body of case law. There also have been significant IRS pronouncements addressing this determination. Finally, statutory provisions provide specific rules regarding the tax consequences of certain leasing transactions.

1. Case law

The determination whether a transaction is respected as a lease for tax purposes generally is made based on the substance of the transaction and not its form.[5] This substantive determination focuses on which party is the owner of the property that is subject to the lease (i.e., which party has the benefits and burdens of ownership with respect to the property).[6] In addition, the transaction must have economic substance or a business purpose in order to be classified as a lease for tax purposes.[7]

The most important attributes of ownership are the upside potential for economic gain and the downside risk of economic loss based on the residual value of the leased property.[8] The presence of a fair market value purchase option in a lease agreement should not impact the determination of tax ownership.[9] Moreover, the fact that such an option is fixed at the estimated fair market value should not by itself cause the lease to be treated as a conditional sale.[10] However, where a lessee is economically or legally compelled to exercise the purchase option because, for example, the option price is nominal in relation to the value of the property, the lease likely would be treated as a conditional sale.[11]

Another important indicia of ownership for tax purposes is the holding of legal title; this factor, however, is not determinative.[12] The right to possess the property throughout its economic useful life also is an attribute of ownership for tax purposes. For example, the entitlement of the lessee to possession of the property for its entire useful life would be a strong indication that the lessee rather than the lessor should be considered the owner of the property for tax purposes.[13]

The economic substance test finds its genesis in the Supreme Court opinion in *Frank Lyon Co., supra.* There, the United States Supreme Court determined that a sale and leaseback should not be disregarded for federal income tax purposes if the transaction:

> is a genuine multi-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached . . . . Expressed another way, so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes.[14]

The IRS challenged the sale-leaseback transaction in *Frank Lyon* on the grounds that it was a sham. However, the Court concluded that, in the absence of specific facts evidencing a sham transaction motivated solely by tax-avoidance purposes, a lessor need only possess "significant and genuine attributes of traditional lessor status," evidenced by the economic realities of the transaction, in order for a lease to be respected for federal income tax purposes. The Court recognized that there can be many business or economic reasons for entering into a lease. Legal, regulatory,

and accounting requirements, for example, can serve as motivations to lease an asset. Instead of trying to identify one controlling factor, the Court used the same test as the other leasing cases—that all facts and circumstances must be considered in determining economic substance. Further, the Court noted that "the fact that favorable tax consequences were taken into account by Lyon on entering into the transaction is no reason for disallowing those consequences." [15]

In the wake of *Frank Lyon,* the Tax Court has refined the analysis of whether a lease should be respected for tax purposes. Under *Rice's Toyota World. Inc.* v. *Commissioner, supra,* and its progeny, the Tax Court will disregard a lease transaction for lack of economic substance only if (i) the taxpayer had no business purpose for entering into the transaction other than to reduce taxes, and (ii) the transaction, viewed objectively, offered no realistic profit potential. Further elaborating on this standard, the Tax Court in *Mukerji* v. *Commissioner* [16] set forth the test that in subsequent cases has been used to determine whether a lease should be disregarded for tax purposes:

> [u]nder such test, the Court must find "that the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering into the transaction, and that the transaction had no economic substance because no reasonable possibility of a profit exists." [17]

Once business purpose is established, a lease transaction should not be classified as a "sham." A finding of no business purpose, however, is not conclusive evidence of a sham transaction. The transaction will still be valid if it possesses some economic substance. The Tax Court has developed an objective test for economic substance. A lease will meet the threshold of economic substance and will be respected when the net "reasonably expected" residual value and the net rentals (both net of debt service) will be sufficient to allow taxpayers to recoup their initial equity investment.[18] Applying this analysis, the Tax Court in several cases has concluded that a purported lease transaction was devoid of business purpose and lacked economic substance because the taxpayers could not reasonably expect to recoup their capital from the projected non-tax cash flows in the lease.[19]

Most recently, outside the context of leasing transactions, the Tax Court in *ACM Partnership* v. *Commissioner* [20] had the opportunity to apply a form of economic substance test. There, the Tax Court stated that "the doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of a transaction that serves no economic purpose other than tax savings."[21] The court further found that the taxpayer could not have hoped to recover its initial investment and its costs under any reasonable economic forecast. This proposition that the economic substance test cannot be satisfied if a taxpayer cannot demonstrate a reasonable expectation of pre-tax profit is consistent with the long-standing body of case law regarding lease transactions.

2. Administrative pronouncements

Through revenue rulings and other administrative pronouncements, the IRS has identified certain principles and factors it considers relevant in determining whether a transaction should be treated for tax purposes as a lease or as a conditional sale.

In Rev. Rul. 55–540,[22] the IRS indicated that conditional sale treatment is evidenced where the lessee effectively has the benefits and burdens of ownership for the economic life of the property, as demonstrated by, for example, the application of rentals against the purchase price or otherwise to create an equity interest, the identification of a portion of rentals as interest, the approximate equality of total rentals and the cost of the property plus interest, or the existence of nominal renewal or purchase options. The passage of legal title itself is not determinative.

In addition, the IRS has issued a series of revenue procedures setting forth guidelines that must be satisfied to obtain an advance ruling that a "leveraged lease" (a transaction involving three parties—a lessor, a lessee, and a lender to the lessor) will be respected as a lease for tax purposes.[23] According to Rev. Proc. 75–21, the guidelines set forth therein were published:

> to clarify the circumstances in which an advance ruling recognizing the existence of a lease ordinarily will be issued and thus to provide assistance to taxpayers in preparing ruling requests and to assist the Service in issuing advance ruling letters as promptly as practicable. *These guidelines do not define, as a matter of law, whether a transaction is or is not a lease for federal income tax purposes* and are not intended to be used for audit purposes. If these guidelines are not satisfied, the Service nevertheless will consider ruling in appropriate cases on the basis of all the facts and circumstances. (*Emphasis added.*)

Thus, the IRS guidelines are intended only to provide a list of criteria that if satisfied ordinarily will entitle a taxpayer to a favorable ruling that a leveraged lease of equipment will be respected as a lease for tax purposes.

With respect to economic substance, the IRS guidelines set forth a profit test that will be met if:

> the aggregate amount required to be paid by the lessee to or for the lessor over the lease term plus the value of the residual investment [determined without regard to the effect of inflation] exceed an amount equal to the sum of the aggregate disbursements required to be paid by or for the lessor in connection with the ownership of the property and the lessor's equity investment in the property, including any direct costs to finance the equity investment, and the aggregate amount required to be paid to or for the lessor over the lease term exceeds by a reasonable amount the aggregate disbursements required to be paid by or for the lessor in connection with the ownership of the property.[24]

The IRS guidelines do not specify any particular amount of profit that a lease must generate.[25]

The IRS itself has not relied exclusively on the criteria set forth in the IRS guidelines when analyzing the true lease status of a lease transaction. Moreover, the courts have not treated the IRS guidelines as determinative when analyzing whether a transaction should be respected as a lease for tax purposes.[26] Rather, the IRS guidelines are viewed as constituting a "safe harbor" of sorts. Accordingly, satisfaction of the conservative rule set forth by the applicable IRS guideline with respect to a particular criterion usually is viewed as an indication that the transaction should not be challenged on such a criterion.

3. Statutory provisions

The party that is treated as the owner of the leased asset is entitled to depreciation deductions in respect of such asset. The Deficit Reduction Act of 1984 enacted the "Pickle" rules (named after one of the sponsors of the provision, Representative J.J. Pickle), which restrict the benefits of accelerated depreciation in the case of property leased to a tax-exempt entity.

The Pickle rules generally provide that, in the case of any "tax-exempt use property" subject to a lease, the lessor shall be entitled to depreciate such property using the straight-line method and a recovery period equal to no less than 125 percent of the lease term.[27] Tax-exempt use property, for this purpose, generally is tangible property leased to a tax-exempt entity, which is defined to include any foreign person or entity.[28] In applying the Pickle rules, Treasury regulations adopted in 1996 provide that the lease term will be deemed to include certain periods beyond the original duration of the lease. Under these regulations, which extend beyond the reach of the statutory provision, the lease term includes both the actual lease term and any period of time during which the lessee (or a related person) (i) agreed that it would or could be obligated to make a payment of rent or a payment in the nature of rent or (ii) assumed or retained any risk of loss with respect to the property (including, for example, holding a note secured by the property).[29]

B. Administration's Budget Proposals

The Administration's FY 2000 budget includes several proposals that could have the effect of completely rewriting longstanding tax law on leasing transactions. These proposals, if enacted, would replace the substantial and specific body of law regarding leasing transactions that has developed over the last forty years with broad and largely undefined standards that could be used by IRS revenue agents to challenge traditional leasing transactions undertaken by companies operating in the ordinary course of business in good-faith compliance with the tax laws. Moreover, the proposal to modify the tax rules applicable to cross-border leasing would penalize U.S. lessors and would further hamper the ability of U.S.-based multinationals to compete in the export market.

1. Proposal to deny certain tax benefits to persons avoiding income tax as a result of tax avoidance transactions

The proposal would expand the current-law rules of I.R.C. section 269 to authorize Treasury to disallow any deduction, credit, exclusion, or other allowance obtained in a tax-avoidance transaction.[30] For this purpose, a tax-avoidance transaction would be any transaction in which the present value of the reasonably expected pretax profit from the transaction is insignificant relative to the present value of the reasonably expected net tax benefits from the transaction. In addition, the term "tax-avoidance transaction" would be defined to cover certain transactions involving the improper elimination or significant reduction of tax on economic income.

This proposal creates the entirely new and vague concept of a "tax-avoidance transaction." The first prong of the definition of a tax-avoidance transaction is styled as an objective test requiring a determination of whether the present value of the reasonably expected pre-tax profit from a transaction is insignificant relative to the present value of the reasonably expected net tax benefits from the transaction. However, the inclusion of so many subjective concepts in this equation precludes it from operating as an objective test. As an initial matter, what constitutes the "transaction" for purposes of this test?[31] Next, what are the mechanics for computing pre-tax economic profits and net tax benefits and for determining present values (e.g., what discount rate should be used)? Further, where is the line drawn regarding the significance of the reasonably expected pre-tax economic profit relative to the reasonably expected net tax benefits? Moreover, is the determination of "insignificance" transaction-specific; stated otherwise, does the form of the transaction affect the determination of what will be considered "insignificant" for these purposes?

Not only is this prong of the test extremely vague, the uncertainty is compounded by the second prong of the definition of tax-avoidance transaction. Under this alternative formulation, certain transactions involving the improper elimination or significant reduction of tax on economic income would be considered to be tax-avoidance transactions even if they did not otherwise constitute tax-avoidance transactions under the profit/tax benefit test described above. The inclusion of this second prong renders the definition entirely subjective, with virtually no limit on the IRS's discretion to deem a transaction to be a tax-avoidance transaction.

Under this proposal, once the IRS had used its unfettered authority to determine independently that a taxpayer had engaged in a tax-avoidance transaction, the IRS would be entitled to disallow any deduction, credit, exclusion, or other allowance obtained by the taxpayer in such transaction. Thus, even though a taxpayer's transaction has economic substance and legitimate business purpose, the IRS would be empowered to deny the tax savings to the taxpayer if another route to achieving the same end result would have resulted in the remittance of more tax. In other words, if an IRS revenue agent believed for any reason that a taxpayer's transaction was too tax efficient, he or she would have the power to strike it down, even if the actual pre-tax return on the transaction satisfied any objective benchmark for appropriate returns. That power could be invoked without regard to the legitimacy of the taxpayer's business purpose for entering into the transaction or the economic substance underlying the transaction.

In the context of leasing transactions, this proposal effectively could wipe out the entire body of law that has developed over the last forty years. A leasing transaction that is scrutinized and passes muster under the benefits and burdens of ownership, business purpose, and economic substance tests could run afoul of this vague new standard. This proposal would completely disregard the presence of a business purpose, ignoring the business reality that lease transactions often are motivated by criteria that would not be taken into account under this new standard. It would replace the traditional economic analysis of lease transactions with this new and largely undefined standard. The longstanding law regarding the treatment of leasing transactions allows taxpayers to employ prudent tax planning to implement business objectives while giving the IRS the tools it needs to address potentially abusive transactions. The extraordinary power that would be vested both in Treasury and in individual IRS revenue agents is unnecessary and would create substantial uncertainty that would frustrate commerce done through traditional leasing transactions.

2. Proposal to preclude taxpayers from taking tax positions inconsistent with the form of their transactions

The proposal generally would provide that a corporate taxpayer could not take any position on a tax return or refund claim that the income tax treatment of a transaction differs from the treatment dictated by the form of the transaction if a "tax-indifferent party" has an interest in the transaction, unless the taxpayer discloses the inconsistent treatment on its original return for the year the transaction is entered into. The form of the transaction would be determined based on all the facts and circumstances, including the treatment given the transaction for regulatory or foreign law purposes. A "tax-indifferent party" would be defined to include foreign persons, native American tribal organizations, tax-exempt organizations, and domestic corporations with expiring loss or credit carryforwards.[32]

This proposal would have a chilling effect on a variety of leasing transactions. For example, the proposal could affect "inbound" lease transactions (i.e., transactions involving a foreign lessor and U.S. lessee), where the transaction takes the form of a lease under foreign law but constitutes a financing for U.S. tax purposes under the body of law described above. The proposal also might be implicated by "out-

bound" lease transactions (i.e., transactions involving a U.S. lessor and foreign lessee), where the transaction takes the form of a lease for U.S. tax purposes under the body of law described in the preceding section but is treated as a financing under foreign law. If the "form" of the transaction is to be determined for purposes of the proposal by taking into account the foreign law treatment of the transaction, what is the "form" of this transaction? In many cases, the U.S. lessor or lessee does not know and is not able to ascertain the treatment of the transaction under foreign law. In such instances, the U.S. party would have to file some sort of protective disclosure, which would result in a deluge of filings with respect to leasing transactions. Query then whether such disclosure would be of any use to the IRS. This proposal also would have a chilling effect on municipal leases where the city (or other governmental unit) and the lessor treat the lease as a conditional sale for tax purposes. Moreover, the proposal represents a serious departure from the treatment of leasing transactions under present law.

Under well-established law, a taxpayer may disavow the form of a transaction if the taxpayer's actions show an honest and consistent respect for the substance of the transaction. If such consistency exists, the taxpayer can successfully disavow the form of the transaction by introducing "strong proof" that the parties intended the transaction to be something different from its form.[33]

The IRS recently applied the "strong proof" standard to an inbound Japanese leveraged lease transaction of an aircraft.[34] In determining that the U.S. lessee had met this burden of proof, and thus remained the owner of the aircraft for U.S. tax purposes (despite the fact that the Japanese lessor was considered the owner of such aircraft for Japanese tax purposes), the IRS stated:

> dual tax ownership will not be a concern in the United States when it is solely the result of differing U.S. and foreign legal standards of tax ownership being applied to the same facts because tax ownership is determined under U.S. legal standards without regard to the tax ownership treatment obtained under foreign law. Thus, the United States need not be concerned where the taxpayer in a cross-border transaction is able to show that the same facts that led the foreign taxing authorities to conclude that ownership lies in the foreign party, also support the conclusion that the taxpayer is the owner under U.S. standards.

In the context of leasing transactions, the Administration's proposal is unnecessary and is a clear departure from longstanding rules applicable to leasing transactions as expressly sanctioned by the IRS.

3. Proposal to limit "inappropriate" tax benefits for lessors of tax-exempt use property

The proposal would deny recognition of a net loss from a leasing transaction involving tax-exempt use property during the lease term. For this purpose, the leasing transaction would be defined to include the lease itself and all related agreements (i.e., sale, loan, and option agreements) entered into by the lessor with respect to the lease of the tax-exempt use property. Property leased to foreign persons, governments, and tax-exempt organizations would be considered tax-exempt use property.

This proposal would adversely impact a variety of common leasing transactions, including leasing to municipalities and tax-exempt organizations and export leasing. Domestic manufacturers, distributors, and retailers alike avail themselves of export leasing, not only as a pure financing vehicle for major equipment sales, but also as a powerful sales tool to promote equipment sales abroad. Lease financing is attractive to customers for a variety of reasons, including the preservation of cash, possible balance sheet accounting benefits, and a hedge against obsolescence risk. Consider, as an example, a U.S. manufacturer seeking to expand its export sales. That manufacturer's foreign competition is offering lease financing to its customer base. The U.S. manufacturer can compete in the global market only by offering lease financing on comparable terms. This proposal, which would increase the cost of export leasing, hampers the ability of U.S.-based multinationals to compete in the export markets.

This proposal, which affects all deductions and losses with respect to leasing transactions, is much broader than the current Pickle depreciation rules that severely limit depreciation deductions for U.S. lessors that lease to foreign lessees. For example, assume that a U.S. lessor enters into a cross-border lease with a Mexican lessee with the rent stated in pesos. A currency loss due to a devaluation of the peso, realized upon receipt of the peso-denominated rent, might have to be deferred under this proposal. Other types of actual losses could be deferred similarly. In these situations, the proposal would have the effect of denying the current recognition for tax purposes of actual current economic losses.

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The only rationale that has been offered for the proposal is Treasury Department concern regarding a narrow class of relatively recent cross-border leasing transactions commonly referred to as "LILO" transactions. As the leasing industry has repeatedly told Treasury, those transactions would be eliminated if the IRS were simply to finalize regulations that it has proposed under section 467. The relevant statutory provision, I.R.C. section 467, was enacted in 1984—15 years ago; the relevant regulations were issued in proposed form in 1996—3 years ago. Yet Treasury and the IRS have chosen not to take the simple step of finalizing the section 467 regulations in order to address these transactions. Indeed, after the release of the FY 2000 budget proposals, which included this proposal, Treasury and the IRS addressed the treatment of LILO transactions through the issuance of Rev. Rul. 99–14, choosing to use the weaker tool available to them—the issuance of a revenue ruling setting forth a litigating position—rather than the stronger weapon in their arsenal—the finalization of regulations that have remained in proposed form for 3 years. The additional tool that this legislative proposal would provide is unnecessary and would be harmful to a significant sector of the economy.

Not only should the Congress reject this proposal, it should consider taking action to help U.S. companies engaged in leasing expand in the global marketplace. In this regard, the leasing industry has repeatedly objected to the Treasury regulations that treat the lease term, for purposes of the Pickle rules, as including periods beyond the actual lease term. The Congress should act to reverse these overreaching regulations. Moreover, the Congress should consider repeal of the Pickle rules themselves.

IV. IMPACT OF ADMINISTRATION'S BUDGET PROPOSALS

A. Impact on Common Transactions

1. Leveraged lease

Consider a standard domestic leveraged lease under which an airline carrier enters into a "sale-leaseback" transaction in order to finance a newly manufactured aircraft. Under this transaction, the airline carrier purchases the aircraft from the aircraft manufacturer and immediately sells it to an institutional investor. The investor finances the acquisition through an equity investment equal to 25 percent of the $100 million purchase price and a fixed-rate nonrecourse debt instrument from a third-party lender equal to the remaining 75 percent. Immediately after the sale, the investor leases the aircraft to the airline carrier pursuant to a net lease for a term of 24 years. Upon the expiration of the lease term, the aircraft will be returned to the investor (the lessor). During year 18 of the lease, the airline carrier (the lessee) will have an option to purchase the aircraft from the investor for a fixed amount, which will be set at an amount greater than or equal to a current estimate of the then-fair market value of the aircraft. As the tax owner of the aircraft, the lessor is entitled to depreciation deductions in respect of the aircraft and deductions in respect of the interest that accrues on the loan.

The lease in this example complies with applicable case law and with the cash flow and profit tests set forth in Rev. Proc. 75–21. In fact, the sum of the rentals and the expected residual value exceeds the aggregate disbursements of the lessor and the lessor's equity investment, together with applicable costs, by approximately $18 million (or 18 percent of the asset purchase price).

Even though this transaction complies with the established body of leasing law, it appears that it potentially could be characterized as a "tax-avoidance transaction" under the Administration's proposal, discussed above. As noted above, the manner in which the proposal would test whether a transaction is or is not a "tax-avoidance transaction" is capable of numerous different interpretations and appears to be highly subjective. Under a range of potential applications of the proposal to this transaction, it might be determined that the lessor would reasonably expect an annual pre-tax return anywhere in the range of 2.5 percent to 5.5 percent. On an after-tax basis, the lessor might be determined to reasonably expect an annual return anywhere in the range of 6.5 percent to 8.5 percent. Depending on the particular manner in which the proposed test might be applied, the differential between the pre-tax and the after-tax returns could be large enough to suggest that an IRS agent might take the position that the discounted value of the reasonably expected pre-tax profit is not sufficient under the proposed test when compared to the discounted value of the reasonably expected net tax benefits.

Regardless of how the test is applied, however, the tax advantages received by the lessor in this example are identical to the tax benefits that would be received by any owner of the property financing the property in a similar manner and in the same tax bracket. If the tax benefits are disallowed only for lessors, leasing will be put at a disadvantage relative to direct ownership. There is no sensible policy that

would declare a leasing transaction to lack economic substance when the identical cash flows and tax benefits would occur for any similarly situated direct owner of such an asset.

2. Export leases

Export leases are another example of a type of commonplace leasing transaction that could be impacted adversely by the Administration's budget proposals. Leaving aside the general question whether these types of leases might be deemed to constitute "tax-avoidance transactions," they would be hit by the separate Administration proposal specifically targeting leasing arrangements involving tax-exempt parties. The proposal, as discussed above, generally would preclude a lessor of tax-exempt use property from recognizing a net loss generated during the lease term by a leasing transaction involving tax-exempt use property.

Consider a commonplace "operating lease" transaction under which a foreign airline carrier seeks to lease a new aircraft from a U.S. manufacturer. The lessor finances the acquisition of such aircraft through an equity investment equal to 20 percent of the purchase price and a loan from a third-party lender equal to the remaining 80 percent. The lessor leases the aircraft to the foreign airline carrier pursuant to an operating lease for a term of 5 years. The rents due thereunder, as well as the expected residual value of the aircraft, are dictated by the market. Upon expiration of the lease term, the aircraft will be returned to the lessor, whereupon the lessor will in all likelihood re-lease the aircraft for additional 5-year periods to other airline carriers. The lessor, as the tax owner of the aircraft, will be entitled to depreciation deductions in respect of the aircraft, using the straight-line method over a term equal to 12 years (i.e., the class life, which is greater than 125 percent of the 5-year lease term), and deductions in respect of the interest that accrues on the loan. For purposes of this example, it is assumed that the lessor will sell the aircraft for its estimated residual value at the end of the second re-lease period in year 15.

The effect of the Administration's proposal would be to decrease the return to the lessor. The decrease could be large enough that the U.S. lessor could not offer attractive aircraft financing, surrendering this business opportunity to a foreign lessor and manufacturer. Under current law, the lessor would be able to achieve an after-tax yield of approximately 6.7 percent. That return is based, in part, on the rents due under the lease (and the re-lease) and the residual value of the aircraft upon the expiration of the re-lease (in each case, net of any debt service), and, in part, on the net tax benefits available to such lessor. If, as would be required under the Administration's proposal, the net tax losses available to the lessor in the early years had to be carried forward to offset the taxable income generated by such lease in the later years, the after-tax yield of the lessor (holding all other variables constant) would drop to approximately 6.1 percent.

Or, consider a transaction under which a foreign airline carrier seeks to finance a new aircraft produced by a U.S. manufacturer on a long-term basis. The foreign airline carrier purchases the aircraft from the U.S. manufacturer and immediately sells it to a U.S. institutional investor. The investor finances the acquisition through an equity investment equal to 13 percent of the purchase price and a fixed-rate nonrecourse debt instrument from a third-party lender equal to the remaining 87 percent. Immediately after the sale, the investor leases the aircraft to the foreign airline carrier pursuant to a net lease for a term of 24 years. Upon expiration of the lease term, the aircraft will be returned to the investor (the lessor). At the end of year 18.5 of the lease, the foreign airline carrier (the lessee) will have the option to purchase the aircraft for a fixed amount, which will be set at an amount equal to or greater than a current estimate of the then-fair market value of the aircraft. The investor, as the tax owner of the aircraft, will be entitled to depreciation deductions in respect of the aircraft, using the straight-line method over a term that is at least equal to 125 percent of the lease term, and deductions in respect of the interest that accrues on the loan. In the early years of the lease term, the depreciation deductions and interest expense deductions exceed the amounts paid by the lessee to the lessor. The lease in this example complies with applicable case law and with the cash flow and profits tests set forth in Rev. Proc. 75–21.

The effect of the Administration's tax-exempt use property proposal would be to increase the cost of financing this transaction. Under current law, the investor in this example is able to offer the lessee financing at a rate that would equate to the airline borrowing at about a 7.1-percent interest rate—a lower rate than the lessee could hope to achieve if it financed the acquisition through a loan. This lower cost of capital is due to the tax deferral created when the lessor takes depreciation and interest deductions in the early years of the lease, amounting to net losses, and recognizes income in the later years. Carrying forward these net losses to offset taxable income generated by the lease, as the Administration proposal would require, would

increase the 7.1.-percent effective interest rate in this example by *40 basis points*, to 7.5 percent. Taking into account the dollar size of these transactions (with typical deals in the hundreds of millions of dollars), a 40 basis point shift would render this U.S. manufacturer/lessor's financing uncompetitive in the global markets.

B. Impact on Competitiveness

The ability of U.S. equipment manufacturers to compete in global markets may depend in part on their ability to arrange financing terms for their potential customers that are competitive with those that can be arranged by foreign producers. The Administration's budget proposals would make it much more difficult and potentially impossible to arrange financing on competitive terms.

For example, consider the case of a U.S. aircraft manufacturer seeking to expand into the European market.[35] A European airline may find price to be a final determining factor in comparing an aircraft manufactured by a U.S. company with one produced by a European manufacturer. Financing provisions, such as lease terms, directly influence the cost. The U.S. manufacturer's ability to sell its aircraft to the European airline may be contingent on its ability to assist the airline with arranging a suitable lease that is competitive with the lease terms that can be offered with respect to the European aircraft.

As shown in the examples above (see section IV. A), a U.S. aircraft manufacturer might be able to offer a European airline a short-term operating lease or a long-term financial lease, taking into account current U.S. tax law, at a rate that would be attractive to the foreign airline. In the financial lease, the airline effectively would borrow at a 7.1-percent interest rate. The European aircraft manufacturer, if it worked through a German investor, might be able to offer financing to the airline at a much lower rate, potentially as low as 5.5 percent.[36] A chief reason for this disparity is the favorable tax treatment of leased property under German law, including significantly accelerated depreciation for the lessor even when the lessee is a tax-exempt entity under German tax law. Under the present Pickle rules, a U.S. export lease on U.S. equipment cannot compete with a German lease on similar German equipment. The availability of favorable lease rules in foreign jurisdictions, such as the German rules, already hinders the ability of U.S. companies to compete in the global market. Changes to the rules further impairing the tax treatment of export leasing will further disadvantage U.S. leasing companies and U.S. manufacturers vis-à-vis their foreign counterparts.

If enacted, the Administration's budget proposals would tilt the balance in these competitive financing situations even further against the U.S. manufacturer. For leasing-intensive industries, the proposals could make it prohibitive to expand in existing markets or to enter into emerging markets on a competitive basis.

The Administration's proposals also would impede the ability of U.S.-based financial institutions to compete in the worldwide leasing market. If enacted, the Administration's proposals would give foreign-based financial institutions a leg up in providing financing. The impact of these proposals on the U.S. financial sector, an important part the U.S. economy, should not be overlooked.

C. Impact on Exports

Because the Administration's proposals effectively would make U.S.-manufactured goods in leasing-intensive industries more expensive in foreign markets, these measures could be expected to have an adverse effect on American exports.

A significant percentage of American exports is attributable to leasing. While no exact data regarding this percentage is available, consider that data discussed in section II, above, indicated that nearly one third of all equipment investment, at least on a domestic basis, is financed through leasing. Further, consider that exports of equipment in 1997 represented 43 percent of all goods exported by the United States.[37] Moreover, the share of exported goods accounted for by equipment has been rising steadily since 1980. Despite the strong showing of U.S. exported equipment, we live in a highly competitive world and face worldwide competition in our export markets and at home for these products.

In certain sectors most likely to be leasing-intensive, exports are accountable for a substantial share of domestic production. For example, exports account for 50 percent of U.S. production of aircraft, aircraft engines, and other aircraft parts; 28 percent of U.S. production of construction equipment; 31 percent of U.S. production of farm machinery; 40 percent of U.S. production of machine tools; and 56 percent of U.S. production of mining machinery. In the absence of these exports, domestic employment in these equipment-producing industries would be substantially reduced.

D. Impact on Start-Ups, Companies in Economic Downturn

Some companies that directly own their assets may find that they have a higher cost of capital than their competitors due to special tax circumstances. For example,

companies in a loss position (as is the case for many businesses in the start-up phase) and companies paying AMT (which often hits companies experiencing economic downturns) often have a higher cost of capital because they cannot immediately claim all of the depreciation allowances provided under the tax law. These companies may be at a competitive disadvantage relative to other firms. Some regard it as unfair that a company in the start-up phase or recovering from an economic downturn faces higher costs for new investment than its competitors.

Through leasing, a company in these circumstances often can achieve a cost of capital comparable to that of its competitors. Leasing helps to "level the playing field" between companies in an adverse tax situation and their competitors by equalizing the cost of capital. For certain assets, leasing can lower the cost of capital for a firm in this tax situation by as much as one percentage point. This can mean the difference between successfully competing and bankruptcy. Rehabilitation or liquidation in bankruptcy can be more detrimental to U.S. revenues than the granting of ordinary depreciation and interest deductions.

By denying the benefits of leasing, the Administration's proposals would further increase the cost of capital for companies in such circumstances. As a result, the economy suffers real losses. Investment may be allocated not on the basis of who is the most efficient or productive producer, but who is in the most favorable tax situation. In the absence of leasing, a company in a loss position facing a higher cost of capital than its competitors—might not be able to undertake new investment even if, in the absence of taxes, it would be the most efficient firm.

V. CONCLUSION

The Leasing Coalition urges Members of the Senate Finance Committee to reject the Administration's tax proposals that would adversely affect the leasing industry. As discussed above, we believe these proposals inappropriately would overturn the longstanding and carefully crafted body of tax law governing common leasing transactions and would have a deleterious impact on the U.S. economy. Moreover, we find it highly objectionable that these common and legitimate business transactions effectively are being cast by the Administration as "corporate tax shelters." Instead of considering proposals at this time that would impair the competitiveness of the leasing industry and industries that manufacture goods commonly acquired through lease arrangements, we respectfully would suggest that the Administration and Congress consider ways to help U.S. companies that use leasing as a form of financing expand in the global marketplace.

ENDNOTES

[1] *General Explanations of the Administration's Revenue Proposals,* Department of the Treasury, February 1999, at 113.

[2] *Id.* at 97.

[3] U.S. Department of Commerce, Economics and Statistics Administration, Bureau of Economic Analysis.

[4] Equipment Leasing Association.

[5] *Helvering* v. *F. & R. Lazarus & Co.,* 308 U.S. 252 (1939).

[6] *Estate of Thomas* v. *Commissioner,* 84 T.C. 412 (1985).

[7] *See Rice's Toyota World. Inc.* v. *Commissioner,* 81 T.C. 184 (1983), *aff'd in part, rev'd in part,* 752 F.2d 89 (4th Cir. 1985); *Frank Lyon Co.* v. *United States,* 435 U.S. 561 (1978).

[8] *Swift Dodge* v. *Commissioner,* 692 F.2d 651 (9th Cir. 1982), *rev'g,* 76 T.C. 547 (1981).

[9] *Lockhart Leasing Co.* v. *Commissioner,* 54 T.C. 301, 314–15 (1970), *aff'd* 446 F.2d 269 (10th Cir. 1971).

?[10] *See Frank Lyon Co.* v. *United States, supra.*

[11] *Oesterreich* v. *Commissioner,* 226 F.2d 798 (9th Cir. 1955), *rev'g,* 12 T.C.M. 277 (1953).

[12] *Coleman* v. *Commissioner,* 87 T.C. 178, 201 (1986), *aff'd* 883 F.2d 303 (3d Cir. 1987).

[13] *Pacific Gamble Robinson* v. *Commissioner,* 54 T.C.M. 915 (1987).

[14] *Id.* at 583.

[15] *Id.* at 561.

[16] 87 T.C. 926 (1986).

[17] *Id.* at 959 (quoting *Rice's Toyota World. supra,* at 91).

[18] *See Mukerji, supra.*

[19] *See Goldwasser* v. *Commissioner,* 56 T.C.M. 606 (1988); *Casebeer* v. *Commissioner,* 54 T.C.M. 1432 (1987); and *James* v. *Commissioner,* 87 T.C. 905 (1986).

[20] 157 F.3d 231 (3rd Cir. 1998).

[21] *Id.* at 130.

[22] 1955–2 C.B. 39. *See also* Rev. Rul. 55–541, 1955–2 C.B. 19.

[23] *See* Rev. Proc. 75–21, 1975–1 C.B. 715 (setting forth several requirements that must be satisfied for the Service to rule that a transaction is a lease for tax purposes); Rev. Proc. 75–28, 1975–1 C.B. 752 (specifying information that must be submitted pursuant to Rev. Proc. 75–21); Rev. Proc. 76–30, 1976–2 C.B. 647 (providing that the Service will not issue an advance ruling if the property subject to the "lease" is limited use property); Rev. Proc. 79–48, 1979–2 C.B. 529 (modifying Rev. Proc. 75–21 to allow the lessee to pay for certain improvements).

[24] Rev. Proc. 75–21, *supra.*

[25] The IRS guidelines understate the actual profit earned over the lease term by failing to adjust the residual value of the investment for inflation.

[26] In a footnote in *Frank Lyon, supra* at n. 14, the Supreme Court specifically recognized that the IRS guidelines "are not intended to be definitive." Moreover, in *Estate of Thomas* v. *Commissioner,* 84 T.C. 412, 440 n. 15 (1985), the Tax Court viewed the failure to satisfy all the IRS guidelines as not determinative because the facts and circumstances demonstrated that the transaction satisfied the "spirit" of the guidelines.

[27] I.R.C. section 168(g).

[28] I.R.C. section 168(h).

[29] Treas. Reg. Section 1.168(i)–2(b)(1).

[30] The "tax-avoidance transaction" concept also is implicated in several other Administration proposals relating to the consequences of corporate tax shelters. Under these proposals, a corporate tax shelter is defined as an arrangement in which a corporate participant obtains a tax benefit in a tax-avoidance transaction. If a corporate tax shelter is found to exist, the Administration proposals would (1) impose a significantly increased substantial understatement penalty, (2) deny deductions for fees for tax advice and impose a 25-percent excise tax on such fees, and (3) impose a 25-percent excise tax on certain rescission provisions or provisions guaranteeing tax benefits. If a transaction is determined to be a tax-avoidance transaction, each of these proposals also potentially would be applicable.

[31] By itself, the determination of the scope of the transaction is both extremely complex and vitally important to the application of this test. Some of the questions to be resolved include: Do the qualified nonrecourse indebtedness rules control the determination of whether debt is considered part of a transaction? If recourse debt is taken into account in defining the transaction, how is the appropriately allocable amount of such debt to be determined? In addition, in defining the transaction, will an implicit charge for the use of capital be taken into account? Will allocations of internal expenses and corporate overhead to the transactions be required? Moreover, will a lease of multiple assets or multiple classes of assets be treated as a single transaction or multiple transactions? All of these questions and more must be answered in order to determine the scope of the transaction, which would be only the starting point in applying this test.

[32] The "tax-indifferent party" concept also is implicated in a separate Administration proposal that would impose U.S. tax on any income allocable to a tax-indifferent party with respect to a corporate tax shelter.

[33] *Coleman* v. *Commissioner,* 87 T.C. 178, 201 (1986), *aff'd* 883 F.2d 303 (3d Cir. 1987); *Illinois Power Co.* v. *Commissioner,* 87 T.C. 1417 (1986). In *Commissioner* v. *Danielson,* 378 F.2d 771 (3rd Cir. 1967), *cert. denied,* 389 U.S. 858 (1967), a case involving a stock purchase agreement, the court stated that a taxpayer can challenge the tax consequences of his agreement only through the production of proof which "would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc." *Id.* at 775. The court in *Danielson* itself distinguished leasing transactions as a context in which the standard set forth in Danielson was not to apply. *See Helvering* v. *Lazarus, supra;* Tech. Adv. Mem. 9307002 (October 5, 1992).

[34] Tech. Adv. Mem. 9802002 (September 18, 1997).

[35] About half of the aircraft flown in Europe are leased rather than owned by airlines.

[36] Using similar assumptions and terms as under the example in section IV.A.

[37] Department of Commerce, Bureau of Economic Analysis.

Statement of Management Compensation Group (MCG)

I. INTRODUCTION

We appreciate the opportunity to submit this written statement for the record of the Senate Finance Committee hearing on the "Revenue Raising Proposals in the Administration's Fiscal Year 2000 Budget." We are the Management Compensation Group ("MCG"), a group of independently owned firms located across the country, dedicated to assisting businesses to provide retirement, health and other benefits to their employees. We help small, medium and larger businesses finance benefit plans through the purchase of corporate-owned life insurance ("COLI"). The use of COLI serves a valid social and economic purpose in financing these benefit plans.

The Administration's FY 2000 Budget reproposes a modification to the COLI rules which was soundly rejected by Congress last year. The President's proposal, which was also contained in his FY 1999 Budget, would apply the proration rule adopted in the Taxpayer Relief Act of 1997 (P.L. 105–34) to virtually all COLI, by eliminating exceptions to the rule for employees, officers and directors (the "COLI proposal"). Without discussion, the COLI proposal is listed in the FY 2000 Budget under the heading of "Corporate Tax Shelters."

As in the testimony we submitted last year, we again strenuously OBJECT to the President's COLI proposal.

In this statement, we will provide a description of the President's COLI proposal; background on the legitimate business uses of COLI and the history of tax changes; support for why COLI is not a tax shelter; and a discussion of why the President's COLI proposal should again be rejected outright by Congress.

II. THE PRESIDENT'S COLI PROPOSAL

Under current law, businesses are generally allowed a tax deduction for interest on indebtedness incurred in their trade or business. Businesses often own life insurance policies on the lives of their employees, officers and directors. These policies meet a number of business needs, including: (1) providing financial liquidity; (2) allowing businesses to fund employee and retirement benefits; (3) providing continuation of business operations upon the death of a key executive; and (4) providing survivors with death benefit protections.

The tax laws deny an interest deduction on any indebtedness WITH RESPECT TO life insurance policies. Therefore, any interest which is directly related or "traceable" to a life insurance policy is already denied under current law. If there is no relationship between the indebtedness and a corporate-owned life insurance policy on an employee, officer or director, then there is no denial of interest.

The President's FY 2000 Budget plan reproposes a modification of the COLI rules which was proposed in his FY 1999 Budget and soundly rejected by Congress last year. The proposal would change the current COLI rules and deny interest deductions on indebtedness incurred by a business completely UNRELATED to the ownership of insurance on an employee, officer or director. This proposal would have a devastating impact on businesses and employees throughout the country.

III. BACKGROUND OF BUSINESS USES OF COLI AND HISTORY OF TAX CHANGES

(1) Permanent Life Insurance For Business

The use of permanent life insurance in a business setting first arose as a means to protect against the premature death of key employees. The savings element in permanent life insurance also allowed for the accumulation of value for use in the buyback of stock or to protect against business interruption.

As businesses saw a need to fund for pension and other benefit liabilities that fell outside of their qualified plans, COLI in its current use evolved. The combination of predictable premiums, long-term asset accumulation and protection against death benefit liabilities makes COLI an ideal funding vehicle for these programs.

In these arrangements, businesses purchase COLI in an amount necessary to match the emerging liabilities for benefits outside of qualified plans. The COLI asset is typically placed in a trust, and specific arrangements are made to eliminate excess assets from building up within the trust. While such assets remain available to creditors should bankruptcy occur, they are otherwise pledged and held in trust for the sole purpose of extinguishing corporate liability associated with the benefit plans.

Funds used to purchase COLI are paid with after-tax dollars. The growth of these funds only serves to help the plans keep pace with the emerging liability. If cash value is withdrawn from the policies, it is subject to taxation at ordinary income rates. The company foregoes a current deduction, unlike qualified pension plans, and provides a dedicated buffer for future pension payments. Funding under these plans is typically limited to those eligible for participation in these programs.

(2) History Of Tax Changes Related To COLI

In the past, Congress has been concerned about the use of COLI as a pure investment vehicle without appropriate insurance elements. As a consequence, it has acted to restrict COLI and certain investment-oriented insurance products, while protecting the tax-deferred nature of permanent life insurance.

The 1954 Code contained a provision limiting interest deductions on loans taken out directly or otherwise to purchase insurance (Code section 264). Since then, Congress has strengthened this provision several times. Most recently, in the Taxpayer Relief Act of 1997 (the "1997 Act"), Congress eliminated a broad range of exceptions and generally disallowed any interest on indebtedness "with respect to" the ownership of a life insurance contract. This disallowed any direct and "traceable" interest. A limited exception for "key person" policies under $50,000 remained in place.

The 1997 Act also added a new "proration" rule which denied interest deductions on indebtedness "unrelated" to the ownership of insurance policies. An exception to the proration rule was provided for insurance purchased on lives of employees, officers, directors, and 20 percent owners (Code section 264(f)). This exception is the subject of the President's COLI proposal.[1]

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[1] Other changes affecting insurance products occurred over the years. Certain investment-oriented insurance products called "modified endowments" were restricted by Congress in 1988. This class of policies loses many or some of the favorable treatment available to other contracts under Code section 72. Congress in 1990 imposed another limitation on insurance policies with

Continued

IV. COLI IS NOT A "TAX SHELTER"

Without discussion, the COLI proposal is listed in the FY 2000 Budget under the heading of "Corporate Tax Shelters." COLI is not a loophole and is not a corporate tax shelter. As discussed above, the use of COLI is well-documented as a legitimate means of funding employee retirement, health and other benefits. While some would argue that Congress has already provided special tax-favored treatment specifically to encourage businesses to provide health and pension benefits and that it was not intended that COLI be used to circumvent statutory limits, these arguments are specious and do not support a determination that COLI is a "tax shelter."

Congress has long been aware of the legitimate use of COLI to fund retiree health benefits and supplemental pension benefits. The tax results achieved through the use of COLI are not "unintended," are not "unwarranted," and do not involve "aggressive interpretations" of the law. The legitimate use of COLI does not involve tax evasion, is not offered under conditions of confidentiality and clearly does not fall within the existing definition of "corporate tax shelter," under section 6111(d) of the Code. By any reasonable standard the use of COLI does not rise to the level of being described as a "corporate tax shelter."

V. DISCUSSION OF PROPOSAL

The President's COLI proposal is seriously flawed, inequitable, overly broad, and unjustified. It must again be REJECTED by Congress.

(1) "Tax Arbitrage" Is A Smoke-Screen and Ignores Existing Statutory Limitations

While the Administration has in the past suggested that traditional COLI provides unwarranted tax arbitrage, the argument is not persuasive and is nothing but a smoke screen to mask its attempt to tax inside build up of life insurance—a proposal that likewise has been resoundingly rejected in the past.

There are legitimate tax policy reasons for allowing ordinary and necessary tax deductions for businesses that incur indebtedness and pay interest expenses. Similarly, there is a valid tax policy reason for allowing businesses to own permanent life insurance and for allowing the growth of these policies to be tax-deferred.

To arbitrarily tie these two fundamental tax concepts together as a means of raising revenue is disingenuous. If denying a deduction for an expense completely unrelated to an item of income were acceptable, we would have complete chaos in the tax code.

An example of how ill-conceived this policy would be is the case of a taxpayer who earns tax-deferred income in a ROTH IRA and also makes tax deductible mortgage interest payments. If the taxpayer's mortgage interest deduction were denied on the theory that he/she has "tax arbitrage" from unrelated tax-deferred earnings in the ROTH IRA, the entire tax code would have to be reviewed and the deductibility of deductions would always be in question. The purpose of the tax deferral, in this case to increase the ability of Americans to save for retirement and the interest deduction, to promote home ownership, are completely unrelated. There is no connection between the ROTH IRA and the mortgage indebtedness just as there is no connection here between the business indebtedness and the COLI policy. In the business setting, the analogy would be to deny an interest deduction on the purchase of office equipment solely because a business purchased key man life insurance.

Importantly, current law contains safeguards for interest that is "related" or "traceable" to the ownership of life insurance, denying interest deductions in such cases. These safeguards came about through major reforms by Congress over the past 20 years to the taxation of life insurance. Starting in the early 1960s and continuing through the mid-1990s, these changes to the Internal Revenue Code address perceived problems and prevent abusive leveraging of life insurance. As described above, the most recent changes occurred in the 1997 Act.

The President's COLI proposal ignores this history and statutory safeguards, and goes well beyond the established criteria approved by Congress and the Administration. Rather than looking at whether there are specific relationships between the policy and the indebtedness or the policy and other criteria deemed to be "investment oriented," the President's COLI proposal attempts to disallow deductions for completely unrelated interest. The Administration apparently believes that allowing a taxpayer a deduction for interest incurred on indebtedness in the operation of a business is wrong if the business owns life insurance on its employees, officers, or

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the enactment of the deferred acquisition cost provision (Code section 848)(the "DAC tax"). This provision limits the ability of insurance companies to deduct immediately the costs incurred in issuing a policy. The economic effect of the DAC provision has been to impose a federal premium tax.

directors, even if the business indebtedness is completely unrelated to the insurance. This belief is contrary to fundamental principals of tax policy as well as the social objectives such deductions are meant to achieve.

(2) The COLI Proposal is Inequitable

By denying interest deductions on businesses that own life insurance, the President's COLI proposal creates unjustified inequities between businesses that rely on debt financing and those that are equity-financed. Under the proposal, two taxpayers in the same industry would be treated differently for tax purposes depending on whether they incurred debt in the operation of their business or whether they relied on equity investmehts.

In addition, businesses in different industries would be treated differently as a result of the proposal. Many capital intensive industries rely heavily on debt and would be disproportionately disadvantaged because the proposal would deny their interest deductions. This would occur even though the debt-financed businesses would own the same amount of life insurance and provide the same amount of employee and retirement benefits as their equity-financed competitors.

(3) Back Door Tax Increase on Cash Value and Unrealized Appreciation in Business Assets

Like the proposal which was rejected last year, the President's FY 2000 budget proposal would apply the 1997 proration rules to all COLI and BOLI. Effectively, this would result in a backdoor taxation of cash values on all business life insurance.

As stated above, permanent life insurance has traditionally been a tax-favored investment for good social and tax policy reasons. The essential element of the insurance—to protect against the premature death of a key employee—and the use of the "cash value" savings element—to protect against business interruption or to fund pension and retirement benefits—have long been recognized as worthy goals.

By denying an interest deduction to businesses that own such policies and tying the denial to the "pro-rated" amount of "unborrowed cash value," the Administration is indirectly "taxing" the cash value on permanent insurance owned by a taxpayer. Traditional concepts of fairness should prevent the Administration to do indirectly what they choose not to do directly.

Moreover, this indirect tax increase on the cash value of a life insurance policy results in a tax on the "unrealized appreciation" in a taxpayer's asset. This result would be similar to taxing a homeowner each year on the appreciation of his/her home.

Fundamental concepts of tax policy dictate that taxes generally should be incurred on the "recognition" of a taxable event, such as a sale or exchange of property. To now impose a tax on "unrealized appreciation" would not only violate traditional concepts of tax policy, but could result in huge administrative burdens on taxpayers and the government if followed in other areas of the law.

Finally, it should be recognized that the cash value of life insurance is incidental to the underlying purpose of a "permanent life insurance" policy. The fundamental nature of the policy is the protection of risk of death. Cash value is merely an incident of this purpose. Legally, cash value is reserved to pay death benefits and is provided to policyholders through Non-Forfeiture provisions mandated under State law.

(4) Unjustified Elimination of Funding for Employee and Retirement Benefits

The President's COLI proposal would increase current taxes on all businesses that own or are the beneficiaries of a permanent life insurance policy. It would seriously curtail the availability of the benefits these policies fund and increase the risk of business failure from loss of a key employee. While there is a clear relationship between the providing of insurance and the funding of benefits, there is no relationship between interest on business indebtedness and unrelated insurance used to fund benefits.

Current rules already limit potential abuses in traditional COLI applications. Code section 264 prevents leveraged arbitrage from tax-deductible borrowing "related to" a corporate-owned life insurance policy. Code section 7702 and 7702A require corporate-owned policies to provide a reasonable amount of death benefit protection. And qualified plan limits restrict the amount of insurance that can be purchased by an employer on a currently deductible basis. It is not clear what public purpose extending these rules to cover unrelated interest deductions would serve.

The effect of the President's COLI proposal would be to limit wholly appropriate business uses of life insurance by making the cost of insurance products economically infeasible. Eliminating business owned life insurance could result in the elimination or reduction in the amount of employer-provided employee and retirement

benefits. Such a change would put unnecessary and undue pressure on Social Security and public financing of benefits. At a time when the country faces significant funding problems with Social Security, there is no sound policy reason to put additional burdens on financing of employee benefits and retirement savings.

In attempting to correct perceived abuses of COLI, the proposal unnecessarily deprives businesses of the legitimate benefits of COLI to protect against business interruption, loss of a key employee, or to fund employee benefits. The COLI proposal is overly broad and imposes restrictions far beyond those needed to address any perceived abuse. If there are abuses to be corrected, they should be addressed in a more narrow manner.

(5) COLI Proposal is Inconsistent with Well-founded Savings and Retirement Policies

At the very same time that the President and Congress are calling for more tax incentives for personal savings and directing attention to the impending retirement security crisis, the President is proposing a provision that would ultimately reduce personal savings.

The President and Congress have repeatedly called for new long-term savings provisions (*e.g.,* Universal Savings Accounts (USAs), ROTH 401(k)s) and expansions of existing savings provisions (*e.g.,* increases in traditional IRA limits, Roth IRAs limits, and 401(k) limits). By indirectly "taxing" life insurance which funds retirement and benefit programs, the COLI proposal moves in the complete opposite direction of such efforts. By undermining these initiatives, the COLI proposal stands out as a stark example of inconsistent and contradictory tax and retirement policy.

Moreover, the President's COLI proposal will harm retirement savings initiatives and have an overall negative impact on the National savings rate in the United States.

VI. CONCLUSION

Like last year, we urge the Committee to again reject in its entirety the Administration's COLI proposal. The proposal is seriously flawed, inequitable, overly broad, and unjustified. It negatively impacts life insurance policyholders and the entire insurance industry, including insurance companies and agents across the United States. Moreover, it goes well beyond any perceived abuses raised by the Administration. It was rejected by Congress last year and should be rejected again.

We would be happy to provide the Committee with additional information about the legitimate business uses of life insurance at any time.

STATEMENT OF THE MASSACHUSETTS MUTUAL LIFE INSURANCE COMPANY

Massachusetts Mutual Life Insurance Company is the eleventh largest life insurance company in the United States, doing business throughout the nation. The Company offers life and disability insurance, deferred and immediate annuities, and pension employee benefits. Through its affiliates, Massachusetts Mutual offers mutual funds and investment services. The Company serves more than two million policyholders nationwide and, with its affiliates, has more than $175 billion in assets under management. Massachusetts Mutual is deeply concerned about the Administration's renewed attack on cash value life insurance and annuities. The Administration would seriously impair the ability of families and businesses to make reasonable provisions for retirement and survivor needs. We appreciate the opportunity to offer testimony concerning the Administration's proposals.

BUSINESS OWNED LIFE INSURANCE

The Administration has renewed its proposal to penalize businesses that hold cash value life insurance, a proposal that Congress rejected last year after extensive review. This year, the Administration has tried to categorize business life insurance as a tax shelter that provides unwarranted benefits to business entities. However, in the Administration's own terms, the definition of a tax shelter does not include any "tax benefit clearly contemplated by the applicable provision" of current tax law. Over the past few years, Congress has repeatedly examined the tax treatment of business life insurance. The current rules are a direct product of that analysis. Congress clearly considered the tax benefits for business life insurance when it passed the recent amendments to the applicable provisions of the Internal Revenue Code. In reality, the Administration proposal is an attack on the inside build-up of policy values.

Congress has already eliminated the use of life insurance for tax arbitrage. Congress has created appropriate and effective limitations on the ability of a business

entity to deduct interest on debt when it holds cash value life insurance. Following amendments enacted in 1996, federal law allows a business to take an interest deduction for loans against only those insurance policies covering the life of either a 20% owner of the business or another key person. No more than 20 individuals may qualify as key persons and the business can deduct interest on no more than $50,000 of policy debt per insured life. A special rule grandfathers policies issued before June 21, 1986. The 1997 tax act then limited the interest a business can deduct on its general debt if the business also has cash value life insurance on a person other than its employee, officer, director or 20% owner (or a 20% owner and spouse). To determine its allowable interest deductions, a business must reduce its general debt proportionately to take into consideration the unborrowed cash values in policies it holds on insureds not covered by these exceptions. This "pro rata" disallowance rule applies to policies issued or materially changed after June 8, 1997.

The President's budget proposals would destroy the carefully crafted limitations set by the 1996 and 1997 amendments to the Internal Revenue Code. The Administration would extend the pro rata disallowance rule to all business owned life insurance policies except those covering 20% owners. Although the Treasury Report and the Joint Committee explanation are ambiguous on the subject, the report issued by the OMB indicates that the Administration would also eliminate the interest deduction for loans against any policies other than those insuring 20% owners of the business. In addition, the Administration would not grandfather policies that were purchased under prior laws.

The proposals would make cash value life insurance prohibitively expensive for all businesses. By excepting only policies that insure 20% owners, the Administration ignores the fact that business life insurance serves many legitimate, non-tax purposes. Certainly, life insurance provides a means for businesses to survive the death of an owner, offering immediate liquidity for day-to-day maintenance of the business or the funds to purchase the decedent's interest from heirs who are unwilling or incapable of continuing the business. The Administration has declared that an exception for policies insuring 20% owners would adequately protect the legitimate business use of cash value life insurance. Nevertheless, despite the Administration's unsupported assertions, the purchase of life insurance to fund business buy-outs is not the sole legitimate use of business insurance. Businesses employ life insurance for many other equally meritorious purposes.

A business must protect itself from the economic drain and instability caused by the loss of any major asset. More than any machinery, realty or tangible goods, the talents of its key personnel sustain a business as a viable force in the economy. Life insurance provides businesses with the means to protect the workplace by replacing revenues lost on the death of a key person and by offsetting the costs of finding and training a suitable successor. Businesses use life insurance to provide survivor and post-retirement benefits to their employees, officers and directors. As part of a supplemental compensation package, these benefits help attract and retain talented and loyal personnel, the very individuals who are crucial to the ongoing success of any business. The Administration proposal would significantly increase the cost for a business to protect itself or to provide benefits. In fact, the Administration would penalize businesses for providing even a split-dollar life insurance plan to assist employees in providing for the security of their families.

In 1996, Congress revised the rules for deducting interest on policy loans to impose limits on the number of insureds and the amount of policy debt. Businesses need to retain the ability to borrow against policies on their key persons without incurring a tax penalty. Buying key person insurance makes sound business sense, but it requires a long-term commitment of capital. The business policyholder must have the flexibility to borrow against such policies in times of need without adverse tax consequences. The current key person exception is especially important to smaller businesses that have less access to alternative sources of borrowing. The rules enacted in 1996 have successfully curtailed the abusive sale of life insurance for tax leverage.

Two years ago, Congress examined the tax treatment of general debt where a business also happened to hold cash value life insurance. Based on this review, it created a tax penalty for businesses that hold life insurance on their debtors, customers or any insureds other than their employees, officers, directors or 20% owners. Last year, as part of its fiscal year 1999 budget, the Administration proposed extending the penalty to all business life insurance policies other than those covering 20% owners. Congress re-examined the treatment of unrelated business debt and rejected the Administration's proposal last year. Now, the Administration has submitted the same proposal, with no better tax policy justification than it has offered in the past.

The legitimate needs for workplace protection insurance have not altered in the past three years. Nor will the business need for life insurance simply disappear if the pro rata disallowance rule is extended to policies covering employees, officers and directors. However, the resulting cost for businesses will increase if they cannot deduct interest on their general debt because they also hold cash value life insurance. The pro rata rule disallows that part of a business' interest deduction which is in the same proportion to its total interest deduction as the unborrowed cash values of policies it holds are to its total assets. As a result, the Administration proposal would most seriously hurt smaller businesses with higher debt to asset ratios and service companies that hold fewer assets but depend on their personnel for their economic well being. In effect, these businesses which rely more heavily on the contributions and talents of their workforce will incur a heavier financial burden if they try to insure against the risk of losing key personnel or if they try to provide employee benefits. Term insurance does not provide businesses with a reasonable alternative to cash value insurance. While often appropriate for temporary arrangements, term insurance is both costly and unsuitable for long-range needs. The loss of interest deductions on unrelated borrowing is an exceedingly harsh punishment to impose on a business for taking prudent financial measures to protect its valuable human assets or to provide benefits for its employees and retirees.

Congress has repeatedly examined the tax treatment of business owned life insurance. Amendments it has passed in the last several years have effectively curtailed the use of life insurance for tax arbitrage. There is no reason to change the rules yet again. There is no justification for the Administration's proposal to penalize businesses that purchase cash value life insurance to safeguard their own well being or to provide benefits for their workforce. Businesses use life insurance for legitimate purposes. Like any other taxpayer, a business also needs some stability in the tax law in order to make long-term plans for its own financial welfare and that of its employees. The Administration would have Congress revisit the tax treatment of business life insurance, for the fourth time in four years, with the express purpose of removing the carefully crafted rules set in the 1996 and 1997 tax acts.

MULTIPLE-EMPLOYER WELFARE BENEFIT PLANS

Internal Revenue Code Section 419A prescribes the requirements under which an employer can deduct contributions to a multiple-employer plan that provides certain welfare benefits for participating employees. For any employer to secure the deduction, the plan must involve ten or more employers and must meet certain other restrictions. Among other permissible benefits, multiple-employer plans can provide death benefits for covered employees. The Administration proposes to ban the use of cash value life insurance to provide death benefits under multiple-employer welfare plans.

Essentially, this proposal is nothing more than another attack on the business use of cash value life insurance. The Administration has declared that term insurance would provide adequately for the promised employee benefits. Notwithstanding the Administration's assertions, it is a basic fact that term insurance becomes expensive for long-range needs and for older employees. A business that participates in a multiple-employer plan might prefer term insurance for younger or more mobile employees and permanent insurance for the more mature employees who are expected to remain with the employer. The use of permanent insurance allows the plan to lock in more favorable insurance rates for the latter category of employees. The flexibility to use either term or cash value insurance allows businesses to make appropriate provisions for their various employees. Permanent policies also create a pool of values the plan trustee can access for premium payments when current year contributions to the plan are inadequate to sustain existing levels of coverage.

All assets in a multiple-employer plan must be applied for the benefit of the participating employees. The employers have no right or access to the plan assets. In fact, the existing law imposes a 100% excise tax on any asset or funds reverting to an employer. Therefore, the already specious arguments against a business holding cash value life insurance have no merit when applied to policies in a multiple-employer welfare benefit plan. The business gets no tax shelter for the growth in policy values and cannot leverage the policies' inside build-up either directly or indirectly. Since the insurance must benefit the participating employees, it clearly does not fit within the Administration's characterization of a corporate tax shelter.

Welfare benefit plans covered under Section 419A cannot provide any form of deferred compensation, experience rating or segregation of plan assets by individual employers. The Internal Revenue Service currently has the authority to regulate welfare benefit plans in order to deny employers any tax deduction for contributions to abusive arrangements. That abuses exist with welfare benefit plans is a fact, as

illustrated in several recent court cases. That the Service has not exercised its regulatory authority is, however, another fact. The solution to any abuses is not for Congress to legislate against the use of a particular form of life insurance but for the Service to establish clear guidelines for multiple employer plans.

DAC TAX

In 1990, Congress passed Internal revenue Code Section 848, requiring insurers to capitalize and amortize the acquisition costs arising from the sale of certain non-pension life insurance, annuity and other insurance products. Rather than identify actual acquisition costs, Section 848 employs a proxy method to determine the portion of otherwise deductible life company expenses an insurer must capitalize. Known as the "DAC" tax (for deferred acquisition costs), the proxy method uses as its base set percentages of the premium collected for different types of contracts. The rate for annuities is 1.75% of premium and, for individual life insurance, the rate is 7.70%. To compute the amount of general deductions that it must capitalize rather than deduct currently, an insurance company would then total the relevant percentages of the premiums it received. Capitalized amounts are generally amortized over 10 years, using a half year convention: i.e., of the amount capitalized, the insurer would deduct 5% in the year of capitalization, 10% in each of the next 9 years, and 5% in the following year. Small insurers get a corresponding 5-year amortization.

The Clinton Administration proposes significant increases to the DAC rates for annuities and cash value life insurance. The annuity rate would rise to 4.25% for the first five years, and to 5.15% thereafter. For permanent life insurance, the rate would jump to 10.50% for the first five years and to 12.85% thereafter. These proposed increases are draconian and would significantly impede the ability of insurers to compete in the financial market. Moreover, the owners of annuities and cash value life insurance policies would ultimately bear the burden of the higher DAC rates. The steep rise in the DAC rates would inevitably increase the cost for policyholders who use life insurance as a safety net or annuities as a safeguard against outliving their assets. The Administration proposal, which would increase the cost for policyholders to provide for their retirement and survivor needs, is inconsistent with its stated goal of encouraging taxpayers to take responsibility for their financial well being.

When enacted, the DAC tax imposed a major tax increase on the life insurance industry, raising by approximately 50% the aggregate tax paid by the industry at the time. The 5-year revenue estimate was $8 billion, while the industry tax bill at the time ranged from $3 to $3.5 billion per year. The Administration's current proposal would turn an already significant tax into a punitive economic burden.

The DAC provision represents a very arbitrary and costly addition to the tax burden on the life insurance industry and its customers. Despite its name and stated intent, the DAC tax focuses not on company acquisition expenses but rather on gross premium receipts. The fact that an insurer's successful efforts to control or reduce expenses have no effect on its DAC capitalization highlights the arbitrary nature of the tax. The proxy bears no relation to the company's actual acquisition costs, particularly in the current financial environment when costs are dropping significantly throughout the industry. Purportedly targeting acquisition costs, Section 848, in reality, taxes gross revenue. With a base of total premium rather than first year premium, the DAC tax targets gross revenues.

Moreover, the DAC provision ignores the fact that the federal tax system already imposes a proxy capitalization requirement. Insurers must also reduce their reserve deductions by a formula that effectively amortizes policy acquisition costs. In effect, insurers suffer a double hit. They must use a lower reserve deduction to take into account acquisition costs and they must also defer deductions for deemed "acquisition" costs.

Increased taxes on the premiums insurers receive will raise the price of insurance products and make it more difficult for consumers to protect their survivors and provide for retirement needs. In pricing life insurance, a common industry practice is to charge for DAC as if it were another premium tax, but in the 1–1½% range, a method that reflects the DAC cost to the insurer. This one component of the federal income tax ultimately costs policyholders more than half of the total state tax imposed on life insurance purchases. The Administration proposal would increase this cost to more than the total state tax cost. When Congress is looking for ways to encourage personal savings, it makes no sense to increase taxes on annuities and life insurance, products designed specifically for long-term financial planning.

The Administration would justify the significant increase in the DAC rates as a means to guarantee that life insurers pay their fair share of federal income taxes.

Contrary to widespread misperception, the life insurance industry is already a substantial federal taxpayer. As measured by a Coopers & Lybrand study done for the American Council of Life Insurance, the average effective tax rate for U.S. life insurers was 31.9% over the 10-year period of 1986–1995. The effective tax rate for all U.S. corporations for that same period was only 25.3%. In fact, the Coopers & Lybrand study reveals that life insurers' effective tax rate rose from 23.9% in the 1986–1990 period to 37.1% for the period 1991 through 1995. The hefty increase in the effective tax rate resulted primarily from the enactment of the DAC provision. The current DAC tax on premiums hurts the life insurance industry in competing with other financial intermediaries for savings dollars. Surely, no increase in this tax is warranted.

CONCLUSION

The revenue provisions contained in the President Clinton's budget for fiscal year 2000 would drastically increase the tax burden on life insurers and their policyholders. The Administration would penalize businesses for using cash value life insurance to provide for their own financial protection and to extend benefits for their workforce. Congress has recognized the legitimate business use of permanent life insurance and, in the past few years, crafted a careful set of rules to eliminate the potential use of insurance as a tax arbitrage. The Administration would now overturn all those rules it so recently signed into law, not because of any discernible abuse but because it deems the purchase of cash value life insurance to be an inappropriate use of business funds. The proposed ban on cash value life insurance in multiple employer plans would deprive a business of the discretion to determine the most reasonable funding for its long-term employee benefits. Finally, the proposed changes in DAC rates would increase the tax burden on an industry that is already heavily taxed, diminish that industry's competitiveness in the financial market, and raise the consumer cost of products best suited to encourage savings and responsible planning for inevitable future needs. With projected budget surpluses, it is inconceivable that the Administration would seek to raise substantial taxes from an industry uniquely qualified to help families and businesses provide for their financial security.

STATEMENT OF MERRILL LYNCH & CO., INC.

Merrill Lynch is pleased to provide this written statement for the record of the April 27, 1999 hearing of the Committee on Finance on "Revenue Raising Proposals in the Administration's Fiscal Year 2000 Budget."[1]

I. INTRODUCTION

Merrill Lynch believes that a strong, healthy economy will provide for increases in the standard of living that will benefit all Americans as we enter the challenges of the 21st Century. Investments in our nations future through capital formation will increase productivity enabling the economy to grow at a healthy rate. Merrill Lynch is, therefore, extremely supportive of fiscal policies that raise the United States savings and investment rates. For this reason, Merrill Lynch has been a strong and vocal advocate of policies aimed to balance the federal budget. Merrill Lynch applauds the efforts of this Congress to finally reach the commendable goal of balancing the budget.

While Merrill Lynch applauds the efforts of many to balance the federal budget, it is unfortunate that some of the tax changes proposed by the Administration in its FY 2000 Budget would raise the costs of capital and discourage capital investment—policies contradictory to the objective of a balanced budget. The Administration's FY 2000 Budget contains a number of revenue-raising proposals that would raise the cost of financing new investments in plant, equipment, research, and other job-creating assets. This will have an adverse effect on the economy.

Moreover, many of these proposals have previously been fully considered and rejected out-of-hand by Congress. On many prior occasions, Merrill Lynch has spoken out against the negative impact such proposals would have on our Nation.

Based on concerns raised by Merrill Lynch and other serious concerns, many of the capital market proposals which the Administration is now reproposing were rejected outright in prior years by Congress. We see no legitimate reason to now reconsider these unsound policies.

The U.S. enjoys the world's broadest and most dynamic capital markets. These markets allow businesses to access the capital needed for growth, while providing investment vehicles individuals can rely on to secure their own futures. Our pre-

eminent capital markets have long created a competitive advantage for the United States, helping our nation play its leading role in the global economy. In a period of record budget surplus, the last thing Congress should be considering are more taxes on the capital markets.

Merrill Lynch remains seriously concerned about the damage the Administration's proposals could cause to the capital-raising activities of American business and the investments these companies are making for future growth. Merrill Lynch believes these proposals are anti-investment and anti-capital formation. If enacted, they would increase the cost of capital for American companies, thereby harming investment activities and job growth.

Unfortunately, the Administration's proposals would servc to limit the financing alternatives available to businesses, harming both industry and the individuals who invest in these products. Merrill Lynch believes this move by the Administration to curtail the creation of new financial options runs directly counter to the long-run interests of our economy and our country.

Moreover, there is no policy consistency to many of the Administration's proposals. In many cases, they are a "one-way" street which results in a "heads I win, tails you lose" type standard. By creating anti-taxpayer results on one-side of a transaction, without applying the same rules to the other side of the transaction, the Administration creates further inequities in the Code and erodes voluntary compliance with the tax system.

While Merrill Lynch is opposed to all such proposals in the Administration's FY 2000 Budget,[2] our comments in this written statement will be limited to the proposals that:

• Defer original issue discount deduction on convertible debt. This proposal would place additional restrictions on the use of hybrid preferred instruments and convertible original issue discount ("OID") bonds and would defer the deduction for OID and interest on convertible debt until payment in cash (conversion into the stock of the issuer or a related party would not be treated as a "payment" of accrued OID). This proposal is nearly identical to ones proposed by the Administration in its FY '97, FY '98, and FY '99 budget plans, which were repeatedly rejected by Congress.

• Eliminate the dividends-received deduction ("DRD") for certain preferred stock. This proposal would deny the 70- and 80-percent DRD for certain types of preferred stock. The proposal would deny the DRD for such "nonqualified preferred stock" where: (1) the instrument is putable; (2) the issuer is required to redeem the securities; (3) it is likely that the issuer will exercise a right to redeem the securities; or (4) the dividend on the securities is tied to an index, interest rate, commodity price or similar benchmark. This proposal is also nearly identical to ones proposed in previous budgets, which were also repeatedly rejected by Congress.

Hereinafter these proposals will be referred to as the "Administration's proposals."

To be clear, these proposals are *not* "loopholes" or "corporate tax shelters." They are fundamental changes in the tax law that will increase taxes on savings and investment. They do little more than penalize middle-class Americans who try to save through their retirement plans and mutual funds. Rather than being a hit to Wall Street, as some claim, these proposals are a tax on Main Street—a tax on those who use capital to create jobs all across America and on millions of middle-class individual savers and investors.

It is unfortunate that the Treasury has chosen to characterize these proposals as "unwarranted corporate tax subsidies" and "tax loopholes." The fact is, the existing tax debt/equity rules in issue here have been carefully reviewed—some for decades—by Treasury and Internal Revenue Service ("IRS") officials, and have been deemed to be sound tax policy by the courts. Far from being "unwarranted" or "tax loopholes," the transactions in issue are based on well established rules and are undertaken by a wide range of the most innovative, respected, and tax compliant manufacturing and service companies in the U.S. economy, who collectively employ millions of American workers.

Merrill Lynch urges Congress to get past misleading "labels" and weigh the proposals against long standing tax policy. Under such analysis, these proposals will be exposed for what they really are—nothing more than tax increases on Americans.

Merrill Lynch believes that these proposals are ill-advised, for four primary reasons:

• *They Will Increase The Cost of Capital, Undermining Savings, Investments, and Economic Growth.* While Treasury officials have stated their tax proposals will primarily affect the financial sector, this is simply not so. In reality, the burden will fall on issuers of, and investors in, these securities—that is, American businesses and individuals. Without any persuasive policy justification, the Administration's proposals would force companies to abandon efficient and cost-effective means of fi-

nancing now available and turn to higher-cost alternatives, and thus, limit productive investment. Efficient markets and productive investment are cornerstones to economic growth.

- *They Violate Established Tax Policy Rules.* These proposals are nothing more than *ad hoc* tax increases that violate established rules of tax policy. In some cases, the proposals discard tax symmetry and deny interest deductions on issuers of debt instruments, while forcing holders of such instruments to include the same interest in income. Disregarding well-established tax rules for the treatment of debt and equity only when there is a need to raise revenue is a dangerous and slippery slope that can lead to harmful tax policy consequences.
- *They Will Disrupt Capital Markets.* Arbitrary and capricious tax law changes have a chilling effect on business investment and capital formation. Indeed, the Administration's proposals have already caused significant disruption in capital-raising activities, as companies reevaluate their options.
- *They Will Fail to Generate Promised Revenue.* The Administration's proposals are unlikely to raise the promised revenue, and could even lose revenue. Treasury's revenue estimates appear to assume that the elimination of the tax advantage of certain forms of debt would cause companies to issue equity instead. To the contrary, most companies would likely move to other forms of debt issuance—ones that carry higher coupons and therefore involve higher interest deductions for the issuer.

At a time when the budget is balanced and the private sector and the federal government should join to pursue ways to strength the U.S. economy, the Administration has proposed tax law changes that would weaken the economy by disrupting capital-raising activities across the country. Merrill Lynch strongly urges the Administration and Congress to set aside these proposals. Looking forward, Merrill Lynch would be delighted to participate in full and open discussions on the Administration's proposals, so that their ramifications can be explored in depth.

The following are detailed responses and reaction to three of the Administration's proposals that would directly affect capital-raising and investment activities in the U.S.

II. PROPOSAL TO DEFER OID DEDUCTION ON CONVERTIBLE DEBT

The Administration's FY 2000 Budget contains proposals that would defer the deduction for original issue discount ("OID") until payment and deny an interest deduction if the instrument is converted to the stock of the issuer or a related party. These proposed changes to fundamental tax policy rules relating to debt and equity come under two separate (but related) proposals. Similar proposals were proposed and rejected by Congress a number of times in the past three years.

One proposal, among other things, defers OID on convertible debt. The only stated "Reasons for Change" relating specifically to this proposal is contained in the Treasury Department's "General Explanations of the Administration's Revenue Proposals" (February 1999) (the "Green Book"):

> "In many cases, the issuance of convertible debt with OID *is viewed by market participants as a de facto purchase of equity.* Allowing issuers to deduct accrued interest and OID is inconsistent with this market view."

This is the same justification used in Treasury's 1997 and 1998 Green Book and rejected by Congress.

Merrill Lynch strongly opposes the Administration's proposal to defer deductions for OID on Original Issue Discount Convertible Debentures ("OIDCDs") for a number of reasons more fully described below. To summarize:

- The Treasury's conclusion that the marketplace treats OIDCD as de facto equity is erroneous and inconsistent with clearly observable facts;
- In an attempt to draw a distinction between OIDCDs and traditional convertible debt, Treasury has in prior years misstated current law with regard to the deduction of accrued but unpaid interest on traditional convertible debentures, and apparently continues to rely on such misstatements;
- The proposal ignores established authority that treats OIDCDs as debt, including guidance from the IRS in the form of a private letter ruling;
- The proposed elimination of deductions for OID paid in stock is at odds with the tax law's general treatment of expenses paid in stock;
- The proposal would destroy the symmetry between issuers and holders of debt with OID. This symmetry has been the pillar of tax policy regarding OID. The Administration offers no rationale for repealing this principle;
- The proposal disregards regulations adopted after nearly a decade of careful study by the Treasury and the Internal Revenue Service. Consequently, the Administration's proposal would hastily reverse the results of years of careful study;

• While billed as a revenue raiser, it is clear that adoption of the Administration's proposal would in fact reduce tax revenue; and

• Finally, this proposal has been fully considered by Congress and rejected a number of times in prior years.

A. Treasury's Conclusion That The Market Treats OIDCD As De Facto Equity Is Erroneous And Inconsistent With Clearly Observable Facts.

The proposal is based on demonstrably false assumptions about market behavior, which assumptions are also inconsistent with clearly observable facts. *There is no uncertainty in the marketplace regarding the status of OIDCDs as debt.* These securities are booked on the issuers' balance sheets as debt, are viewed as debt by the credit rating agencies, and are treated as debt for many other legal purposes, including priority in bankruptcies. In addition, zero coupon convertible debentures are typically sold to risk averse investors who seek the downside protection afforded by the debentures. Thus, both issuers and investors treat convertible bonds with OID as debt, not equity. Accordingly, *it is clear that the market's "view" supports the treatment of OIDCD as true debt for tax purposes.*

Treasury makes clear that its proposal would not affect "typical" convertible debt on the grounds that the "typical" convertible debentures are not certain to convert. Because OIDCDs have been available in the market place in substantial volume for over ten years, it is possible to compare the conversion experience of so-called "typical" convertible debentures with the conversion experience of OIDCDs, nearly all of which have been zero coupon convertible debt. The data shows that "typical" convertible debentures are much more likely to convert to equity, that is, to be paid off in stock, than zero coupon convertible debentures.

The instruments in question are truly debt rather than equity. An analysis of 97 liquid yield option notes ("LYONs") sold in the public market between 1985 and 1998, shows that 57 of those issued had already been retired (as of December 1997). Of those 57, only 15 were finally paid in stock. The other 42 were paid in cash. The remaining 40 of the 97 issues were still outstanding as of December 31, 1997. If those 40 securities were called, only 19 of them would have converted to stock and the other 21 would have been paid in cash. In other words, the conversion features of only 19 of the 40 issues remaining outstanding are "in the money." Overall, only 35% of the public issuances of LYONs had been (or would be if called) paid in stock. Thus, in only 35% of these OIDCD issuances had the conversion feature ultimately controlled.

On the other hand, an analysis of 669 domestic issues of "typical" convertible debt retired since 1985 shows just the opposite result (as of December 1997). Seventy-three percent (73%) of these offerings converted to the issuer's common stock. Accordingly, based on historical data, typical convertible debt is significantly more likely to be retired with equity than cash, as compared to LYONs.

The Treasury's proposal is clearly without demonstrable logic. It makes no sense to say that an instrument that has approximately a 30% probability of converting into common stock is "viewed by market participants as a de facto purchase of equity," and therefore, the deduction for OID on that instrument should be deferred (or denied), while an instrument that has over a 70% probability of conversion should be treated for tax purposes as debt.[3] We would be happy to provide this data, and any other relevant information, to the Administration and Congress.

B. Prior Misstatements of Current Law Continue to Be Relied Upon

In prior year's Budget proposals, Treasury's has made statements of "Current Law," which apparently continue to be relied upon in its FY 2000 Budget. These statements misstate the law regarding interest that is accrued but unpaid at the time of the conversion. The Treasury has in the past suggested that the law regarding "typical" convertible debt is different from the law for convertible debt with OID. This is clearly not the case. Both the Treasury's own regulations and case law require that stated interest on a convertible bond be treated the same as OID without regard to whether the bondholder converts.

When the Treasury finalized the general OID regulations in January, 1994 (T.D. 8517), the Treasury also finalized Treasury Regulations section 1.446–2 dealing with the method of accounting for the interest. The regulations state:

> "Qualified stated interest (as defined in section 1.1273–1(c)) accrues ratably over the accrual period (or periods) to which it is attributable and accrues at the stated rate for the period (or periods)." See, Treas. Reg. Section 1.446–2(b).

All interest on a debt obligation that is not OID is "qualified stated interest." Treasury regulations define "qualified stated interest" under Treas. Reg. Section 1.1273–1(c) as follows:

(i) In general, qualified stated interest is stated interest that is unconditionally payable in cash or in property . . . or that will be constructively received under section 451, at least annually at a single fixed rate . . .

(ii) Unconditionally payable . . . *For purposes of determining whether interest is unconditionally payable, the possibility of a nonpayment* due to default, insolvency or similar circumstances, or *due to the exercise of a conversion option described in section 1272–1(e) is ignored.* This applies to debt instruments issued on or after August 13, 1996 (emphasis added).

Thus, according to the Treasury's own regulations, fixed interest on a convertible bond is deductible as it accrues without regard to the exercise of a conversion option. The Treasury's suggestion to the contrary in the description of the Administration's proposal contradicts the Treasury's own recently published regulations.

In addition, case law from the pre-daily accrual era established that whether interest or OID that is accrued but unpaid at the time an instrument converts is an allowable deduction depends on the wording of the indenture. In *Bethlehem Steel Corporation* v. *United States,* 434 F.2nd 1357 (Ct. Cl. 1971), the Court of Claims interpreted the indenture setting forth the terms of convertible bonds and ruled that the borrower did not owe interest if the bond converted between interest payment dates. The Court merely interpreted the indenture language and concluded that no deduction for accrued but unpaid interest was allowed because no interest was owing pursuant to the indenture. The Court stated that if the indenture had provided that interest was accrued and owing, and that part of the stock issued on conversion paid that accrued interest, a deduction would have been allowed. The indentures controlling all of the public issues of zero coupon convertible debt were written to comply with the *Bethlehem Steel* court's opinion and thus, the indentures for all of these offerings provide that if the debentures convert, part of the stock issued on conversion is issued in consideration for accrued but unpaid OID.

Thus, there is no tax law principle that requires a difference between "typical" convertible bonds and zero coupon convertible deductions. The only difference is a matter of indenture provisions and that difference has been overridden by the Treasury's own regulations.

C. Proposal Ignores Established Authority That Treats OIDCDs As Debt, Including Guidance From The IRS In The Form Of A Private Letter Ruling.

Under current law, well-established authority treats OIDCDs as debt for tax purposes, including guidance from the IRS in the form of a private letter ruling. The IRS has formally reviewed all the issues concerning OIDCDs and issued a private letter ruling confirming that the issuer of such securities may deduct OID as it accrues. See, PLR 9211047 (December 18, 1991). Obviously rather than having not exploited [a] lack of guidance from the IRS, issuers of OIDCDs have relied on official IRS guidance in the form of a private letter ruling. That the IRS issued a ruling on this topic confirms that OIDCDs do not exploit any ambiguity between debt and equity. If any such ambiguity existed the IRS would not have issued its ruling.

D. Proposal Is Inconsistent With The Fundamental Principle That Payment In Stock Is Equivalent To Payment In Cash.

We would now like to focus not on the timing ~~of the~~ deduction but on the portion of the Administration's proposal that would deny the issuer a deduction for accrued OID if ultimately paid in stock. The proposal is inconsistent with the general policy of the tax law that treats a payment in stock the same as a payment in cash. A corporation that issues stock to purchase an asset gets a basis in that asset equal to the fair market value of the stock issued. There is no difference between stock and cash. A corporation that issues stock to pay rent, interest or any other deductible item may take a deduction for the item paid just as if it had paid in cash.

More precisely on point, the 1982 Tax Act added section 108(e)(8)[4] to repeal case law that allowed a corporate issuer to escape cancellation of indebtedness income if the issuer retired corporate debt with stock worth less than the principal amount of the corporate debt being retired. The policy of that change was to make a payment with stock equivalent to a payment with cash. Section 108(e)(8) clearly defines the tax result of retiring debt for stock. As long as the market value on the stock issued exceeds the amortized value of the debt retired, there is no cancellation of indebtedness income. The Administration's proposal to treat payment of accrued OID on convertible debt differently if the payment is made with stock rather than cash is inconsistent with the fundamental rule that payment with stock is the same as payment with cash. The Administration's proposal would create an inconsistency without any reasoned basis.

E. Treasury's Proposal Removes The Long Established Principle Of Tax Symmetry Between Issuers And Holders Of Debt With OID.

As discussed above, the current law is clear that an issuer of a convertible debenture with OID is allowed to deduct that OID as it accrues. The Service's private letter ruling, cited above, confirms this result. It is important to note that the OID rules were originally enacted to ensure proper timing and symmetry between income recognition and tax deductions for tax purposes. Proposals that disrupt this symmetry violate this fundamental goal of tax law.

The Administration's proposal reverses the policy of symmetry between issuers and holders of OID obligations. Since 1969, when the tax law first addressed the treatment of OID, the fundamental policy of the tax law has been that holders should report OID income at the same time that the issuer takes a deduction. The Administration's proposal removes this symmetry for convertible debt with OID. Not only would the holders report taxable income before the issuer takes a deduction, but if the debt is converted, the holders would have already reported OID income and the issuer would never have an offsetting deduction. The Administration does not offer any justification for this unfairness.

F. Treasury's Proposal Is An Arbitrary Attempt To Reverse Tax Policies That Were Adopted After Nearly A Decade Of Careful Study.

The manner in which this legislative proposal was offered is a significant reason to doubt the wisdom of enacting a rule to defer or deny deductions for OID on convertible debentures. When the Treasury issued proposed regulations interpreting 1982 and 1984 changes in the Internal Revenue Code regarding OID, the Treasury asked for comments from the public regarding whether special treatment was necessary for convertible debentures. *See,* 51 Federal Register 12022 (April 18, 1986).

This issue was studied by the Internal Revenue Service and the Treasury through the Reagan, Bush and Clinton Administrations. Comments from the public were studied and hearings were held by the current Administration on February 16, 1993. When the current Treasury Department adopted final OID regulations in January of 1994, the final regulations did not exclude convertible debentures from the general OID rules. After nearly nine years of study under three Administrations and after opportunity for public comment, the Treasury decided that it was not appropriate to provide special treatment for OID relating to convertible debentures. Merrill Lynch suggests that it is not wise policy to reverse a tax policy that Treasury had adopted after nearly a decade of study and replace it with a policy previously rejected by Congress on a number of occasions.

G. Proposal Regarding OID Convertible Debentures Would Reduce Tax Revenue.

While billed as a "revenue raiser," adoption of the Administration's proposal with respect to OIDCDs would in fact reduce tax revenue for the following reasons:

- Issuers of OIDCDs view them as a debt security with an increasing strike price option imbedded to achieve a lower interest rate. This a priori view is supported by the historical analysis of OIDCDs indicating that over 70% have been, or if called would be, paid off in cash.
- If OIDCDs were no longer economically viable, issuers would issue straight debt.
- Straight debt rates are typically 200 to 300 basis points higher than comparable rates. Therefore, issuers' interest deductions would be significantly greater.
- According to the Federal Reserve Board data, at June 30, 1995 over 60% of straight corporate debt is held by tax deferred accounts versus less that 30% of OIDCDs held by such accounts.

Consequently, the empirical data suggests that if OIDCDs are not viable, issuers will issue straight debt with higher interest rates being deducted by issuers and paid to a significantly less taxed holder base. The Administration's proposal would therefore reduce tax revenue while at the same time interfering with the efficient operation of the capital markets.

Giving full consideration to the above data, Merrill Lynch believes rejection of the proposal with respect to OIDCDs is warranted and the reasons for doing so compelling.

III. PROPOSAL TO ELIMINATE THE DRD ON CERTAIN PREFERRED STOCK.

The Administration has proposed to deny the 70-and 80-percent DRD for certain types of preferred stock. The proposal would deny the DRD for such "nonqualified preferred stock" where: (1) the instrument is putable; (2) the issuer is required to redeem the securities; (3) it is likely that the issuer will exercise a right to redeem the securities; or (4) the dividend on the securities is tied to an index, interest rate,

commodity price or similar benchmark. A similar proposal was proposed and rejected by Congress a number of times in the past three years.

It has long been recognized that the "double taxation" of dividends under the U.S. tax system tends to limit savings, investment, and growth in our economy. The DRD was designed to mitigate this multiple taxation, by excluding some dividends from taxation at the corporate level.

Unfortunately, the Administration's proposal to eliminate the DRD on certain stock would significantly undermine this policy. In the process, it would further increase the cost of equity capital and negatively affect capital formation.

From an economic standpoint, Merrill Lynch believes that in addition to exacerbating multiple taxation of corporate income, the Administration's proposal is troubling for a number of reasons and would have a number of distinct negative impacts:

- *Dampen Economic Growth.* If the DRD elimination were enacted, issuers would react to the potentially higher cost of capital by: lowering capital expenditures, reducing working capital, moving capital raising and employment offshore, and otherwise slowing investments in future growth. In particular, American banks, which are dependent on the preferred stock market to raise regulatory core capital, would see a significant increase in their cost of capital and, hence, may slow their business-loan generation efforts.
- *Limit Competitiveness of U.S. Business.* The elimination of the DRD would also further disadvantage U.S. corporations in raising equity vis-à-vis our foreign competitors, especially in the UK, France, and Germany. In these countries, governments have adopted a single level of corporate taxation as a goal, and inter-corporate dividends are largely or completely tax free. As long as American firms compete in the global economy under the weight of a double-or triple-taxation regime, they will remain at a distinct competitive disadvantage.
- *Discriminate Against Particular Business Sectors and Structures.* The Administration's proposal may have a disproportionate impact on taxpayers in certain industries, such as the financial and public utility industries, that must meet certain capital requirements. Certain types of business structures also stand to be particularly affected. Personal holding companies, for example, are required to distribute their income on an annual basis (or pay a substantial penalty tax) and thus do not have the option to retain income to lessen the impact of multiple levels of taxation.
- *Companies Should Not Be Penalized for Minimizing Risk of Loss.* As a result of the Administration's proposal, the prudent operation of corporate liability and risk management programs could result in disallowance of the DRD. Faced with loss of the DRD, companies may well choose to curtail these risk management programs.
- *No Tax Abuse.* In describing the DRD proposal, the Administration suggests that some taxpayers "have taken advantage of the benefit of the dividends received deduction for payments on instruments that, while treated as stock for tax purposes, economically perform as debt instruments." To the extent Treasury can demonstrate that the deduction may be subject to misuse, targeted anti-avoidance rules can be provided. The indiscriminate approach of eliminating the DRD goes beyond addressing inappropriate transactions and unnecessarily penalizes legitimate corporate investment activity.

While the overall revenue impact of the DRD proposal may be positive, Merrill Lynch believes the revenue gains will not be nearly as large as projected, due to anticipated changes in the behavior of preferred-stock issuers and investors.

- *Issuers of Preferred Stock.* Eliminating the DRD will increase the cost of preferred-stock financing and cause U.S. corporations to issue debt instead of preferred stock because of interest deductibility. This overall increase in deductible interest would result in a net revenue loss to Treasury.
- *Secondary Market for Preferred Stock.* Currently, the market for outstanding preferred stock is divided into two segments:

    1. A multi-billion dollar variable-rate preferred stock market where dividends are set via Dutch auctions. The dividend rate on these securities will necessarily increase to adjust for the elimination of the DRD, and may cause some of these issuers to call these preferred securities at par and replace them with debt. This will result in a revenue loss to Treasury.
    2. A multi-billion dollar fixed-rate preferred stock market where the issuing corporations cannot immediately call the securities. Retail investors, who comprise 80% of this market cannot utilize the DRD and therefore pay full taxes on dividends. Hence, there will be no meaningful revenue gains to Treasury from this market segment.

This proposal may also create losses for individual investors. Institutions, which own approximately 20% of all fixed-rate preferred stock, may sell their holdings

given the increased taxation. Individual investors will bear the brunt of any price decline, because they currently account for about 80% of the fixed-rate preferred market. These capital losses, when taken, will offset any capital gains and result in a revenue loss to Treasury.

At a time when U.S. tax policy should be moving toward fewer instances of "double taxation," Merrill Lynch believes it would be a mistake to eliminate the DRD on certain limited-term preferred stock. Any such action will make "triple taxation" even more pronounced in, and burdensome on, our economy.

V. CONCLUSION

Based on the discussion set forth above, Congress should reject the Administration's proposals out of hand. These proposals which include the deferral of legitimate interest deductions and the elimination of the DRD are nothing more than tax increases which raise the cost of financing new investments, plant, equipment, research, and other job-creating assets. These tax increases hurt the ability of American companies to compete against foreign counterparts and are born by the millions of middle-class Americans who try to work and save through their retirement plans and mutual fund investments. These impediments to investment and savings would hurt America's economic growth and continued leadership in the global economy. At a time of budget surpluses, the last thing Congress should be considering are increased taxes on capital markets.

Moreover, from a tax policy perspective, the Administration's proposals are ill-advised, arbitrary and capricious tax law changes that have a chilling effect on business investment and capital formation. Indeed, the Administration's proposals are nothing more than ad hoc tax increases that violate established rules of tax policy. In some cases, the proposals discard tax symmetry and deny interest deductions on issuers of certain debt instruments, while forcing holders of such instruments to include the same interest in income. Disregarding well-established tax rules for the treatment of debt and equity only when there is a need to raise revenue is a dangerous and slippery slope that can lead to harmful tax policy consequences.

The Administration's proposals also are unlikely to raise the promised revenue, and could even lose revenue. Treasury's revenue estimates appear to assume that the elimination of the tax advantage of certain forms of debt would cause companies to issue equity instead. To the contrary, most companies would likely move to other forms of debt issuance—ones that carry higher coupons and therefore involve higher interest deductions for the issuer.

Far from being "unwarranted" or "tax loopholes," the transactions in issue are based on well established rules and are undertaken by a wide range of the most innovative, respected, and tax compliant manufacturing and service companies in the U.S. economy, who collectively employ millions of American workers.

Merrill Lynch urges Congress to get past misleading "labels" and weigh the proposals against long standing tax policy. Under such analysis, these proposals will be exposed for what they really are nothing more than tax increases on Americans.

For all the reasons stated above, the Administration's proposals should *again* be rejected in toto.

ENDNOTES

[1] Merrill Lynch also endorses the comments submitted to the Committee on these provisions by the Securities Industry Association and The Bond Market Association.

[2] Other anti-business, anti-growth proposals include the generic "corporate tax shelter" proposals, the proposal to modify the rules for debt-financed portfolio stock, the proposal to require accrual of the time value element on forward sale of corporate stock and the proposal to increase the proration percentage for property & casualty (P&C) insurance companies. There is no inference of support for proposals not mentioned in this written statement.

[3] Given this data, even if one accepted the Treasury's assertion that probability of conversion in some way governed appropriate tax treatment, the proposal obviously addresses the wrong convertible security.

[4] All section references are to the Internal Revenue Code of 1986, as amended.

JOINT STATEMENT OF THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS AND THE ASSOCIATION FOR ADVANCED LIFE UNDERWRITING

The National Association of Life Underwriters (NALU) and the Association for Advanced Life Underwriting (AALU) submit this statement strongly opposing the Administration's Fiscal Year 2000 budget proposal that imposes new taxes on the business uses of life insurance. NALU represents more than 104,000 life insurance

agents, most of them rank-and-file professionals, around the country. AALU, a conference of NALU, represents those whose businesses focus on specialized life insurance applications in business, employee benefits, and estate planning situations. Together, NALU and AALU represent the interests not only of our more than 100,000 life and health insurance professionals, but also the millions of individuals and businesses that own life insurance.

Currently, thousands of businesses—small and large—own life insurance that protects them and millions of people they employ from major financial hardship resulting from the death of key persons. Business life insurance also enables businesses to attract, retain and provide benefits to current and retired employees. Such critically important and long-standing business uses of life insurance should not be disturbed. We therefore urge Members of the Senate Finance Committee to reject the Administration's proposal, which would effectively eliminate these essential business, job and benefit protections by imposing a major tax disincentive for purchasing life insurance or continuing to keep current policies in force.

ADMINISTRATION'S PROPOSAL IS A BROAD ATTACK ON THE VAST MAJORITY OF THE BUSINESS USES OF LIFE INSURANCE AND UNFAIRLY CATEGORIZES TRADITIONAL USES AS "CORPORATE TAX SHELTERS."

The Administration's proposal would be devastating in its economic effects. Specifically, it would impose a tax penalty—directly based on accumulating cash value—on businesses that own life insurance and have any debt whatsoever. The only exception would be for policies covering 20 percent or greater owners.

For example, consider a small partnership of 10 equal owners. The partnership carries key person insurance on its principal rainmaker. It also has a bank loan, secured by its accounts receivable, taken out to pay for new, updated office equipment. Under the Clinton proposal, this partnership would have to reduce its deduction for interest paid on the office equipment loan just because it carries life insurance on one of its owners. The bank loan for office equipment is in no way connected to the life insurance, yet the deductible interest on that loan is affected by the Clinton proposal. This is inherently unfair. It puts the partnership in a position of having to pay a tax penalty for its decision to carry permanent life insurance for a long-standing, traditional life insurance purpose.

Businesses have the need, at various times, both to own permanent life insurance and to borrow. Given the fact that life insurance represents a long-term investment of perhaps forty years, any automatic tax penalty imposed on businesses that own permanent life insurance and which engage in unrelated borrowing will seriously undermine business uses of life insurance and the benefits that they provide.

Almost as disturbing as the business life insurance proposal itself, is the fact that the proposal is included within the "corporate tax shelter" portion of the Administration's budget. Such common business uses of life insurance as key-person protection, buy-sell agreements, split dollar, deferred compensation and employee benefits serve very important functions and should certainly not be characterized as tax shelters.

The Administration's characterization of the business uses of permanent life insurance as tax shelters may well betray an inappropriate, negative bias against the product. The Administration proposes broadening the definition of what constitutes a tax shelter, but even under this looser standard, the Administration states that a tax shelter does not include "a tax benefit clearly contemplated by the applicable provision." Department of Treasury, General Explanation of the Administration's Revenue Proposals at 96 (February 1999).

It would be hard to argue that the tax attributes of the business uses of life insurance are not clearly contemplated, given the fact that Congress has examined such uses and such tax attributes in each of the past four years, and enacted legislation covering such uses in 1996 and 1997. In fact, in 1997 Congress made a clear decision *not* to apply the tax penalty now proposed, where the life insurance policies cover the lives of officers, directors, employees or twenty or greater percent owners.

CURRENT LAW SETS APPROPRIATE STANDARDS FOR BUSINESS LIFE INSURANCE

In 1996, Congress largely eliminated the ability of businesses to deduct interest on loans associated with life insurance. This general rule applies whether the business borrows directly from a life insurance policy or borrows indirectly by pledging the life insurance policy as collateral for a loan. It also applies if there is a demonstrable connection between the decision to purchase life insurance and the decision to borrow and deduct interest.

The only exceptions from this business life insurance loan disallowance are for (1) contracts purchased on or before June 20, 1986 or (2) contracts covering key per-

sons, provided the indebtedness is not greater than $50,000 per insured life and the total number of such persons cannot exceed the greater of (a) 5 or (b) the lesser of (i) 5 percent of total officers and employees or (ii) 20.

In 1997, after a well-publicized intent by Fannie Mae to initiate a multibillion dollar program of purchasing permanent life insurance on the lives of mortgage borrowers, Congress enacted legislation, which for the first time and under very narrow circumstances, disallowed otherwise deductible interest without first requiring a link between the decisions of a business to purchase life insurance and to borrow money.

NALU and AALU did not oppose this legislation because we understood a Congressional disapproval of the expansion of the use of permanent life insurance by businesses beyond a long-established utilization to cover the lives of owners, officers, directors and employees. We appreciated that Congress was surgical in structuring the legislation to prevent a widespread new use of permanent life insurance to cover borrowers, while causing little disturbance to the long-standing ability of businesses to use permanent life insurance to protect themselves, their 20 percent or greater owners, officers, directors and employees and to provide benefits for them. We reluctantly yielded on the point that it's unfair to penalize life insurance ownership because of a business's decision to borrow for reasons and using assets *unrelated* to life insurance. Despite our deeply-rooted conviction that tying insurance ownership to unrelated loan interest is inherently unfair and wrong, we understood Congress' goal was to prevent the expansion of the use of life insurance outside of the employment context.

In 1999, for the second year in a row, the Clinton Administration budget proposal includes a provision which would broadly impose the tax penalty which is now narrowly targeted on business uses of life insurance covering individuals like mortgage borrowers, who are *not* 20 percent or greater owners, officers, directors or employees. Nothing is said in the proposal that would justify this devastating and ill-advised departure. Businesses which utilize permanent life insurance to insure their key persons should not be penalized because they engage in unrelated borrowing.

CURRENT BUSINESS USES OF LIFE INSURANCE WHICH WOULD BE HIT BY THE ADMINISTRATION PROPOSAL

The Administration's proposal would impose a tax penalty on all current and future policyholders, except those covering twenty percent or more owners, and would penalize life insurance used for the following traditional purposes. The examples listed below illustrate why it is essential that the Administration's proposal be rejected:

- Successful continuation of business operations following the death of an insured key employee.

Virtually every business has one or more employees whose production is critical to the business' financial health. It could be key management personnel, or perhaps it is the salesperson who brings in the work for the business to perform. Other examples include those whose jobs demand the creativity of product development, a marketing initiative or a merger or acquisition, the success of which depends heavily on the continued personal involvement of these individuals. Or it may be the extra-skilled technician who knows how to work the crucial computer or manufacturing system that is the heart of the business' performance.

There are many situations in which such individuals are *not* twenty or greater percent owners.

When one or more of these individuals die, the business faces the enormous cost of replacing these workers' individual skills. During the time when a replacement is sought and during the "learning curve" period when the new worker(s) get up to speed, the firm is likely to lose both new business and productivity with respect to existing business. In this so-called "key person" scenario, it is this measurable loss that life insurance death benefits replace.

- Purchase of a business interest, thereby enabling the insured's family to obtain a fair value for its business interest and permitting the orderly continuation of the business by its new owners or the redemption of stock to satisfy estate taxes and transfer costs of an insured stockholder's estate.

Life insurance protects businesses against the financial devastation that occurs when one of several business owners dies. The buy-sell or stock redemption involves the use of life insurance to pay the decedent owner's heirs the decedent's ownership interest. This avoids the use of business assets—which may not be in liquid form—to meet this obligation. Without the use of business life insurance for these purposes, either the decedent's heirs will become potentially active participants in the business as they exercise their new ownership rights, or—in the worst case—the

business itself might have to be sold in order to satisfy the financial obligation to the decedent owner's heirs.

In each of these scenarios, the existence of death benefits could very well spell the difference between the continued operation of the business and its failure. The continued operation of the business, of course, means the continuation of the jobs that the business provides to its employees, and the continuation of the business's impact on other businesses in the community. It also means that the business will continue to pay its income taxes to the Federal and state governments and contribute to our overall economic growth.

As with the case of key person insurance, there are many needs for a business to utilize life insurance for buy-sell or stock redemption purposes, which involve owners who have less than a twenty percent interest in the entity.

• Creation of funds to facilitate benefit programs for long-term current and retired employees, such as programs addressing needs for retirement income, post-retirement medical benefits, disability income, long-term care or similar needs. Payment of life insurance or survivor benefits to families or other beneficiaries of insured employees. Facilitation of employee ownership of and benefits from permanent life insurance death and retirement income protection through split dollar arrangements.

The success of any business is contingent on attracting and retaining the employees that it needs, through appropriate compensation and benefit packages. This can be particularly difficult in situations addressed by the Administration's proposal—individuals who have no ownership interest or an interest of less than twenty percent. Life insurance, through the above means, provides effective ways for businesses to hire and retain a high quality workforce. Providing employee benefits is especially difficult for small businesses, and life insurance offers the flexibility and cost feasibility that makes it possible.

CONCLUSION

In conclusion, NALU and AALU urge Congress to reject the Administration's misconceived proposal on business life insurance. The business use of life insurance is *not* a tax shelter; it protects businesses against the loss of key persons, provides for the orderly continuation of businesses and facilitates the ability of businesses to attract and retain quality employees.

Thank you.

STATEMENT OF THE NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

As requested in Press Release No. 106–100 (April 20, 1999), the National Association of Real Estate Investment Trusts® ("NAREIT") respectfully submits these comments in connection with the Committee on Finance's review of certain revenue provisions presented to the Committee as part of the Administration's Fiscal Year 2000 Budget.

NAREIT's comments address the Administration proposals to (1) modify the real estate investment trust ("REIT") asset tests to permit REITs to own taxable REIT subsidiaries; (2) modify the treatment of closely held REITs; and (3) amend section 1374[1] to treat an "S" election by a large C corporation as a taxable liquidation of that C corporation. We appreciate the opportunity to present these comments.

NAREIT is the national trade association for real estate companies. Members are REITs and other publicly-traded businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses. REITs are companies whose income and assets are mainly connected to income-producing real estate. By law, REITs regularly distribute most of their taxable income to shareholders as dividends. NAREIT represents over 200 REITs or other publicly-traded real estate companies, as well as over 2,000 investment bankers, analysts, accountants, lawyers and other professionals who provide services to REITs.

EXECUTIVE SUMMARY

Taxable REIT Subsidiaries. NAREIT welcomes the Administration's taxable REIT subsidiary proposal as a very significant step in the right direction to modernize the REIT rules. Current law requires REITs to use awkward methods in order to provide services to third parties, and also prevents REITs from remaining competitive in providing needed and emerging services to their tenants. The taxable REIT subsidiary structure would codify, yet simplify, the current law structure, while simul-

taneously allowing a REIT to provide new services to its tenants so long as these services are subject to a corporate level tax.

As an alternative to the Administration's REIT subsidiary proposal, NAREIT recommends that Congress enact the Real Estate Investment Trust Modernization Act of 1999 being drafted by Senators Mack and Graham (the "Mack/Graham Bill"). The Mack/Graham Bill would incorporate the principles of the Administration proposal, with four significant exceptions. First, the Mack/Graham Bill would require taxable REIT subsidiaries to fit within the current, unified 25 percent asset test, rather than the complex and cumbersome 5 and 15 percent assets tests under the Administration proposal. Second, the Mack/Graham Bill would limit interest deductions on debt between a REIT and its taxable subsidiary in accordance with the current earnings stripping rules of section 163(j), whereas the Administration would eliminate even a reasonable amount of intra-party interest deductions. Third, the Mack/Graham Bill would prohibit a taxable REIT subsidiary from operating or managing hotels, while allowing a subsidiary to lease a hotel from its affiliated REIT so long as (a) the rents are set at market levels, and (b) the rents are not tied to net profits, and (c) the hotel is operated by an independent contractor. Fourth, the Mack/Graham Bill would not apply the new rules on taxable REIT subsidiaries to current arrangements so long as a new trade or business is not engaged in and substantial new property is not acquired, unless the REIT affirmatively elects taxable REIT subsidiary status. Conversely, the Administration proposal would apply to current arrangements after an undefined period of time.

Closely Held REITs. NAREIT supports the Administration's intention to craft a new ownership test intended to correspond to a REIT's primary mission: to make investment in income-producing real estate accessible to ordinary investors. However, we believe that the Administration's proposal is too broad, and therefore should be narrowed to prevent non-REIT C corporations from owning 50 percent or more of a REIT's stock (by vote or value). In addition, the new rules should not apply to so-called "incubator REITs" that have proven to be a viable method by which ordinary investors can access publicly traded real estate investments.

Built-in Gain Tax. Congress has rejected the Administration's call for a change in the section 1374 rules for three straight budgets. NAREIT recommends that Congress again reject this proposal. We also ask Congress to conduct oversight of the IRS to ensure that it does not do administratively what it has not been able to achieve by legislation.

BACKGROUND ON REITS

A REIT is essentially a corporation or business trust combining the capital of many investors to own and, in most cases, operate income-producing real estate, such as apartments, shopping centers, offices and warehouses. Some REITs also are engaged in financing real estate. REITs must comply with a number of requirements, some of which are discussed in detail in this statement, but the most fundamental of these are as follows: (1) REITs must pay at least 95 percent of their taxable income to shareholders;[2] (2) REITs must derive most of their income from real estate held for the long term; and (3) REITs must be widely held.

In exchange for satisfying these requirements, REITs (like mutual funds) benefit from a dividends paid deduction so that most, if not all, of a REIT's earnings are taxed only at the shareholder level. On the other hand, REITs pay the price of not having retained earnings available to expand their business. Instead, capital for growth, capital expenditures and payment of loan principal largely comes from new money raised in the investment marketplace from investors who have confidence in the REIT's future prospects and business plan.

Congress created the REIT structure in 1960 to make investments in large-scale, significant income-producing real estate accessible to the smaller investor. Based in part on the rationale for mutual funds, Congress decided that the only way for the average investor to access investments in larger-scale commercial properties was through pooling arrangements. In much the same ways as shareholders benefit by owning a portfolio of securities in a mutual fund, the shareholders of REITs can unite their capital into a single economic pursuit geared to the production of income through commercial real estate ownership. REITs offer distinct advantages for smaller investors: greater diversification through investing in a portfolio of properties rather than a single building and expert management by experienced real estate professionals.

Despite the advantages of the REIT structure, the industry experienced very little growth for over 30 years mainly for two reasons. First, at the beginning REITs were handcuffed. REITs were basically passive portfolios of real estate. REITs were permitted only to own real estate, not to operate or manage it. This meant that REITs

needed to use third party independent contractors, whose economic interests might diverge from those of the REIT's owners, to operate and manage the properties. This was an arrangement the investment marketplace did not accept warmly.

Second, during these years the real estate investment landscape was colored by tax shelter-oriented characteristics. Through the use of high debt levels and aggressive depreciation schedules, interest and depreciation deductions significantly reduced taxable income—in many cases leading to so-called "paper losses" used to shelter a taxpayer's other income. Since a REIT is geared specifically to create "taxable" income on a regular basis and a REIT is not permitted to pass "losses" through to shareholders like a partnership, the REIT industry could not compete effectively for capital against tax shelters.

In the Tax Reform Act of 1986 (the "1986 Act"), Congress changed the real estate investment landscape. On the one hand, by limiting the deductibility of interest, lengthening depreciation periods and restricting the use of "passive losses," the 1986 Act drastically reduced the potential for real estate investment to generate tax shelter opportunities. This meant, going forward, that real estate investment needed to be on a more economic and income-oriented footing.

On the other hand, as part of the 1986 Act, Congress took the handcuffs off REITs. The Act permitted REITs not merely to own, but also to operate and manage most types of income producing commercial properties by providing "customary" services associated with real estate ownership. Finally, for most types of real estate (other than hotels, health care facilities and some other activities that consist of a higher degree of personal services), the economic interests of the REIT's shareholders could be merged with those of the REIT's operators and managers.

Despite Congress' actions in 1986, significant REIT growth did not begin until 1992. One reason was the real estate recession in the early 1990s. During the late 1980s banks and insurance companies kept up real estate lending at a significant pace. Foreign investment, particularly from Japan, also helped buoy the marketplace. But by 1990 the combined impact of the Savings and Loan crisis, the 1986 Act, overbuilding during the 1980s by non-REITs and regulatory pressures on bank and insurance lenders, led to a nationwide depression in the real estate economy. During the early 1990s commercial property values dropped between 30 and 50 percent. Credit and capital for commercial real estate became largely unavailable. As a result of this capital crunch, many building owners defaulted on loans, resulting in huge losses by financial institutions. The Resolution Trust Corporation took over the real estate assets of insolvent financial institutions.

Against this backdrop, starting in 1992, many private real estate companies realized that the best and most efficient way to access capital was from the public marketplace through REITs. At the same time, many investors decided that it was a good time to invest in commercial real estate—assuming recovering real estate markets were just over the horizon. They were right.

Since 1992, the REIT industry has attained impressive growth as new publicly traded REITs infused much needed equity capital into the over-leveraged real estate industry. Today there are over 200 publicly traded REITs with an equity market capitalization exceeding $140 billion. These REITs are owned primarily by individuals, with 49 percent of REIT shares owned directly by individual investors and 37 percent owned by mutual funds, which are owned mostly by individuals. Today's REITs offer smaller real estate investors three important qualities never accessible and available before: liquidity, security and performance.

Liquidity. REITs have helped turn real estate liquid. Through the public REIT marketplace of over 200 real estate companies, investors can buy and sell interests in portfolios of properties and mortgages—as well as the management associated with them—on an instantaneous basis. Illiquidity, the bane of real estate investors, is gone.

Security. Because real estate is a physical asset with a long life during which it has the potential to produce income, investors always have viewed real estate as an investment option with security. But now, through REITs, small investors have an added level of security never available before in real estate investment. Today's security comes from information. Through the advent of the public REIT industry (which is governed by SEC and securities exchange-mandated information disclosure and reporting), the flow of available information about the company and its properties, the management and its business plan, and the property markets and their prospects are available to the public at levels never before imagined. As a result, REIT investors are provided a level of security never available before in the real estate investment marketplace.

Performance. Since their inception, REITs have provided competitive investment performance. Over the past 20 years, REIT market performance has been comparable to that of the Russell 2000 and has exceeded the returns from fixed income

and direct real estate investments. Because REITs annually pay out almost all of their taxable income, a significant component of total return on investment reliably comes from dividends. In 1998, REITs paid out almost $11 billion in dividends to their shareholders. Just as Congress intended, today small investors have access through REITs to large-scale, income producing real estate on a basis competitive with large institutions and wealthy individuals.

But REITs certainly do not just benefit investors. The lower debt levels associated with REITs compared to real estate investment overall have a positive effect on the overall economy. Average debt levels for REITs are 35–40 percent of market capitalization, compared to leverage of 80 percent and higher used by privately owned real estate (which has the effect of minimizing income tax liabilities). The higher equity capital cushions REITs from the severe effects of fluctuations in the real estate market that have traditionally occurred. The ability of REITs to better withstand market downturns has a stabilizing effect on the real estate industry and lenders, resulting in fewer bankruptcies and work-outs. The general economy benefits from lower real estate losses by federally insured financial institutions.

NAREIT believes the future of the REIT industry will see a continuous and significant shift from private to public ownership of U.S. real estate. At the same time, future growth may be limited by the competitive pressures for REITs to be able to provide more services to their tenants than they are currently allowed to perform. Although the 1986 Act took off the handcuffs and the Taxpayer Relief Act of 1997 included additional helpful REIT reforms, REITs still must operate under certain significant, unnecessary restrictions. NAREIT looks forward to working with Congress and the Administration further to modernize and improve the REIT rules so that REITs can continue to offer smaller investors opportunities for rewarding investments in income-producing real estate.

I. TAXABLE REIT SUBSIDIARIES

As part of the asset diversification tests applied to REITs, a REIT may not own more than 10 percent of the outstanding voting securities of a non-REIT corporation pursuant to section 856 (c)(5)(B).[3] The Administration's Fiscal Year 1999 Budget proposed to amend section 856(c)(5)(B) to prohibit REITs from holding stock possessing more than 10 percent of the vote or value of all classes of stock of a non-REIT corporation.[4] Significantly, the Administration's Fiscal Year 2000 Budget proposes an exception to this vote or value rule for taxable REIT subsidiaries.

A. Background and Current Law

The activities of REITs are strictly limited by a number of requirements that are designed to ensure that REITs serve as a vehicle for public investment in real estate. First, a REIT must comply with several income tests. At least 75 percent of the REIT's gross income must be derived from real estate, such as rents from real property, mortgage interest and gains from sales of real property (not including dealer sales).[5] In addition, at least 95 percent of a REIT's gross income must come from the above real estate sources, dividends, interest and sales of securities.[6]

Second, a REIT must satisfy several asset tests. On the last day of each quarter, at least 75 percent of a REIT's assets must be real estate assets, cash and government securities. Real estate assets include interests in real property and mortgages on real property. As mentioned above, the asset diversification rules require that a REIT not own more than 10 percent of the outstanding voting securities of an issuer (other than a qualified REIT subsidiary under section 163(j)). In addition, no more than 5 percent of a REIT's assets can be represented by securities of a single issuer (other than a qualified REIT subsidiary).

REITs have been so successful in operating their properties and providing permissible services to their tenants that they have been asked to provide these services to non-tenants, building off of expertise and capabilities associated with the REIT's real estate activities. In addition, mortgage REITs are presented with substantial opportunities to service the mortgages that they securitize. The asset and income tests, however, restrict how REITs can engage in these activities. A REIT can earn only up to 5 percent of its income from sources other than rents, mortgage interest, capital gains, dividends and interest. However, many REITs have had the opportunity to maximize shareholder value by earning more than 5 percent from third party services.

Starting in 1988, the Internal Revenue Service ("IRS") issued private letter rulings to REITs approving a structure to facilitate a REIT providing a limited amount of services to third parties.[7] These rulings sanctioned a structure under which a REIT owns no more than 10 percent of the voting stock and up to 99 percent of the value of a non-REIT corporation through nonvoting stock. Usually, managers or shareholders of the REIT own the voting stock of the "Third Party Subsidiary"

("TPS," also known as a "Preferred Stock Subsidiary"). The TPS typically either provides to unrelated parties services already being delivered to a REIT's tenants, such as landscaping and managing a shopping mall in which the REIT owns a joint venture interest, or engages in other real estate activities, such as development, which the REIT cannot undertake to the same extent. A TPS of a mortgage REIT typically services a pool of securitized mortgages and sells mortgages as part of the securitization process that has the effect of lowering homeowners' interest rates.

The REIT receives dividends from the TPS that are treated as qualifying income under the 95 percent income test, but not the 75 percent income test.[8] Accordingly, a REIT continues to be principally devoted to real estate operations. While the IRS has approved using the TPS for services to third parties and "customary" services to tenants the REIT could otherwise provide, the IRS has not permitted the use of these subsidiaries to provide impermissible, non-customary real estate services to REIT tenants.[9]

B. Administration Proposal

In 1998, the Administration proposed changing the asset diversification tests to prevent a REIT from owning securities in a C corporation that represent 10 percent of either the corporation's vote or its value. The proposal would have applied with respect to stock acquired on or after the date of first committee action. In addition, to the extent that a REIT's ownership of TPS stock would have been grandfathered by virtue of the effective date, the grandfather status would have terminated if the TPS engaged in a new trade or business or acquired substantial new assets on or after the date of first committee action.

In its Fiscal Year 2000 Budget, the Administration again proposes to base the 10 percent asset test on either vote or value. However, it also proposes an exception for two types of taxable REIT subsidiaries ("TRS"). A qualified business subsidiary ("QBS") would be the successor to the current TPS and could engage in the same activities as can a TPS today. A REIT could not own more than 15 percent of its assets in QBSs. The second type of TRS would be a qualified independent contractor subsidiary ("QIKS"), which could provide non-customary services to the affiliated REIT's tenants. A REIT could not own more than 5 percent of its assets in QIKSs as part of its 15 percent TRS allocation.

A TRS could not deduct any interest payments to its affiliated REIT, and 100% excise tax penalties would be imposed to the extent that any pricing between a TRS and either its affiliated REIT or that REIT's tenants was not set on an arms' length basis. The new TRS rules would apply to all existing TPSs after a time period to be determined by Congress.

C. Statement in Support of Taxable REIT Subsidiaries

The REIT industry has grown significantly during the 1990s, from an equity market capitalization under $10 billion to a level approaching $150 billion. The TPS structure is used extensively by today's REITs and has been a small, but important, part of recent industry growth. These subsidiaries help ensure that the small investors who own REITs are able to maximize the return on their capital by taking full economic advantage of core business competencies developed by REITs in owning and operating the REIT's real estate or mortgages. NAREIT appreciates the Administration's recognition that it makes sense to allow a REIT to utilize these core competencies through taxable subsidiaries so long as the REIT remains focused on real estate and the subsidiary's operations are appropriately subject to a corporate level tax.

In addition, the Administration's proposal recognizes that the REIT rules need to be modernized to permit REITs to remain competitive. By virtue of the "customary" standard in defining permissible REIT rental activities, REITs must wait until their competitors have established new levels of service before providing that service to their customers. This "lag effect" assures that REITs are never leaders in their markets, but only followers, to the detriment of their shareholders. Under the Administration proposal, the REIT could render such services to its tenants through a subsidiary that is subject to corporate tax.

The Administration's TRS proposal is a significant step in the right direction, but NAREIT requests Congress instead to enact the Mack/Graham Bill. The Mack/Graham closely follows the Administration's subsidiary proposal, but improves and clarifies this concept in four major ways.

First, the Mack/Graham Bill would require taxable REIT subsidiaries to fit within the current, unified 25 percent asset test, rather than the unnecessarily complex and cumbersome 5 and 15 percent assets tests under the Administration proposal described above. Requiring two types of TRSs would cause severe complexity and administrative burdens, such as allocating costs between a QBS and a QIKS with-

out incurring a 100% excise tax. Further, the Code should encourage, rather than prohibit, the same TRS providing the same service to its affiliated REIT's tenants and to third parties to make it easier to ensure that the pricing of those services is set at market rates. Moreover, the 5 and 15 percent limits are unnecessarily restrictive given the fact that the subsidiary is subject to a corporate level tax on all of its activities. The Mack/Graham Bill adopts the better approach of treating TRS stock as an asset that must fit within the current 25 percent basket of non-real estate assets a REIT can own, along with other non-real estate assets such as personal property.

Second, the Mack/Graham Bill would limit interest deductions on debt between a REIT and its taxable REIT subsidiary in accordance with the current earnings stripping rules of section 163(j), whereas the Administration would eliminate even a reasonable amount of intra-party interest deductions. Congress confronted very similar earnings stripping concerns in the 1980s with respect to foreign organizations and their U.S. subsidiaries and resolved these concerns by enacting section 163(j). This section permits interest deductions on objective, modest amounts of related party debt. Section 163(j) is easily implemented and guidance has been provided by final regulations. The Mack/Graham Bill would adopt even more strict rules for REITs and their subsidiaries by limiting the interest deductions to market rates. Clearly, REITs should not be forced to comply with an absolute denial of legitimate interest deductions when foreign organizations in similar circumstances are not so limited.

Third, the Administration's proposal does not address whether REITs could use a TRS to own or operate hotels. Given Congress' decision in 1998 to curtail the activities of so-called hotel paired share REITs, NAREIT believes it appropriate to ensure that taxable REIT subsidiaries cannot replicate the activities of these entities. The Mack/Graham Bill would prohibit a taxable REIT subsidiary from operating or managing hotels, while allowing a subsidiary to lease a hotel from its affiliated REIT so long as (a) the rents are set at a market levels, (b) the rents are not tied to net profits, and (c) the hotel is operated by an independent contractor.

Fourth, the Mack/Graham Bill would not apply the new rules on subsidiaries to current arrangements so long as a new trade or business is not engaged in and substantial new property is not acquired, unless the REIT affirmatively elects, on a timely basis, taxable REIT subsidiary status for such TPS. Conversely, the Administration proposal would become effective after an undefined period of time. REITs have planned their operations based on IRS rulings starting in 1988 that have sanctioned TPSs and should not be penalized for following established law. The Mack/Graham Bill would adopt the concepts in last year's Administration's effective date that acknowledged the IRS' acquiescence to the TPS structure.

II. CLOSELY HELD REITS

The Administration's Fiscal Year 1999 Budget proposes to add a new rule, creating a limit of 50 percent on the vote or value of stock any entity could own in any REIT.

A. Background and Current Law

As discussed above, Congress created REITs to make real estate investments easily and economically accessible to the small investor. To carry out this purpose, Congress mandated two rules to ensure that REITs are widely held. First, five or fewer individuals cannot own more than 50% of a REIT's stock.[10] In applying this test, most entities owning REIT stock are "looked through" to determine the ultimate ownership of the stock by individuals. Second, at least 100 persons (including corporations and partnerships) must be REIT shareholders.[11] Both tests do not apply during a REIT's first taxable year, and the "five or fewer" test only applies in the last half of all taxable years.[12]

The Administration appears to be concerned about non-REITs establishing "captive REITs" and REITs doing "step-down preferred" transactions used for various tax planning purposes the Administration finds abusive such as the "liquidating REIT" structure curtailed by the 1998 budget legislation.[13] The Administration proposes changing the "five or fewer" test by imposing an additional requirement. The proposed new rule would prevent any "person" (i.e., a corporation, partnership or trust, including a pension or profit sharing trust) from owning stock of a REIT possessing more than 50 percent of the total combined voting power of all classes of voting stock or more than 50 percent of the total value of shares of all classes of stock. Certain existing REIT attribution rules would apply in determining such ownership, and the proposal would be effective for entities electing REIT status for taxable years beginning on or after the date of first committee action.

B. Statement Providing Limited Support for Administration Proposal on Closely Held REITs

NAREIT shares the Administration's concern that the REIT structure not be used for abusive tax avoidance purposes, and therefore NAREIT concurs as to the intent of the proposal. We are concerned, however, that the Administration proposal casts too broad a net, prohibiting legitimate and necessary use of "closely held" REITs. A limited number of exceptions are necessary to allow certain entities to own a majority of a REIT's stock. NAREIT certainly agrees with the Administration's decision to exclude a REIT's ownership of another REIT's stock from the proposed new ownership limit.[14] NAREIT would like to work with Congress and the Administration to ensure that any action to curb abuses does not disallow legitimate and necessary transactions.

First, an exception should be allowed to enable a REIT's organizers to have a single large investor for a temporary period, such as in preparation for a public offering of the REIT's shares. Such an "incubator REIT" sometimes is majority owned by its sponsor to allow the REIT to accumulate a track record that will facilitate its going public. The Administration proposal would prohibit this important approach which, in turn, could curb the emergence of new public REITs in which small investors may invest.

Second, there is no reason why a partnership, mutual fund, pension or profit-sharing trust or other pass-through entity should be counted as one entity in determining whether any "person" owns 50 percent of the vote or value of a REIT. A partnership, mutual fund or other pass-through entity is usually ignored for tax purposes. The partners in a partnership and the shareholders of a mutual fund or other pass-through entity should be considered the "persons" owning a REIT for purposes of any limits on investor ownership. Similarly, the Code already has rules preventing a "pension held" REIT from being used to avoid the unrelated business income tax rules,[15] and therefore the new ownership test should not apply to pension or profit-sharing plans. Instead, NAREIT suggests that the new ownership test apply only to non-REIT C corporations that own more than 50 percent of a REIT's stock.[16]

C. Summary

NAREIT supports a change in the REIT rules to prevent the abusive use of closely held REITs, but is concerned that the Administration proposal is overly broad. NAREIT looks forward to working with Congress and the Administration to craft a solution that will prevent such abuses without impeding legitimate and necessary transactions, such as those mentioned above.

III. SECTION 1374

The Administration's Fiscal Year 2000 Budget proposes to amend section 1374 to treat an "S" election by a C corporation valued at $5 million or more as a taxable liquidation of that C corporation followed by a distribution to its shareholders. This proposal also was included in the Administration's Fiscal Year 1997, 1998 and 1999 proposed budgets.

A. Background and Current Law

Prior to its repeal as part of the Tax Reform Act of 1986, the holding in a court case named General Utilities permitted a C corporation to elect S corporation, REIT or mutual fund status (or transfer assets to an S corporation, REIT or mutual fund in a carryover basis transaction) without incurring a corporate-level tax. With the repeal of the General Utilities doctrine in 1986, such transactions arguably would have been immediately subject to tax but for Congress' enactment of section 1374. Under section 1374, a C corporation making an S corporation election pays any tax that otherwise would have been due on the "built-in gain" of the C corporation's assets only if and when those assets are sold or otherwise disposed of during a 10-year "recognition period." The application of the tax upon the disposition of the assets, as opposed to the election of S status, works to distinguish legitimate conversions to S status from those made for purposes of tax avoidance.

In Notice 88–19, 1988–1 C.B. 486 (the "Notice"), the IRS announced that it intended to issue regulations under section 337(d)(1) that in part would address the avoidance of the repeal of General Utilities through the use of REITs and regulated investment companies ("RICs," i.e. mutual funds). In addition, the IRS noted that those regulations would enable the REIT or RIC to be subject to rules similar to the principles of section 1374. Thus, a C corporation can elect REIT status and incur a corporate-level tax only if the REIT sells assets in a recognition event during the 10-year "recognition period."

In a release issued February 18, 1998, the Treasury Department announced that it intends to revise Notice 88–19 to conform to the Administration's proposed

amendment to limit section 1374 to corporations worth less than $5 million, with an effective date similar to the statutory proposal. This proposal would result in a double layer of tax: once to the shareholders of the C corporation in a deemed liquidation and again to the C corporation itself upon such deemed liquidation.

Because of the Treasury Department's intent to extend the proposed amendment of section 1374 to REITs, these comments address the proposed amendment as if it applied to both S corporations and REITs.

B. Statement in Support of the Current Application of Section 1374 to REITs

As stated above, the Administration proposal would limit the use of the 10-year election to REITs valued at $5 million or less. NAREIT believes that this proposal would contravene Congress' original intent regarding the formation of REITs, would be both inappropriate and unnecessary in light of the statutory requirements governing REITs, would impede the recapitalization of commercial real estate, likely would result in lower tax revenues, and ignores the basic distinction between REITs and partnerships.

A fundamental reason for a continuation of the current rules regarding a C corporation's decision to elect REIT status is that the primary rationale for the creation of REITs was to permit small investors to make investments in real estate without incurring an entity level tax, and thereby placing those persons in a comparable position to larger investors. H.R. Rep. No. 2020, 86th Cong., 2d. Sess. 3–4 (1960).

By placing a toll charge on a C corporation's REIT election, the proposed amendment would directly contravene this Congressional intent, as C corporations with low tax bases in assets (and therefore a potential for a large built-in gains tax) would be practically precluded from making a REIT election. As previously noted, the purpose of the 10-year election is to allow C corporations to make S corporation and REIT elections when those elections are supported by non-tax business reasons (e.g., access to the public capital markets), while protecting the Treasury from the use of such entities for tax avoidance.

Additionally, REITs, unlike S corporations, have several characteristics that support a continuation of the current section 1374 principles. First, there are statutory requirements that make REITs long-term holders of real estate. The 100 percent REIT prohibited transaetions tax [17] complements the 10-year election mechanism.

Second, while S corporations may have no more than 75 shareholders, a REIT faces no statutory limit on the number of shareholders it may have and is required to have at least 100 shareholders. In fact, some REITs have hundreds of thousands of beneficial shareholders. NAREIT believes that the large number of shareholders in a REIT and management's responsibility to each of those shareholders preclude the use of a REIT as a vehicle primarily to circumvent the repeal of General Utilities. Any attempt to benefit a small number of investors in a C corporation through the conversion of that corporation to a REIT is impeded by the REIT widely-held ownership requirements.

The consequence of the Administration proposal would be to preclude C corporations in the business of managing and operating income-producing real estate from accessing the substantial capital markets' infrastructure comprised of investment banking specialists, analysts, and investors that has been established for REITs. In addition, other C corporations that are not primarily in the business of operating commercial real estate would be precluded from recognizing the value of those assets by placing them in a professionally managed REIT. In both such scenarios, the hundreds of thousands of shareholders owning REIT stock would be denied the opportunity to become owners of quality commercial real estate assets.

Furthermore, the $5 million dollar threshold that would limit the use of the current principles of section 1374 is unreasonable for REITs. While many S corporations are small or engaged in businesses that require minimal capitalization, REITs as owners of commercial real estate have significant capital requirements. As previously mentioned, it was Congress' recognition of the significant capital required to acquire and operate commercial real estate that led to the creation of the REIT as a vehicle for small investors to become owners of such properties. The capital intensive nature of REITs makes the $5 million threshold essentially meaningless for REITs.

It should be noted that this proposed amendment is unlikely to raise any substantial revenue with respect to REITs, and may in fact result in a loss of revenues. Due to the high cost that would be associated with making a REIT election if this amendment were to be enacted, it is unlikely that any C corporations would make the election and incur the associated double level of tax without the benefit of any cash to pay the taxes. In addition, by remaining C corporations, those entities would not be subject to the REIT requirement that they make taxable distributions of 95%

of their income each tax year. While the REIT is a single-level of tax vehicle, it does result in a level of tax on nearly all of the REIT's income each year.

Moreover, the Administration justifies its de facto repeal of section 1374 by stating that "[t]he tax treatment of the conversion of a C corporation to an S corporation generally should be consistent with the treatment of its [sic] conversion of a C corporation to a partnership." Regardless of whether this stated reason for change is justifiable for S corporations, in any event it should not apply to REITs because of the differences between REITs and partnerships.

Unlike partnerships, REITs cannot (and have never been able to) pass through losses to their investors. Further, REITs can and do pay corporate level income and excise taxes. Simply put, REITs are C corporations. Thus, REITs are not susceptible to the tax avoidance concerns raised by the 1986 repeal of the General Utilities doctrine.

We note that on March 9, 1999, the Treasury Department and the IRS released their 1999 Business Plan, in which it listed a project for "[r]egulations regarding conversion of C corporation to to [sic] RIC or REIT status." On February 22, 1996, the Treasury Department issued a release stating that "the IRS intends to revise Notice 88–19 to conform to the proposed amendment to section 1374, with an effective date similar to the statutory proposal." We urge the Congress to use its oversight authority to be certain that the Treasury Department does not enact the "built-in gain" tax on REITs and RICs administratively. Any such action would directly contravene Congress' repeated rejection of any statutory change in this area.

C. Summary

The 10-year recognition period of section 1374 currently requires a REIT to pay a corporate-level tax on assets acquired from a C corporation with a built-in gain, if those assets are disposed of within a 10-year period. Combined with the statutory requirements that a REIT be a long-term holder of assets and be widely-held, current law assures that the REIT is not a vehicle for tax avoidance. The proposal's two level tax would frustrate Congress' intent to allow the REIT to permit small investors to benefit from the capital-intensive real estate industry in a tax efficient manner.

Accordingly, NAREIT believes that tax policy considerations are better served if the Administration's section 1374 proposal is not enacted. Further, the Administration should not contravene the Congress' clear intent in this area by attempting to impose this double level tax on REITs and RICs by administrative means.

ENDNOTES

[1] For purposes of this Statement, "section" refers to the Internal Revenue Code of 1986, as amended.

[2] From 1960 until 1980, both REITs and regulated investment companies (mutual funds) shared a requirement to distribute at least 90 percent of their taxable income to their shareholders. Although mutual funds continue this 90 percent distribution test, since 1980 REITs have had to distribute 95 percent of their taxable income. To conform to the mutual fund rules once again and to provide more after-tax funds to pay for capital expenditures and debt amortization, NAREIT supports returning the REIT's distribution test to the 90 percent threshold.

[3] The shares of a wholly-owned "qualified REIT subsidiary" ("QRS") of the REIT are ignored for this test.

[4] Since it is a disregarded entity for tax purposes, a qualified REIT subsidiary would be excepted from the requirement that a REIT not own more than 10 percent of the vote or value of another corporation.

[5] I.R.C. § 856(c)(3).

[6] I.R.C. § 856(c)(2).

[7] PLRs 9440026, 9436025, 9431005, 9428033, 9340056, 8825112. See also PLRs 9507007, 9510030, 9640007, 9733011, 9734011, 9801012, 9808011, 9835013.

[8] The REIT does not qualify for a dividends received deduction with respect to TPS dividends. I.R.C. § 857(b)(2)(A).

[9] *But see* PLR 9804022. In addition, the IRS has been flexible in allowing a TPS to engage in an "independent line of business" in which it provides a service to the public and a minority of the users are REIT tenants. *See, e.g.,* PLRs 9627017, 9734011, 9835013.

[10] I.R.C. § 856(h)(1). There is no apparent reason why the proposed ownership test similarly should not be aimed at limiting more than 50 percent stock ownership, rather than 50 percent or more as now proposed.

[11] I.R.C. § 856(a)(5).

[12] I.R.C. §§ 542(a)(2) and 856(h)(2).

[13] NAREIT supported the Administration's and Congress' move to limit the tax benefits of liquidating REITs.

[14] If the proposed test remains applicable to all persons owning more than 50 percent of a REIT's stock, then Congress should apply the exception for a REIT owning another REIT's stock by examining both direct and indirect ownership so as not to preclude an UPREIT owning more than 50 percent of another REIT's stock.

[15] I.R.C. § 856(h)(3).

[16] As under the current "five or fewer" test, any new ownership test should not apply to a REIT's first taxable year or the first half of subsequent taxable years. See I.R.C. §§542(a)(2) and 856(h)(2).
[17] I.R.C. §857(b)(6).

STATEMENT OF THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. Chairman, the National Federation of Independent Business (NFIB) is pleased to have the opportunity to submit the views of its members before the Senate Finance Committee.

NFIB is the nation's largest small business advocacy organization, representing 600,000 members in all fifty states. The typical NFIB member has five employees and grosses approximately $350,000 in annual sales. Our membership mirrors the nation's commercial economy—we have the same representation of retail, service, manufacturing and construction that comprises the nation's business community. NFIB determines its legislative positions and priorities based upon regular surveys of its membership.

Taken as a whole, the President's tax proposals are not small business friendly. Faced with a record tax burden and surplus revenues, the President has proposed to increase taxes rather than cut them. By our count, the President's budget includes almost 80 distinct provisions that would significantly increase the tax burden currently shouldered by taxpayers. While many of these provisions would affect small businesses either directly or indirectly, this testimony will focus on those proposals that conflict with NFIB's tax cut priorities for the 106th Congress—death tax repeal, payroll tax relief, and increased expensing.

DEATH TAXES

Eliminating the federal estate tax through rate reduction is NFIB's number one tax cut priority for the 106th Congress. In a recent survey, nine out of ten of our members supported immediate elimination of the death tax.

NFIB considers death tax repeal to be crucial to the continued survival of the American family business. The death tax has the ability to cripple small businesses that are passed on from one generation to another. In many cases, the tax forces families to liquidate the very enterprise they have worked their whole lives to create. At a minimum, the tax imposes huge costs on families attempting to structure their estates to preserve the family business. Lawyers, trusts, and life insurance policies cost money—money that could be better invested in the business.

The death tax may provide government revenue in the short run, but the longrun costs—destroyed businesses, lost jobs, damaged communities—far outweigh the gains. Recent studies by the Joint Economic Committee and the Institute for Policy Innovation support this observation. Both studies found that the long-term costs of the death tax far outweigh any short-term gains by the Treasury.

Far from recognizing the harm the death tax imposes on family businesses and the economy, the President's budget would actually *increase* death tax collections on family businesses. His budget includes several provisions designed to increase death tax collections, including a provision to limit the ability of families to create and take advantage of Limited Liability Corporations. The Administration appears to be intent on improving the application and collection of death taxes despite the harm it causes to family businesses and the economy as a whole.

The 1995 White House Conference on Small Business singled out death taxes as the fourth most serious problem facing small businesses. Eliminating the death tax would remove one of the greatest obstacles faced by small family businesses. NFIB encourages this committee to support elimination of the Death tax through rate reduction in the tax bill to be considered later this year.

PAYROLL TAXES

A significant disincentive to small business job creation is the burden of payroll taxes on both employers and employees. Of five major tax burdens, payroll taxes were listed as the most costly in the NFIB tax survey, just ahead of personal income taxes. And 53 percent of the respondents listed payroll taxes as either less fair or much less fair than business income taxes.

One payroll tax is especially burdensome—the Federal Unemployment Tax (FUTA). The 1935 Federal Unemployment Tax Act established the FUTA tax to finance the administration and extended benefits of our nation's unemployment compensation system. While this system has worked well for six decades, the tax itself has been subject to abuse that must be addressed. The collection of the tax has cre-

ated an unnecessary burden on employers, while much of the money that Washington collects from this tax goes to finance the deficit instead of running the program.

The President's budget would *increase,* rather than reduce, the burden of payroll taxes on small businesses. Beginning in 2005, the Administration's budget would require certain employers to pay federal and state unemployment taxes monthly (instead of quarterly), if the employer's FUTA tax liability exceeds $1100 in the preceding year.

While this proposal technically qualifies as a "revenue raiser" under existing scoring rules, changing payment schedules does nothing to increase federal revenues in a real way. On the other hand, it will increase the real administrative burden shouldered by small employers. Increasing the frequency of collections means three times the paperwork burden and three times as many opportunities to make a mistake and incur the very large tax penalties associated with payroll tax collections.

Congress should reject the President's proposal and instead work to reform the unemployment system. At the very minimum, Congress should repeal the .2 percent FUTA surtax that was last extended in 1997. The "temporary" FUTA surtax was enacted in 1976 in order to repay borrowing of the federal unemployment trust fund from the Treasury. These debts have since been repaid, yet the FUTA surtax continues to be collected. NFIB supports full and immediate repeal of the FUTA surtax.

SMALL BUSINESS EXPENSING

For decades, NFIB has worked to highlight the importance of expensing to small businesses. Expensing is critical because it reduces tax complexity, increases cash flow, and encourages investment. If businesses are allowed to write-off investments in the year they are purchased, they are more likely to invest and thereby increasing growth and jobs. For many startups, small business expensing provisions can mean the difference between success and failure in any particular year.

Congress recognized the importance of expensing in 1996 when it phased in an increase in the annual limit on small businesses expensing from $17,500 to $25,000 by the year 2003. The President's most recent budget, however, moves in exactly the opposite direction.

The President's budget would *discourage* small business creation by making startup costs more costly. Right now, costs incurred to begin a business—legal fees, consultants, labor costs—that are incurred before a business begins must be amortized over 5 years. The President has proposed to extend the amortization period from 5 years to 15 years. (He also allows a limited amount of expensing.)

Instead of increasing the cost of business startups, the President and Congress should join together to encourage business startups and investment. Congress should (1) increase the expensing limit to $35,000; (2) allow business startup costs to be expensed immediately, and (3) expand the types of investments that can be expensed under section 179.

CONCLUSION

America's small business men and women are calling on Congress to reject the harmful tax increases proposed by the President, and to instead work to reduce the tax burden on Main Street.

The federal tax burden is at an all-time high. The burden is higher than during World War II and higher than at the peak of the Cold War. Congress recognized this burden earlier this year when it adopted a budget that promised taxpayers almost $800 billion in tax relief over the next ten years. NFIB encourages Congress to make small business friendly provisions including death tax repeal, payroll tax reductions, and expanded expensing part of this tax cut package.

STATEMENT OF THE NATIONAL FOOD PROCESSORS ASSOCIATION

[SUBMITTED BY JOHN R. CADY, PRESIDENT AND CEO]

Mr. Chairman and members of the Committee, thank you for the opportunity to offer our views on imposing the Unrelated Business Income Tax (UBIT) on the vital income non-profit organizations derive from their investments.

As you well know, The President's budget proposal for fiscal year 2000 calls for slapping UBIT on annual investment income of more than $10,000 earned by trade associations. NFPA maintains that the idea is sadly blinded by revenues or, worse, retaliation. It does not clearly focus on the many services the private sector performs for our country.

So, on behalf of the National Food Processors Association, the scientific and technical trade group for the nation's $430 billion food processing industry, I must express our strong opposition to the proposal, and to outline how it could hurt efforts to ensure food safety in the United States.

In 1998, NFPA earned $3.6 million of its $15 million budget from investment income, funds which were used, along with dues revenue, to carry out our mission—to provide the best quality food science to our member companies—almost all of it to further food safety. We estimate this tax—over $1 million—could hamper important research efforts that benefit the health and safety of consumers. This would restrict funds for our three laboratory centers—including one just three blocks from the White House.

We are unique among other food trade associations. Our staff includes over 60 food scientists who are involved in a variety of projects to enhance the safety of the products our members market. For example, NFPA scientists are developing a test to detect the inadvertent presence of allergens in food production lines. An estimated five percent of the population—more than 13 million Americans—suffers from some kind of food allergy.

NFPA's scientists are also working on procedures to control and eliminate a variety of pathogens including E. coli 0157:H7, Listeria monocytogenes, and Salmonella All of these foodborne pathogens have been reported in the news recently for causing a number of illnesses and deaths. Our work protects America's food supply and the consumers who rely on its safety.

The Administration's proposal to tax our investment income—an anti-food safety tax—will threaten our ability to conduct important research programs that promote better and safer foods.

A second component of our mission is to translate sound science into sound health and public policies for all Americans. Aside from funding our laboratories that are dedicated to research in food safety and explaining these findings to scientists and consumers alike, we readily share information with federal agencies, other food groups, and health officials both here and abroad.

As the above suggests, NFPA must have the resources to conduct the science and the wherewithal to disseminate it if we are to serve the cause of good science and food safety. We rely on our investment income for these efforts.

Mr. Chairman, this is not a lobbying function, but a right and duty to express and share our findings and opinions openly and freely. The proposed investment tax is akin to stifling free speech.

Companies and trade associations are already denied the ability to deduct lobbying expenses, which many argue with some reason is also an unconstitutional impediment to free speech. Now the administration proposes that large associations should be taxed on income that allows for free speech on non-political matters. I would like to know how Congress can decide what is free speech and what is taxed speech? What yardstick do we use?

Finally, NFPA does not "hide, shelter, or play accounting games with its dues or investment income" as the administration's rationale for this new tax status alleges. Our investment income is used each year to meet operational program requirements. The funding of our association is dependent on yearly dues plus investment income to properly fulfill our food safety mission. Given the overwhelming arguments against the change, I have to wonder if the administration's proposal to tax non-profit associations reflects an apparent desire to target or punish those who have opposed its policy agenda?

There are many organizations, both here in Washington and across the country, that perform important tasks for the great benefit of the people of our country. To tax them is to tax your constituents and put their well being at risk. We trust you will make the right choice and make sure that this new tax on non-profit trade associations does not pass.

Thanks to you, Mr. Chairman, and all the Finance Committee members, for your time and consideration. As always, we will be more than willing to answer any and all questions you may have.

Statement of the National Structured Settlements Trade Association

I. Background and Policy of the Structured Settlement Tax Rules

The National Structured Settlements Trade Association (NSSTA) is an organization composed of more than 500 members which negotiate and fund structured settlements of tort and worker's compensation claims involving persons with serious, long-term physical injuries. Structured settlements provide the injured victim with

the financial security of an assured payout over time. Founded in 1986, NSSTA's mission is to advance the use of structured settlements as a means of resolving physical injury claims.

A. Background

- *Structured settlements in wide use today to resolve physical injury claims*

Structured settlements are used to compensate seriously-injured, often profoundly disabled, victims of torts and workplace accidents. A lump sum recovery used to be the standard in personal injury cases. The injured victim then faced the daunting challenge of managing a large lump sum to cover substantial ongoing medical and living expenses for decades, even for a life-time. All too often, this lump sum swiftly eroded away. When the money was gone, the victim was left still disabled and still unable to work. In such cases, responsibility to care for this disabled person fell to the State Medicaid system and public assistance system.

Structured settlements provide a better approach. A voluntary agreement is reached between the parties generally through their counsel under which the injured victim receives damages in the form of a stream of periodic payments tailored to the future medical expenses and basic living needs of the victim and his or her family from a well-capitalized, financially-secure institution. This process may be overseen by a court, particularly in minor's cases. Often this payment stream is for the rest of the victim's life to make sure that future medical expenses and the family's basic living needs will be met, and that the victim will not outlive his or her compensation.

These are voluntary arrangements. The injured victim has a choice whether or not to take a structured settlement, and generally about a third of the injured victims who are offered a structured settlement take it. The other two-thirds take the cash lump sum.

A recent study underscores the fact that structured settlements typically are used in the case of major physical injuries "when the loss payments are very large." ("Closed Claim Survey for Commercial General Liability: Survey Results, 1997", p. 22, prepared by ISO DATA, Inc., a nonprofit arm of the Insurance Services Office, Inc., which conducted the survey under the auspices of the National Association of Insurance Commissioners (NAIC), the national group of the State insurance regulators).

The ISO study found that of the 215 claims involving structured settlements in the survey sample, 67% arose from "major injuries" ("permanent significant", "permanent major", "permanent grave", death and "temporary major"), with an average total payment of $408,000. The remaining 33% of claims involving structured settlements had an average total payment of $210,000. "Total payment" for this purpose means in effect the total present value of the settlement, and consists of (i) the lump sum of cash paid at settlement, plus (ii) the present value of the future structured payments. The ISO study found that about half of the present value of the case was paid in an upfront lump sum to meet the victim's cash needs (e.g., retrofitting the house for wheelchair access), and the remaining half represented the present value of the structured future payments. (ISO Study, at p. 22). Overall, the ISO study found that the average total present value (including the upfront cash and the present value of the future payments) of a case resolved by structured settlement was $343,000. (ISO Study, at p. 21).

Structured settlements have the strong support of the plaintiff's bar, the defense bar, judges, and mediators.

- *Structured settlements provide crucial financial protection to seriously-injured tort victims*

- Protection against premature dissipation by injured victims lacking the experience to manage the financial responsibilities and risks of investing a large lump sum to cover a substantial, ongoing stream of medical and basic living expenses for a lengthy period.
- Payout tailored to the day-to-day living expenses and the ongoing medical and financial needs of the victim and his or her family.
- Avoids shift of responsibility for care to the taxpayer-financed social safety net.

- *Congress has adopted special tax rules to encourage and govern structured settlements*

Congress has adopted a series of special rules in sections—130, 104, 461(h), and 72 of the Internal Revenue Code to govern the use of structured settlements by providing that the full amount of the periodic payments constitutes tax-free damages to the victim and that the liability to make the periodic payments to the victim may

be assigned to a structured settlement assignment company that will use a financially-secure annuity to fund the damage payments.

In the Taxpayer Relief Act of 1997, in a provision co-sponsored by a majority of the House Ways and Means Committee, Congress recently extended the structured settlement tax rules to worker's compensation to cover physical injuries suffered in the workplace.

B. Structured Settlement Tax Rules Were Adopted by Congress to Protect Victims from Pressure to Dissipate Their Recoveries

In introducing the 1981 legislation that originally enacted the structured settlement tax rules, Sen. Max Baucus (D-Mont.) pointed to the concern over squandering of a lump sum recovery by injured tort victims or their families:

> "In the past, these awards have typically been paid by defendants to successful plaintiffs in the form of a single payment settlement. This approach has proven unsatisfactory, however, in many cases because it assumes that injured parties will wisely manage large sums of money so as to provide for their lifetime needs. In fact, many of these successful litigants, particularly minors, have dissipated their awards in a few years and are then without means of support." [*Congressional Record* (daily ed.) 12/10/81, at S15005.]

By contrast, Sen. Baucus noted: "Periodic payments settlements, on the other hand, provide plaintiffs with a steady income over a long period of time and insulate them from pressures to squander their awards." (*Id.*)

In introducing legislation last year to protect structured settlements and injured victims from the practice of factoring, Sen. Baucus reiterated this original legislative intent:

> "Thus, our focus in enacting these tax rules in sections 104(a)(2) and 130 of the Internal Revenue Code was to encourage and govern the use of structured settlements in order to provide long-term financial security to seriously injured victims and their families and to insulate them from pressures to squander their awards." [*Congressional Record* (daily ed.) 10/5/98, at S11499.]

Therefore, the federal tax rules adopted by Congress to govern structured settlements reflect a policy of insulating injured victims and their families from pressures to dissipate their awards.

In addition, Congress was concerned that the injured victim not have the ability to exercise such control over the periodic payments that he or she would be deemed to have received a lump sum recovery that was then invested on his or her behalf, destroying the fully tax-free nature of the periodic payments to the injured victim. The House Ways and Means and Senate Finance Committee Reports adopting the structured settlement tax rules both state: "Thus, the periodic payments as personal injury damages are still excludable from income only if the recipient taxpayer is not in constructive receipt of or does not have the current economic benefit of the sum required to produce the periodic payments." (H.R. Rep. No. 97–832, 97th Cong., 2d Sess. (1982), 4; Sen. Rep. No. 97–646, 97th Cong., 2d Sess. (1982), 4.)

Reflecting this Congressional policy of protecting injured victims from pressure to squander their recoveries and the need to avoid any risk of constructive receipt of a lump sum by the victim, the structured settlement tax rules prohibit the victim from being able to accelerate, defer, increase, or decrease the periodic payments. (I.R.C. § 130(c)(2)(B)). In addition, the periodic payments must constitute tax-free damages in the hands of the recipient. (I.R.C. § 130(c)(2)(D)).

In compliance with these Congressional requirements and consistent with State insurance and exemption statutes, including "spendthrift" statutes that restrict alienation of rights to payments under annuities and under various types of claims (e.g., worker's compensation and wrongful death claims), structured settlement agreements customarily provide that the periodic payments to be rendered to the injured victim may not be accelerated, deferred, increased or decreased, anticipated, sold, assigned, pledged, or encumbered by the victim.

As the Treasury Department has noted, "Consistent with the condition that the injured person not be able to accelerate, defer, increase or decrease the periodic payments, [structured settlement] agreements with injured persons uniformly contain anti-assignment clauses." (U.S. Department of the Treasury, *General Explanations of the Administration's Revenue Proposals* (Feb. 1999), at p. 192).

Sen. John Chafee (R–R.I.) observed last year in introducing along with Sen. Baucus legislation to protect structured settlements and injured victims from the practice of factoring: "Structured settlement payments are nonassignable. This is consistent with worker's compensation payments and various types of Federal disability payments which also are nonassignable under applicable law. In each case, this is

done to preserve the injured person's long-term financial security." (*Congressional Record* (daily ed.), 10/2/98, at S11340).

II. PURCHASES OF FUTURE STRUCTURED SETTLEMENT PAYMENTS BY FACTORING COMPANIES DIRECTLY UNDERMINE THE IMPORTANT PUBLIC POLICIES SERVED BY STRUCTURED SETTLEMENTS

A. Background

Over the past two years, there has been dramatic growth in a transaction, generally known as a "factoring" transaction, that effectively takes the structure out of structured settlements.

In such a factoring transaction, the injured victim who is receiving periodic payments of damages for physical injuries under a structured settlement sells his or her rights to future periodic payments to a factoring company. In exchange, the injured victim receives from the factoring company a sharply discounted lump sum payment.

This is a transaction that the injured victim enters into with a third party, completely outside of the structured settlement and generally without even the knowledge of the other parties to the structured settlement. The factoring company is not in the structured settlement business, and the structured settlement company is not in the factoring business.

In an effort to avoid the anti-assignment provisions in the structured settlement agreements, the factoring companies typically have the injured victim simply present the structured settlement company with a change of address to a post office box, or change of direct deposit to a bank account, under the control of the factoring company to accomplish the redirection of payments to the factoring company. Thus, the structured settlement company obligated to make the periodic payment damages under the structured settlement is not a party to the factoring transaction and often has no notice of it at all.

At the time the structured settlement is created, the victim has multiple layers of protection by means of State insurance licensing and regulatory requirements and oversight, the Federal tax law requirements for the terms of a structured settlement, legal counsel, and in many cases court oversight. By contrast, the factoring companies and their transactions are completely unregulated.

B. Rapid Growth in Factoring Company Purchases of Structured Settlement Payments

Factoring companies use extensive advertising and telemarketing, as well as direct appeals to plaintiffs' lawyers coupled with a finder's fee, to solicit new business. For example, one major factoring company, J.G. Wentworth, stated in a 1997 Securities and Exchange Commission filing that during the first 9 months of 1997 alone, it ran 56,000 television commercials. Wentworth's SEC filing states that it runs a telemarketing call center with 200 telemarketing stations operating 24 hours a day, 6 days a week.

The factoring companies direct considerable advertising at the plaintiffs' bar, promising the injured victim's lawyer a second fee on the same case—this time by unwinding the structured settlement. For example, an ad by Stone Street Capital, a factoring company, placed in a prominent trial lawyer publication, states:

> "You helped your clients once by winning them a structured settlement. Now you can help them again by showing them how to convert all or a portion of their settlement to a lump-sum payment.
>
> "For each of your clients who exercise this exciting new option, your firm will be compensated for legal fees by facilitating the standardized processing of an annuity purchase agreement. *On average, these fees amount to about $2,000 per conversion.* [Emphasis in original]."

The factoring company business is a rapidly growing one. J.G. Wentworth recently announced that it has undertaken approximately 7,700 structured settlement purchase transactions with a total value of $370 million. According to SEC filings, during the first 9 months of 1997, J.G. Wentworth undertook 3,759 structured settlement purchase transactions. These purchased structured settlement payments had a total undiscounted maturity value of $163.6 million and were purchased for $74.4 million. Blocks of purchased structured settlement payments are now being "securitized" by the factoring companies and marketed on Wall Street.

C. Public Policy Concerns Created by Factoring Company Transactions

Factoring company purchases of structured settlement payments create serious problems affecting all participants in structured settlements and directly thwart the clear Congressional policy that underlies the structured settlement tax rules.

• *Factoring company purchases of structured settlement payments trigger the very same dissipation risks that structured settlements are designed to avoid*

As Sen. Baucus observed "All of the careful planning and long-term financial security for the injured victim and his or her family can be unraveled in an instant by a factoring company offering quick cash at a steep discount." (Congressional Record (daily ed.) 10/5/98, at S11500).

Just as lump sum tort recoveries are frequently dissipated, all too often this lump sum from the factoring company is as quickly dissipated, and the injured person finds himself or herself in the very predicament which the structured settlement was intended to avoid.

Having factored away their only assured source of future financial support and then dissipating the cash received, these injured victims are likely to face an uncertain financial future and may face the prospect of taxpayer-financed assistance programs to cover their future medical expenses and basic living needs.

As Rep. Clay Shaw (R-Fla.) stated in introducing the "Structured Settlement Protection Act" (H.R. 263) along with Rep. Pete Stark (D-Ca.) and a broad bipartisan group constituting a majority of the Members of the House Ways and Means Committee: "As long-time supporters of structured settlements and the congressional policy underlying such settlements, we have grave concerns that these factoring transactions directly undermine the policy of the structured settlement tax rules." (*Congressional Record* (daily ed.) 2/10/99, at E192).

On the Senate side, as Sen. Baucus observed in introducing the same legislation:

> "I speak today as the original Senate sponsor of the structured settlement tax rules that Congress enacted in 1982. I rise because of my very grave concern that the recent emergence of structured settlement factoring transactions—in which factoring companies buy up the structured settlement payments from injured victims in return for a deeply-discounted lump sum—completely undermines what Congress intended when we enacted these structured settlement tax rules." [*Congressional Record,* (daily ed.), 10/5/98, at S11499.]

Sen. Baucus then went on to say:

> "As a long-time supporter of structured settlements and an architect of the Congressional policy embodied in the structured settlement tax rules, I cannot stand by as this structured settlement factoring problem continues to mushroom across the country, leaving injured victims without financial means for the future and forcing the injured victims onto the social safety net—precisely the result we were seeking to avoid when we enacted the structured settlement tax rules." [*Id.,* at S11500.]

Sen. Chafee, lead Republican co-sponsor of the legislation, echoed Sen. Baucus's concerns: "These factoring company purchases directly contravene the intent and policy of Congress in enacting the special structured settlement tax rules." (Congressional Record (daily ed.) 10/2/98, at S11340.)

NSSTA's members are on the front lines. We see the human costs when factoring companies unravel the structured settlements to injured victims. Court records from across the country tell the story—there's the quadriplegic in Oklahoma, the quadriplegic in California, the paraplegic in Texas, the victim of Connecticut with traumatic brain injures dating from childhood, and the injured worker receiving worker's compensation benefits in Mississippi—all selling their future payments to the factoring companies. The human costs in factoring cases such as these were recently chronicled in a *U.S. News & World Report* entitled "Settling for Less—Should accident victims sell their monthly payments?" (January 25, 1999), pp. 62–66.

• *Factoring company purchases often are made at sharp discounts*

In many cases the injured victim's dissipation risks are magnified because the lump sum payment that the injured victim receives in the factoring transaction is so sharply discounted. While factoring transactions apparently reflect a range of discounts, it is not uncommon for an injured victim to receive a lump sum payment of half or even less of the present value of the structured settlement payments being sold.

In one recent case, a 20-year-old structured settlement recipient who was receiving monthly payments from a tort action when she was a child was persuaded to sell a series of her future payments for approximately 36 percent of their discounted present value. A few months later, she was persuaded to sell additional future payments for approximately 15 percent of their discounted present value.

Based on this case and many similar examples from court records, it is clear that in factoring company transactions structured settlement recipients often are persuaded to sell future payments for far less than the payments are worth.

- *Factoring company transactions create serious Federal income tax uncertainties for the original parties to the structured settlement*

The structured settlement tax rules require that the periodic payments constitute tax-free damages on account of personal physical injuries in the hands of the recipient of those payments. (I.R.C. §§130(c)(2)(D); 104(a)(2)). Following the factoring away by the injured victim, the periodic payments are received by the factoring company and its investors and do not constitute tax-free damages in their hands. One of the requirements for a qualified assignment no longer is met. This creates serious Federal income tax uncertainties under the structured settlement tax rules for both the victim and the company funding the structured settlement.

Injured victim

- The injured victim not only loses the benefit of the future tax-free damage payments, but also runs a risk of being taxed on the lump sum received from the factoring company if such payment is treated as received on account of the sale of the victim's future payment rights and not on account of the original injury.
- If the structured settlement payments were freely assignable by the injured victim and a ready market of financial institutions was available to acquire such payments, the victim might be deemed in constructive receipt of the present value of the future payments just as if the payments could be accelerated. In that case, from the outset of the settlement a portion of each periodic payment would be treated as taxable earnings, rather than tax-free damages.

Company funding the structured settlement

Under the structured settlement tax rules, the settling defendant (or its liability insurer) assigns its periodic payment liability to a structured settlement company in exchange for a payment which is excluded from the structured settlement company's income if the structured settlement tax rules under I.R.C. §130 are satisfied and such payment is reinvested in either an annuity or U.S. Treasury obligations precisely matched in amount and timing to the periodic payment obligation to the injured victim. The structured settlement company's income from the payments under the annuity or Treasuries is matched by an offsetting deduction for the damage payment to the victim.

- Once the factoring company buys the injured victim's payments, those payments no longer constitute tax-free personal physical injury damages under Code section 104 in the hands of the recipient, and hence one of the requirements for a qualified assignment under Code section 130(c)(2)(D) no longer is satisfied. The critical question then becomes whether the Code section 130 requirements for a qualified assignment apply only at the time the structured settlement is established or constitute continuing requirements for the structured settlement. On that question, there is no clear-cut answer, and considerable tax uncertainty results.
- The factoring transaction raises the concern that the structured settlement tax rules no longer may be satisfied and the risk that the structured settlement company may be required to recognize and pay tax on amounts previously excluded from its income or to pay tax on the "inside build-up" under the annuity, for which there is no cash distribution to pay the tax. This is a tax risk that the structured settlement company had sought to avoid through use of the anti-assignment provisions in the structured settlement agreement and is not in a position to absorb.
- The structured settlement company may face an obligation to report the payments made to the factoring company as taxable income even though in many cases the identity of the purchaser or even the existence of the factoring transaction itself is unknown.

- *Factoring company transactions create risks of double liability for the structured settlement companies*

While factoring transactions normally involve only the injured victim and the factoring company, the underlying structured settlements typically involve multiple parties such as family members, defendants, liability insurers, and state workers' compensation authorities in workers' compensation cases. Because structured settlement agreements prohibit transfers of payments, if the structured settlement company makes the payments—even unwittingly—to the factoring company, the structured settlement company may become subject to later claims that it paid the wrong

party and could still be required to make the payments as originally required under the settlement. This has happened in several recent cases.

In many cases this risk of double liability is magnified by state statutes that (i) in more than 20 states give statutory effect to contract provisions prohibiting transfers of annuity benefits, and (ii) in nearly all States directly restrict or prohibit transfers of recoveries in various types of cases (*e.g.*, worker's compensation, wrongful death, medical malpractice).

- *The uncertainties created by factoring company transactions may discourage future use of structured settlements*

These tax risks and double liability risks raised by the factoring transaction are risks that the structured settlement company specifically sought to avoid through the anti-assignment provisions in the structured settlement agreement and is not in a financial position to absorb, years after the original structured settlement transaction was entered into.

These uncertainties and unforeseen risks could jeopardize the continued ability of structured settlement companies to fund settlements in the future. The structured settlement company's participation is necessary to enable structured settlements to be undertaken in the first instance by satisfying tl ꞓ objectives of both sides to the claim: the injured victim needs the long-term financial protection that the structured settlement company's funding arrangement provides, and the settling defendant wishes to close its books on the liability rather than bearing an ongoing payment obligation decades into the future.

III. A STRINGENT PENALTY TAX ON FACTORING COMPANY PURCHASERS, SUBJECT TO A LIMITED EXCEPTION FOR GENUINE, COURT-APPROVED HARDSHIP, PROTECTS STRUCTURED SETTLEMENTS, THE INJURED RECIPIENTS, AND THE UNDERLYING CONGRESSIONAL POLICY

A. Gravity of Problem Requires Strong Action by Congress

In acting to address the concerns over factoring companies that purchase structured settlement payments from injured victims the Treasury Department noted that: "Congress enacted favorable tax rules intended to encourage the use of structured settlements—and conditioned such tax treatment on the injured person's inability to accelerate, defer, increase or decrease the periodic payments—because recipients of structured settlements are less likely than recipients of lump sum awards to consume their awards too quickly and require public assistance." (U.S. Department of the Treasury, *General Explanations of the Administration's Revenue Proposals* (Feb. 1999), p. 192).

Treasury then observed that by enticing injured victims to sell off their future structured settlement payments in exchange for a heavily discounted lump sum that may then be dissipated: *"These 'factoring' transactions directly undermine the Congressional objective to create an incentive for injured persons to receive periodic payments as settlements of personal injury claims."* (*Id.*, at p. 192 [emphasis added].)

The Joint Tax Committee's analysis of the issue last year echoes these concerns: "Transfer of the payment stream under a structured settlement arrangement arguably subverts the purpose of the structured settlement provisions of the Code to promote periodic payments for injured persons. (Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal* (JCS–1–99), (February 22, 1999), p. 329).

A natural question is why use the tax system to solve this problem? Isn't consumer protection best left to the States? We believe there are compelling reasons for the Ways and Means Committee to act. The problem is nationwide and mushrooming. A State-by-State approach could take years. Moreover, while noting that the States traditionally have been the province of consumer protection, the Joint Committee's analysis reasons that there is a clear role for the Federal tax law to address the policy concerns raised by sales of structured settlement payments: "On the other hand, the tax law already provides an incentive for structured settlement arrangements, and if practices have evolved that are inconsistent with its purpose, addressing them should be viewed as proper." (Joint Committee *Description, supra,* at p. 330).

Indeed, as Rep. Shaw observed in introducing H.R. 263 which addresses the structured settlement problem by means of a penalty tax on the factoring company: "Because the purchase of structured settlement payments by factoring companies directly thwarts the congressional policy underlying the structured settlement tax rules and raises such serious concerns for structured settlements and injured victims, it is appropriate to deal with these concerns in the tax context." (*Congressional Record* (daily ed.) 2/10/99, at E192).

Similarly, as Sen. Chafee observed last year in introducing the same legislation on the Senate side: "It is appropriate to address this problem through the federal tax system because these purchases directly contravene the Congressional policy reflected in the structured settlement tax rules and jeopardize the long-term financial security that Congress intended to provide for the injured victim. The problem is nationwide, and it is growing rapidly." (*Congressional Record* (daily ed.), 10/2/98, at S11340).

House Ways and Means Chairman Archer has indicated informally that, "If there are abuses out there, we'll look for them, we'll ferret them out, and we will do away with them." (*BNA Daily Tax Reporter,* 12/5/99, GG–1), and in later remarks pointed to transactions that make "an end run around the Code." Clearly, factoring company purchases of structured settlement payments from injured victims fall into the category of abusive transactions to which Chairman Archer refers.

A Federal tax approach also is necessary in order to address the tax uncertainties that the factoring transaction creates for the parties to the original structured settlement.

There is broad bipartisan support among Members of the House Ways and Means Committee, the Senate Finance Committee, and from Treasury for addressing the structured settlement factoring problem by means of a stringent penalty on the factoring company to discourage the transaction, except in cases of genuine, court-approved hardship of the injured victim.

B. Treasury Proposal

The Treasury Department in the Administration's FY 2000 Budget has proposed a 40-percent excise tax on factoring companies that purchase structured settlement payments from injured victims.

Under the Treasury proposal, "any person purchasing (or otherwise acquiring for consideration) a structured settlement payment stream would be subject to a 40 percent excise tax on the difference between the amount paid by the purchaser to the injured person and the undiscounted value of the purchased income stream, unless such purchase is pursuant to a court order finding that the extraordinary and unanticipated needs of the original recipient render such a transaction desirable." (*Treasury General Explanations* (Feb. 1999), at p. 192). The proposal would apply to transfers of structured settlement payments made after date of enactment.

The Treasury proposal represents a strong and appropriate response to the structured settlement factoring problem.

C. Bipartisan Congressional Proposal

1. Stringent penalty on factoring company that purchases structured settlement payments from injured victims

Reps. Clay Shaw (R-Fl.) and Pete Stark (D-Ca.), two senior Members of the Ways and Means Committee, have introduced H.R. 263 (the "Structured Settlement Protection Act") which adopts a similar approach by imposing a 50 percent excise tax on the difference between the amount paid by the purchaser to the injured victim and the undiscounted value of the purchased payment stream.

The Structured Settlement Protection Act is co-sponsored by a broad bipartisan group constituting a majority of the Members of the Ways and Means Committee.

The Structured Settlement Protection Act is endorsed by the National Spinal Cord Injury Association and the National Organization on Disability. It is supported by Treasury.

Sens. John Chafee (R-R.I.) and Max Baucus (D-Mt.) introduced companion legislation last year with similar broad bipartisan support among Finance Committee Members and are preparing to do so again this year.

As Sen. Baucus noted, the excise tax approach is a penalty, not a tax increase or a new tax: "I would stress that this is a penalty, not a tax increase—the factoring company only pays the penalty if it undertakes the transaction that Congress is seeking to discourage because the transaction thwarts a clear Congressional policy." (*Congressional Record* (daily ed.), 10/5/98, at S11500).

2. Exception for limited cases of genuine, court-approved hardship

This stringent excise tax would be coupled with a limited exception for genuine, court-approved financial hardship situations. The excise tax would apply to factoring companies in all structured settlement purchase transactions except in the case of a transaction that is pursuant to a court order finding that "the extraordinary, imminent, and unanticipated needs of the structured settlement recipient or his or her dependents render such a transaction appropriate."

This exception is intended to apply only to a limited number of cases in which a genuinely "extraordinary, imminent, and unanticipated" hardship actually has

arisen (e.g., serious medical emergency for a family member) and which has been demonstrated to the satisfaction of a court, as well as a showing that transferring away such payments will not leave the injured victim and his or her family exposed to undue financial hardship in the future when the structured settlement payments no longer are available.

3. Need to protect the tax treatment of the original structured settlement

In the limited instances of extraordinary and unanticipated hardship determined by court order to warrant relief, adverse tax consequences should not be visited upon the claimant or the other parties to the original structured settlement. Accordingly, the bipartisan Congressional proposal would clarify in the statute or the legislative history that in those limited instances in which the extraordinary, imminent, and unanticipated hardship standard is found to be met by a court, the original tax treatment of the structured settlement under I.R.C. §§104, 130, 72, and 461(h) would be left undisturbed.

That is, the periodic payments already received by the claimant prior to any factoring transaction would remain tax-free damages under Code section 104. The assignee's exclusion of income under Code section 130 arising from satisfaction of all of the section 130 qualified assignment rules at the time the structured settlement was entered into years earlier would not be challenged. Similarly, the settling defendant's deduction under Code section 461(h) of the amount paid to the assignee to assume the liability would not be challenged. Finally, the status under Code section 72 of the annuity being used to fund the periodic payments would remain undisturbed.

Despite the anti-assignment provisions included in the structured settlement agreements and the applicability of a stringent excise tax on the factoring company, there may be a limited number of non-hardship factoring transactions that still go forward. If the structured settlement tax rules under I.R.C. §§130, 72, and 461(h) had been satisfied at the time of the structured settlement and the applicable structured settlement agreements included an anti-assignment provision, the original tax treatment of the other parties to the settlement—i.e., the settling defendant and the Code section 130 assignee—should not be jeopardized by a third party transaction that occurs years later and likely unbeknownst to these other parties to the original settlement.

Accordingly, the bipartisan Congressional proposal also would clarify in the case of a non-hardship factoring transaction, that if the structured settlement tax rules under I.R.C. §§130, 72, and 461(h) had been satisfied at the time of the structured settlement and the applicable structured settlement agreements included an anti-assignment provision, the section 130 exclusion of the assignee, the section 461(h) deduction of the settling defendant, and the Code section 72 status of the annuity being used to fund the periodic payments would remain undisturbed.

Finally, the bipartisan Congressional proposal would clarify the tax reporting obligations of the annuity issuer and section 130 assignee in the event of a factoring transaction. In the case of a factoring transaction, either on a court-approved hardship basis or a non-hardship basis, of which the annuity issuer has actual notice and knowledge, assuming that a tax reporting obligation otherwise would be applicable, the annuity issuer would be obligated to file an information report with the I.R.S. noting the fact of the transfer, the identity of the original payee, and the identity where known of the new recipient of the factored payments. No reporting obligation would exist where the annuity issuer (or section 130 assignee) had no knowledge of the factoring transaction.

CONCLUSION

The Structured Settlement Protection Act fully protects structured settlements, the injured victims, and the Congressional policy underlying structured settlements.

The Structured Settlement Protection Act has broad bipartisan support among Members of the Senate Finance Committee and the House Ways and Means Committee. It is endorsed by the National Spinal Cord Injury Association and the National Organization on Disability. It is supported by Treasury.

This bipartisan Congressional proposal should be included as part of the tax legislation considered by Congress this year.

STATEMENT OF PRICEWATERHOUSECOOPERS TO THE COMMITTEE ON FINANCE U.S. SENATE

FOR THE RECORD OF ITS APRIL 27, 1999, HEARING ON REVENUE PROPOSALS IN THE ADMINISTRATION'S FY 2000 BUDGET

I. Introduction

PricewaterhouseCoopers appreciates the opportunity to submit this written statement to the Senate Finance Committee for the record of its April 27, 1999, hearing on the revenue-raising proposals in the Administration's FY 2000 budget submission.

PricewaterhouseCoopers, the world's largest professional services organization, provides a full range of business advisory services to corporations and other clients, including audit, accounting, and tax consulting. The firm, with more than 6,500 tax professionals in the United States and Canada, works closely with thousands of corporate clients worldwide, including most of the companies comprising the Fortune 500. These comments reflect the collective experiences of many of our corporate clients.

Our testimony focuses on broad new measures proposed by the Administration relating to "corporate tax shelters." Specifically, these include proposals that would (1) modify the substantial understatement penalty for corporate tax shelters; (2) deny certain tax benefits to persons avoiding income tax as a result of "tax-avoidance transactions"; (3) deny deductions for certain tax advice and impose an excise tax on certain fees received with respect to "tax-avoidance transactions"; (4) impose an excise tax on certain rescission provisions and provisions guaranteeing tax benefits; (5) preclude taxpayers from taking tax positions inconsistent with the form of their transactions; and (6) tax income from corporate tax shelters involving "tax-indifferent parties."[1]

In our view, these proposals are overreaching, unnecessary, and at odds with sound tax policy principles. They introduce a broad and amorphous definition of a "corporate tax shelter" that could be used by IRS agents to challenge many legitimate transactions undertaken by companies operating in the ordinary course of business in good-faith compliance with the tax laws. If enacted by Congress, these proposals would represent one of the broadest grants of authority ever given to the Treasury Department in the promulgation of regulations and, even more troubling, to IRS agents in their audits of corporate taxpayers.

II. Observations

A. Revenue data shows no erosion of the corporate tax base.

The Treasury proposals have arisen in response to a perception at the Treasury Department that tax-planning activities are eroding the corporate tax base.[2] The facts suggest otherwise. Corporate income tax payments reached $189 billion in 1998 and are projected by the Congressional Budget Office (CBO) to grow to $267 billion in the next 10 years.[3] Projections by the CBO and the Office of Management and Budget (OMB) show that these corporate revenues will remain relatively stable as a share of the overall economy in the coming years. There is no data in the projections of CBO or OMB to suggest that corporate tax activity will cause corporate tax revenues to decline in the future.

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[1] General Explanation of the Administration's Revenue Proposals, Department of the Treasury, February 1999, pp. 95-105.
[2] Budget of the United States Government: Fiscal Year 2000, Analytical Perspectives, p. 71.
[3] The Economic and Budget Outlook: Fiscal Years 2000-2009, Congressional Budget Office, January 1999, p. 53.

Moreover, corporate income tax receipts as a percentage of taxable corporate profits stood at 32.4 percent in 1998 and are projected to remain relatively constant over the next 10 years (32.5 percent in 2008).[4] This is approximately the effective tax rate that would result by subjecting all corporate taxable income to the graduated corporate tax rate schedule, which taxes income at rates starting at 15 percent and increasing to the top statutory rate of 35 percent.[5] As a result, there is nothing in this forecast to suggest that the corporate tax base is under assault from an imagined new "market" in corporate tax shelters. In fact, during the past four years corporate income tax payments as a percentage of gross domestic product have reached their highest levels since 1980.[6]

B. Proposals are inconsistent with the Congressional view that the scope of Treasury Department authority should be limited.

The Administration's proposals run counter to the spirit of recent Congressional actions. In last year's landmark IRS Restructuring and Reform Act, Congress enacted significant new limitations on the authority of Service agents in audit situations. Now, the Administration is asking Congress to empower agents with broad authority to "deny tax benefits" where they see fit.

Moreover, in last year's Administration budget (for FY 1999), Treasury asked for expansive authority to "set forth the appropriate tax results" and "deny tax benefits" in hybrid transactions[7] and in situations involving foreign losses.[8] Congress dismissed these proposals. The FY 2000 budget proposals now ask for authority of the same type but significantly broader than the authorization that Congress rejected just last year. The Treasury's new proposals thus can be seen as an attempted end run around earlier failed initiatives – this time accompanied by the shibboleth of "stopping tax shelters."

C. Proposals would hit legitimate business transactions.

The Treasury Department's proposals would have a severely detrimental impact on tax analysis and planning relating to a large number of legitimate business transactions. Faced with the regime of draconian sanctions proposed by Treasury, taxpayers would find it difficult to make business decisions with any certainty as to the tax consequences, since even a correct application of existing rules could be overturned based on a finding that a transaction resulted in an "improper deferral" or a "significant reduction of tax."

D. Proposals disregard recent Congressional directives on tax shelter issues.

Congress in 1997 enacted legislation[9] broadening the definition of a "tax shelter" subject to stiff penalties under the Internal Revenue Code and requiring that such arrangements be reported in writing to the Service.[10] The Joint Committee on Taxation's "Blue Book" explanation discusses the intent underlying these changes:[11]

> The Congress concluded that the provision will improve compliance with the tax laws by giving the Treasury Department earlier notification than it generally receives under present law of transactions that may not comport with the tax laws. In addition, the provision will improve compliance by discouraging taxpayers from entering into questionable transactions.

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[4] Ibid.
[5] Approximately 80 percent of corporate income is earned by corporations subject to the 35-percent top statutory rate. The largest 7,500 corporations account for approximately 80 percent of all the corporate income tax collected.
[6] The Economic and Budget Outlook: Fiscal Years 2000-2009, supra n.4., at 131.
[7] General Explanation of the Administration's Revenue Proposals, Department of the Treasury, February 1998, p. 144.
[8] Id. at 143.
[9] Taxpayer Relief Act of 1997, P.L. 105-34.
[10] Under the 1997 legislation, the statutory definition of a tax shelter was modified to eliminate the requirement that the tax shelter have as "the principal purpose" the avoidance or evasion of Federal income tax; the new law requires only that the tax shelter have as "a significant purpose" the avoidance or evasion of tax.
[11] Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997 (JCS-23-97), December 17, 1997, p. 222.

Almost two years later, the Treasury Department has yet to implement the new tax shelter reporting rules. To provide fair notice to taxpayers, Congress made the effective date of these provisions contingent upon Treasury's issuing guidance on the new requirements. But as of this date, no such guidance has been issued. It is totally inappropriate from the standpoint of sound tax policy that Treasury at this time would request expanded authority to address the issue of tax shelters when it has eschewed recent authority explicitly granted by the Congress on the identical issue.

Moreover, the Administration's penalty proposals come at the same time that Treasury and the Joint Committee on Taxation, as required by the 1998 IRS reform legislation, are conducting studies reviewing whether the existing penalty provisions are "effective deterrents to undesired behavior."[12] These studies, which are required to be completed by this summer, are to make any legislative and administrative recommendations deemed appropriate. The Treasury proposals, if enacted, would preempt the careful penalty review process that was designed by the Congress last year.

E. Treasury and IRS already have adequate tools to address abuse.

Treasury and the IRS already have more than adequate tools to address perceived abuses. These include numerous tax penalties and registration requirements relating to tax shelters. These provisions provide a powerful incentive for corporate tax executives to review closely and analyze both the structure and the implementation of any proposed business transaction that results in tax benefits, and to impose prudence on the decision-making process.

In addition, "common-law" tax doctrines give Treasury and the Service the ability to challenge taxpayer treatment of a transaction that they believe is inconsistent with statutory rules and the underlying Congressional intent. For example, these doctrines may be invoked where the Service believes that (1) the taxpayer has sought to circumvent statutory requirements by casting the transaction in a form designed to disguise its substance, (2) the taxpayer artificially has divided the transaction into separate steps, (3) the taxpayer has engaged in "trafficking" in tax attributes, or (4) the taxpayer improperly has accelerated deductions or deferred income recognition.

Further, the Code itself contains numerous anti-abuse provisions – more than 70 – that give the Treasury Department and the Service broad authority to prevent tax avoidance, to reallocate income and deductions, to deny tax benefits, and to ensure taxpayers clearly report income.

Finally, Treasury from time to time has issued IRS Notices stating its intention to issue subsequent regulations to shut down certain transactions. A Notice allows the government (assuming that the particular action is within Treasury's rulemaking authority) to move quickly, without having to await development of the regulations themselves – often a time-consuming process – that will provide more detailed rules concerning a particular transaction.

F. Congress can stop perceived tax shelter abuses when necessary.

In many instances, Congress and Treasury successfully have worked together to identify specific situations where the tax laws are being applied inappropriately and to enact quickly substantive tax-law changes in response. Recent examples include legislation enacted or introduced relating to liquidations of REITs or RICs[13] and transfers of assets subject to liabilities under section 357(c). These targeted legislative changes often have immediate, or even retroactive, application. For example, the section 357(c) proposal now before Congress would be effective for transfers on or after October 19, 1998. Moreover, in some cases, Congress includes language in the legislative history stating that "no inference" is intended regarding the tax treatment under prior law of the transaction addressed in the legislation. This language is intended, in part, to preclude any

[12] P.L. 105-208, sec. 3801.

[13] P.L 105-277, sec. 3001 (provision aimed at attempts to read statutory provisions as permitting income deducted by a liquidating REIT or RIC and paid to its parent corporation to be entirely tax free during the period of liquidation).

interpretation that otherwise might arise that enactment of the provision necessarily means that the transaction in question was sanctioned by prior law.

The Administration's FY 2000 budget proposes a number of legislative proposals that would make tax-law changes to address specified purported abuses. Whether or not the tax policy rationales given by Treasury for these targeted proposals are persuasive, the appropriate manner in which to curb avoidance potential is for Congress to deliberate upon specific legislative proposals, and not to grant broad and unfettered authority to Treasury and IRS agents.

G. Corporate tax executives are prudent.

There are several important reasons why corporate tax executives generally avoid undertaking aggressive, tax-motivated transactions. Corporate tax executives must meet professional and company-imposed ethical standards that preclude taking unsupported, negligent, or fraudulent tax positions.[14] Also, tax penalties reduce shareholder value. If the reversal of a tax position and the cost of the penalties are not properly provided for in a company's financial statements, a restatement of those financial statements may be required, which could be devastating to a corporation's stock value. Financial accounting standards require that all material tax positions that are contingent as to their outcome must be specifically disclosed to shareholders. Also, with most corporations focused on preserving and enhancing their brands, corporate tax executives are careful not to recommend a transaction to management that later might be reported unfavorably in the national press as being improper.

The Administration's "corporate tax shelter" proposals would make the jobs of corporate tax executives nearly impossible. There could be no certainty as to the tax treatment of complex business transactions, which are often undertaken across borders and are subject to a patchwork of laws imposed by U.S., foreign, state, and local taxing jurisdictions. One should bear in mind that these corporate tax executives are the individuals who are in charge of collecting more than half of the tax revenues that fund our government – not only through corporate income tax payments but also through individual income and payroll tax withholding and collection of the bulk of excise taxes.

III. Analysis of Administration's Proposals

A. Modify substantial understatement penalty for corporate tax shelters.

1. Treasury proposal.

The proposal generally would increase the penalty applicable to a substantial understatement by a corporate taxpayer from 20 percent to 40 percent for any item attributable to a "corporate tax shelter," effective for transactions occurring on or after the date of first committee action. In addition, the present-law reasonable cause exception from the penalty would be repealed for any item attributable to a corporate tax shelter.

A "corporate tax shelter" would be defined as any entity, plan, or arrangement (to be determined based on all facts and circumstances) in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction. A "tax benefit" would be defined to include a reduction, exclusion, avoidance, or deferral of tax, or an increase in a refund, but would not include a tax benefit "clearly contemplated by the applicable provision (taking into account the Congressional purpose for such provision and the interaction of such provision with other provisions of the Code)."

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[14] Corporate tax executives are governed by professional conduct standards promulgated by the American Bar Association (ABA) and the American Institute of Certified Public Accountants (AICPA) if the corporate tax executive is a member of either of these two professions. In addition, a corporate tax executive is governed by "Circular 230" (31 C.F.R. Part 10), which provides rules of conduct for practicing before the Service. Additionally, the existing penalty provisions that apply to the corporation act as a significant deterrent to a tax executive's recommending a transaction that might trigger penalties.

A "tax avoidance transaction" would be defined as any transaction in which the reasonably expected pre-tax profit (determined on a present-value basis, after taking into account foreign taxes as expenses and transaction costs) of the transaction is insignificant relative to the reasonably expected net tax benefits (i.e., tax benefits in excess of the tax liability arising from the transaction, determined on a present-value basis) of such transaction. In addition, a tax avoidance transaction would be defined to cover certain transactions involving the improper elimination or significant reduction of tax on economic income.

2. **Analysis.**

This proposal is overbroad, unnecessary, and totally inconsistent with the goals of rationalizing penalty administration and reducing taxpayer burdens. The proposal creates the entirely new and vague concept of a "tax avoidance transaction." The first prong of the definition of a tax avoidance transaction is styled as an objective test requiring a determination of whether the present value of the reasonably expected pre-tax profit from the transaction is insignificant relative to the present value of the reasonably expected tax benefits from the transaction. However, the inclusion of so many subjective concepts in this equation precludes its being an objective test. As an initial matter, what constitutes the "transaction" for purposes of this test? Next, what are the parameters for "reasonable expectation" in terms of both pre-tax economic profit and tax benefits? Further, where is the line drawn regarding the significance of the reasonably expected pre-tax economic profit relative to the reasonably expected net tax benefits?

Not only is this prong of the test extremely vague, the uncertainty is compounded by the second prong of the definition of tax avoidance transaction. Under this alternative formulation, certain transactions involving the improper elimination or significant reduction of tax on economic income would be considered to be tax avoidance transactions even if they did not satisfy the profit/tax benefit test described above. The inclusion of this second prong renders the definition entirely subjective, with virtually no limit on the Service's discretion to deem a transaction to be a tax avoidance transaction.

Elimination of the reasonable cause exception would result in situations where a revenue agent is compelled to impose a 40-percent penalty even though the agent determines that (1) there is substantial authority supporting the return position taken by the taxpayer, and (2) the taxpayer reasonably believed (based, for example, on the opinion or advice of a qualified tax professional) that its tax treatment of the item was more likely than not the proper treatment. If, in that situation, a revenue agent concluded it would be appropriate to "waive" the penalty, the agent could do so only by determining that the transaction in question was not a corporate tax shelter, i.e., that the increased penalty was not applicable. Over time, one clearly unintended consequence of forcing revenue agents to make such choices might be a skewed definition of the term "tax shelter."

The automatic nature of the proposed increased penalty would alter substantially the dynamics of the current process by which the vast majority of disputes between the Service and corporate taxpayers are resolved administratively. Today, even where a corporation and the Service agree that there is a substantial understatement of tax attributable to a tax shelter item, the determination as to whether the substantial understatement penalty should be waived for reasonable cause continues to focus on the merits of the transaction and the reasonableness of the taxpayer's beliefs regarding those merits. If, however, the reasonable cause exception no longer were available, the parties necessarily would have to focus on whether the transaction in question was a "tax avoidance transaction" and other definitional issues unrelated to the underlying merits of the transaction.

Stripping revenue agents of their discretion to waive penalties for reasonable cause would make it more difficult for the Service to achieve its objective of resolving cases at the lowest possible level. Unnecessary litigation also would result. In many cases, the size of the penalty and the absence of flexibility regarding its application could compel the taxpayer to refuse to concede or compromise its position on the merits of the issue, since only by prevailing on the merits could the taxpayer avoid the penalty. Moreover, the mere availability of such an onerous penalty may cause some revenue agents to threaten its assertion as a means of exacting unrelated (and perhaps unwarranted) concessions from the taxpayer. Clearly, the use of the increased substantial

understatement penalty as a "bargaining chip" is not appropriate or warranted for the proper determination of tax liability of a corporation and the efficient administration of the examination process.

Creating new penalties – especially ones whose applicability depends on whether a particular transaction meets an inexact definition – would put too many revenue agents in a position of having to interpret statutes, rules, and regulations unrelated to the substance of the issue or transaction in question. Based on our experience, it is likely that many agents would find it easier and less risky to assert the new penalty rather than expose themselves to being second-guessed by others at the Service as to whether the penalty was applicable. Accordingly, pressures on revenue agents may cause the new penalty to be asserted initially in far too many circumstances than are warranted.

It is evident that Congress believes there is room for significant further improvement and clarity in the administration of penalties. As discussed above, the IRS reform legislation enacted last year requires the Joint Committee on Taxation and the Treasury Department to conduct separate studies regarding whether the current civil tax penalties operate fairly, are effective deterrents to undesired behavior, and are designed in a manner that promotes efficient and effective administration. The Joint Committee and Treasury will make whatever legislative and administrative recommendations they deem appropriate to simplify penalty administration and reduce taxpayer burden. With these important studies in process at this time, this legislative proposal to increase the substantial understatement is ill-conceived and unwarranted.

B. Deny certain tax benefits to persons avoiding income tax as a result of tax-avoidance transactions.

1. Treasury proposal.

The proposal would expand the current-law rules in section 269 to authorize Treasury to disallow a deduction, credit, exclusion, or other allowance obtained in a "tax avoidance transaction" (as defined above). The proposal would be effective for transactions entered into on or after the date of first committee action.

2. Analysis.

In crafting this proposal, Treasury has disregarded the oft-quoted observation of Judge Learned Hand that taxpayers are entitled to arrange their business affairs so as to minimize taxation and are not required to choose the transaction that results in the greatest amount of tax.[15] Under the Treasury proposal, even though a taxpayer's transaction has economic substance and legitimate business purpose, the Service would be empowered to deny the tax savings to the taxpayer if another route of achieving the same end result would have resulted in the remittance of more tax.

Essentially, this proposal would grant unfettered authority to the Service to determine independently whether a taxpayer is engaging in a transaction defined as a "tax avoidance transaction," and, based on that determination, to disallow any deduction, credit, exclusion, or other allowance obtained by the taxpayer. A tax avoidance transaction would be defined to include a transaction involving the "improper elimination" or "significant reduction" of tax on economic income. In other words, if the Service believed for any reason that the taxpayer had structured a transaction that yields too much in tax savings, it would have the power to strike it down. This power could be invoked without regard to the legitimacy of the taxpayer's business purposes for entering into the transaction or the economic substance underlying the transaction. In other words, if the transaction is too tax efficient, then it simply would not be permitted by the Service.

[15] Judge Hand wrote: "Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions" (Comm'r v. Newman, 159 F.2d 848, 850-51 (2d Cir.1947) (dissenting opinion)).

The Administration states that this proposed enormous expansion of the current section 269 rules must be adopted because the current-law restrictions only apply to the acquisition of control or the acquisition of carryover basis property in a corporate transaction. It is important to place the current rules in context. The statutory rule has been in the tax law since 1943. Congress at that time was concerned that corporations were trafficking in net operating losses and excess profits credits.[16] The statute is focused on acquisitions of corporate control and nontaxable corporate reorganizations that produce tax advantages following the combination that were not independently available to the parties prior to the combination.

The original objective for enactment of section 269 – to police the transfer of tax benefits in corporate combinations – has been virtually superseded by other statutes and regulations. For example, sections 382, 383, and 384 provide detailed limitations on the use of NOLs, built-in deductions, and tax credits following certain corporate combinations. The consolidated return regulations under section 1502 contain numerous limitations on the use of net operating losses, built-in deductions, and tax credits following the addition of a new member to a consolidated group. Further, section 1561 places limits on surtax exemptions in the case of certain controlled corporate groups.

The Administration now proposes to expand significantly an outdated and significantly superseded statute. The proposal would cover transactions that significantly reduce tax on what the Service views as "economic income." Such potentially broad application would create uncertainty for corporate taxpayers following prudent tax planning to implement business objectives in a variety of transactions.

C. Denial of deductions for certain tax advice; excise tax on certain fees received with respect to corporate tax shelters.

1. Treasury proposal.

The Treasury proposal would deny a deduction to a corporation for fees paid or incurred in connection with the purchase and implementation of corporate tax shelters and the rendering of tax advice related to corporate tax shelters. The proposal also would impose a 25-percent excise tax on fees received in connection with the purchase and implementation of corporate tax shelters (including fees related to the underwriting or other fees) and the rendering of tax advice related to corporate tax shelters. These proposals would be effective for fees paid or incurred, and fees received, on or after the date of first committee action.

2. Analysis.

The imprecise definition of a corporate tax shelter transaction contained in this and related Treasury proposals would make it difficult for taxpayers and professional tax advisers to determine the circumstances under which this provision would be applicable. The substantive burdens of interpreting and complying with the statute and the administrative problems that taxpayers and the Service would face in attempting to apply this provision cannot be overstated.

Further aggravating the complexity and burdens that are imbedded in this proposal is the fact that the ultimate determination that a particular transaction was a corporate tax shelter may not be made until several years after the fees are paid. In that situation, issues arise as to when the excise tax is due, whether the applicable statute of limitations has expired, and whether and upon what date interest would be owed on the liability. More fundamentally, the creation of the proposed excise tax subjects tax advisers to an entirely new and burdensome tax regime, a regime that again shifts the focus away from the substantive tax aspects of the transaction to unrelated definitional and computational issues.

The real possibility exists that the effect of the proposal may be to deter certain taxpayers from seeking and obtaining necessary advice and guidance from a qualified tax professional in many transactions where the broad and vague scope of the prohibition calls into question the ultimate deductibility of fees. In many such cases, it is

[16] See H.Rpt. No. 871, 78th Cong., 1st Sess. 49 (1943).

likely that qualified tax advice would have either convinced the taxpayer that it would be unwise or improper to enter into the transaction, or resulted in the restructuring of the transaction so as to bring it within full compliance with the letter and spirit of the internal revenue laws.

D. Impose excise tax on certain rescission provisions and provisions guaranteeing tax benefits.

1. Treasury proposal.

The proposal would impose on the corporate purchaser of a corporate tax shelter an excise tax of 25 percent on the maximum payment under a "tax benefit protection arrangement" (including a rescission clause and insurance purchased with respect to a transaction) at the time the arrangement is entered into. The proposal would apply to arrangements entered into on or after the date of first committee action.

2. Analysis.

This proposal breaches basic normative rules of tax law by purporting to tax an expectancy, and by not limiting tax to income received or realized by a taxpayer.

As a practical matter, the provision fails to consider the way rescission provisions or guarantees work. Generally, such an agreement puts the tax adviser at risk for an agreed-upon percentage of the amount of additional tax for which the taxpayer ultimately is liable as a result of the transactions to which the adviser's advice relates. That amount, of course, cannot be determined unless and until the Service proposes adjustments to the taxpayer's liability related to the item or transaction in question, and the taxpayer's correct liability is either agreed upon or determined by a court. Until such time, it is unclear how an excise tax determination appropriately could be made, and assessing tax based upon the highest potential rescission benefits obtainable by a taxpayer in the future, whether actually realized or not, contravenes basic issues of fairness in our normative income tax system.

Further, the creation of the proposed excise tax subjects corporate taxpayers to an entirely new and burdensome tax regime, a regime that again shifts the focus away from the substantive tax aspects of the transaction in question to unrelated matters regarding the taxpayer's use of a tax adviser and the details of its relationship with the adviser. As such, the provision constitutes an unwarranted intrusion into the manner in which corporate taxpayers conduct their business affairs. In addition, the provision not only discourages, but actually stigmatizes, the willingness of qualified tax advisers to stand behind the quality and accuracy of their professional services.

E. Preclude taxpayers from taking tax positions inconsistent with the form of their transactions.

1. Treasury proposal.

The proposal generally would provide that a corporate taxpayer could not take any position on its return or refund claim that the income tax treatment of a transaction differs from that dictated by its form if a "tax-indifferent party" has an interest in the transaction. The form of a transaction would be determined based on all facts and circumstances, including the treatment given the transaction for regulatory or foreign law purposes. A "tax indifferent party" would be defined to include foreign persons, Native American tribal organizations, tax-exempt organizations, and domestic corporations with expiring loss or credit carryforwards. The proposal would be effective for transactions entered into on or after the date of first committee action.

2. Analysis.

The Administration's proposal would turn upside down the most sacred of all tax doctrines: the tax treatment of a transaction should be based on its substance, and not its form, when its form does not properly reflect its

substance. While some courts have said that there are restrictions on when a taxpayer may take a position contrary to the form of its own transaction, even those courts have not imposed an absolute prohibition. If the form chosen by the taxpayer has economic substance, then the taxpayer generally may not assert that the transaction should be taxed in accordance with a different form. However, if the taxpayer can show that the form chosen does not reflect the economic substance of the transaction, then a court generally will evaluate the merits of the taxpayer's claim.

In cases where the tax treatment of a transaction is derived from a written agreement between a taxpayer and a third party, courts have been more hesitant to entertain a substance-over-form argument made by the taxpayer. In these cases, the economic relationship between the taxpayer and other party is established primarily by the agreement itself, rather than independent evidence. The most typical case involves an allocation of the purchase price among various assets after the taxable acquisition of a business. Courts essentially have incorporated the "parol evidence" rule from applicable State law into the tax law. In some circuits, this means that the taxpayer may assert substance over form only with "strong proof." Other circuits, following the so-called "Danielson rule," hold that the taxpayer may assert substance over form only with proof that would render the agreement unenforceable (e.g., proof of mistake or fraud). Courts have limited the application of the strong proof rule or the Danielson rule to cases involving a written agreement between two parties, where the Service is confronted with potentially conflicting tax claims and thus a potential whipsaw.

The Treasury proposal essentially is a drastic expansion of the Danielson rule, with an unusual twist. First, the proposed rule prohibiting taxpayers from asserting substance over form would not be limited to cases involving an economic relationship set forth in a written agreement with a third party; rather, it would apply to any transaction where a taxpayer has chosen a particular form. Second, the proposal would apply where there are *no* potentially conflicting tax claims, and thus no potential for whipsaw, contrary to the approach adopted by the courts.

The fact that a taxpayer, under the proposal, could disclose on its return that it was treating a transaction differently than the transaction's form does not answer these criticisms. The meaning of "form" would be unclear in many circumstances. Does "form" refer to the label given to the transaction or instrument, or does it refer to the rights and liabilities set forth in the documentation? For example, if an instrument is labeled debt, but has features in the documentation typically associated with an equity interest, is the form debt or equity?

This proposal would have the unfortunate effect of forcing the taxpayer and the Service to fight over the characterization of a transaction's form, when they ought to be debating the substance of the transaction. The proposal does not subject the Service to the same rule, i.e., the Service would not be precluded from asserting substance over form.

F. Tax income from corporate tax shelters involving tax-indifferent parties.

1. Treasury proposal.

The proposal would impose tax on "tax-indifferent parties" on income allocable to such a party in a corporate tax shelter, effective for transactions entered into on or after the date of first committee action.

2. Analysis.

This proposal ignores the fact that many businesses operating in the global economy are not U.S. taxpayers, and that in the global economy it is increasingly necessary and common for U.S. companies to enter into transactions with such entities. Moreover, the fact that a tax-exempt person earns income that would be taxable if instead it had been earned by a taxable entity cannot in and of itself be viewed as objectionable by the government – if that were the case, the solution simply would be to repeal all tax exemptions. This overreaching Treasury proposal cannot be justified on any tax policy grounds.

Invocation of a rule that would impose tax on otherwise nontaxable persons should require some greater evidence of tax abuse than the mere fact that one of the parties is a foreign person or a tax-exempt entity. The only limit on the application of this proposed rule would be the basic definition of a corporate tax shelter, but as discussed elsewhere in this testimony, that overbroad definition and the nearly unfettered authority contained in the proposal likely would cover many routine business arrangements.

Moreover, as it applies to foreign persons in particular, the provision is overbroad in two significant respects. First, treating foreign persons as tax-indifferent ignores the fact that in many circumstances they may be subject to significant U.S. tax, either because they are subject to the withholding tax rules, because they are engaged in a U.S. trade or business, or because their income is taxable to their U.S. shareholders. To treat all such persons as by definition tax-indifferent would lead to the application of the tax-indifferent party tax to persons that are already subject to U.S. tax. The coordination of normal U.S. taxes with the special tax- indifferent party tax is not addressed by the proposals, so it is not clear whether it is intended that a second U.S. tax would be collected in such cases. If that is not the intent, then coordination rules would be required, which could create substantial complexity, particularly when the liability for the tax-indifferent party tax is imposed on other parties to the transaction.

Second, limiting the collection of the tax to parties other than treaty-protected foreign persons does not hide the fact that the tax-indifferent party tax would constitute a significant treaty override. Collecting the tax-indifferent party liability from other parties would function purely as a collection mechanism, much like a withholding tax, but it is the income of the foreign person that would be subject to the tax.[17] Imposing such a tax on treaty-protected income remains inconsistent with treaty obligations regardless of the collection mechanism adopted. Such a treaty override seems doubly objectionable in a context in which the tax avoidance about which Treasury is concerned is not that of the treaty-protected foreigner, but rather that of another taxpayer. Thus, while Treasury and Congress may conclude that in certain circumstances a treaty override is required to advance significant U.S. tax policy goals, this misguided and unnecessary provision does not justify the serious damage to treaty relationships that it would engender.

IV. Recommendations

We respectfully urge Congress to reject the Administration's broad proposals relating to "corporate tax shelters." As discussed above, the proposals could affect many legitimate business transactions, further hamstringing corporate tax executives seeking to navigate the maze of federal, State, and international tax laws applicable to corporations. Congress already has provided Treasury with ample administrative tools – some of which Treasury has not yet self-activated – to address situations of perceived abuse. There is no demonstrated need at this time to expand these tools, particularly in such a way that would give the Service's revenue agents nearly carte blanche authority to "deny tax benefits." Instead, where specific areas of concern are identified, Congress and the Treasury should work together – as they have done in the past – to enact legislation targeting such cases.

[17] Depending on the terms of the relevant contractual arrangements, the other participants who paid the tax on the income of the foreign person might well seek to recover that tax from the foreign person.

STATEMENT OF THE PUERTO RICO CONSERVATION TRUST FUND

INTRODUCTION AND OVERVIEW

This testimony outlines the comments of the Conservation Trust of Puerto Rico ("Conservation Trust" or "Trust") on the Administration's fiscal year 2000 budget proposal to increase, for a five year period, the amount of the rum excise tax that is covered over to Puerto Rico and the U.S. Virgin Islands. The proposal would dedicate to the Conservation Trust a portion of the amount covered over to Puerto Rico. This proposal was originally developed in the 105th Congress after the Trust lost its funding source in 1996 upon repeal of the Qualified Possession Source Investment Income ("QPSII") provisions of Section 936 of the Internal Revenue Code ("Code").

The Trust strongly supports the short-term funding proposal included in the fiscal year 2000 budget request. Passage of this proposal would allow the Trust to become more independent by building a sufficient endowment to guarantee the Trust's long-term viability. This short-term plan has bipartisan support in both the Senate Finance Committee and the Ways and Means Committee, and will help the Trust continue to meet its sole mission of preserving and protecting the most ecologically valuable natural lands and historic sites of Puerto Rico.

CONSERVATION TRUST'S PURPOSE AND FINANCING

The Conservation Trust is a non-profit institution specifically created to carry out a joint plan of the U.S. and Puerto Rico for the protection and enhancement of the natural resources and beauty of Puerto Rico. The Trust was established in 1968 by an agreement between the U.S. Department of the Interior and the Government of Puerto Rico. The Trust is classified by the Internal Revenue Service as exempt under 501(c)(3) and 509(a)(3) of the Code as an institution organized and operated to perform the functions of the U.S. and Puerto Rico in the area of conservation. The Commonwealth Department of the Treasury also classifies the Trust as a non-profit institution.

Since its inception, the Trust has acquired more than 6,000 acres of endangered land and through various programs protects an additional 7,000 acres. The Trust's acquisition represents 80% of all land acquired for permanent conservation in Puerto Rico by public or private entities over the last 20 years. The Trust also engages in educational programs which include, among other things, the design of environmental and conservation curricula, the adoption of schools, summer camps, and environmental interpretation of properties, and a reforestation program. Despite the Trust's active role, however, only 5% of the Island is under some protection by either the Federal or Commonwealth conservation agencies or the Conservation Trust.

For the first 10 years of its existence, the Trust was funded through a fee imposed by the Department of the Interior on petroleum and petrochemical companies operating in Puerto Rico under the Oil Import Allocation Program. Upon expiration of the Oil Import Allocation Program, the Trust sustained its activities through the use of income generated by companies doing business in the Island and eligible to take the "possessions tax credit" under Section 936 of the Code. The Trust was authorized by local law to participate in financial transactions that utilized QPSII. Through mid–1996, this funding mechanism generated almost 80% of the Trust's revenues.

SECTION 936 CHANGES ELIMINATED FUNDING SOURCE FOR CONSERVATION TRUST

The Omnibus Budget Reconciliation Act of 1993 ("OBRA '93") phased-down the possessions credit significantly during tax years 1994 to 1998. Additionally, OBRA '93 increased the rum tax cover over from $10.50 to $11.30 for the same five taxable years, ending on September 31, 1998. Viewing the Section 936 legislation as a signal that reliance on the QPSII program was infeasible and the program was at risk of being eliminated altogether after 1998, the Trust made significant adjustments to its land acquisition plans and capital improvement programs after passage of OBRA '93. In addition to these adjustments, a major portion of the Trust's yearly income was reallocated to build an endowment fund designed to reach $90 million by 1998.

In 1996, however, Congress passed the Small Business Job Protection Act. This legislation repealed the QPSII provisions of Section 936, thereby cutting off an essential outside funding source much earlier than any such loss was expected.

The elimination of the Section 936 and the QPSII provisions has had a substantial negative impact on the Trust's operations. Specifically, the repeal has eliminated the Trust's primary income source used to meet endowment goals. Since passage of the Small Business Job Protection Act in 1996, the volume of funds invested in Trust notes has decreased from an average of $1.3 billion to $1.4 billion to ap-

proximately $550 million, of which $120 million is from pre-1997 long-term investments. Additionally, the net income made per transaction has diminished because of the increase in the rates the Trust must now pay to obtain new financing.

The loss of Section 936 income has also impeded the Trust's ability to complete pre-1996 conservation efforts as well as start new projects. Prior to the repeal of Section 936, the Trust acquired and began restoring Esperanza, an historic sugar mill site on the Island. The Trust had also planned to purchase a salt landing necessary to preserving the fish and migratory bird population on the Island. The loss of QPSII funds, however, severely limited the Trust's ability to continue restoration efforts at Esperanza or to make additional acquisitions, such as the salt landing. The Trust's financial constraints are also inhibiting its ability to properly address the damage resulting from Hurricane Georges.

The Trust has proven extremely effective at advancing its mission, however, there is still much more work that needs to be done. These goals will be impossible to reach without short-term financing to build an endowment sufficient to guarantee the Trust's viability. Congressman Crane's proposal, which the Administration included in its Fiscal Year 2000 budget request, will provide such short-term support.

DESCRIPTION OF CURRENT LAW AND PROPOSED SOLUTION FOR THE TRUST

I. Current law.

Section 5001 of the Internal Revenue Code ("the Code") imposes an excise tax of $13.50 per proof gallon on distilled spirits made or imported into the U.S. Section 7652 of the Code further provides for a payment (a "cover over") of $10.50 per proof gallon of the excise tax levied on rum that is imported into the U.S., Puerto Rico, or the Virgin Islands.

OBRA '93 provided that, for a five-year period, $11.30 of the excise tax be covered over to the treasury of Puerto Rico. After September 30, 1998, the amount covered over to Puerto Rico returned to the pre-OBRA '93 amount of $10.50.

II. Proposed Solution.

The Administration's fiscal year 2000 budget proposal would increase the rum excise cover over from $10.50 to $13.50 per proof gallon for Puerto Rico and the Virgin Islands for five years, beginning October 1, 1999. Of such amount that is covered over to Puerto Rico, $.50 per proof gallon would be dedicated to the Trust. The proposal would be effective for rum imported or brought into the U.S. after September 30, 1999 and before October 1, 2004. This proposal is also reflected in legislation (S. 213) that Senator Daniel P. Moynihan (D-NY) introduced this year.

CONCLUSION

Enactment of the cover-over proposal would allow the Trust to become more independent by building a sufficient endowment to guarantee the Trust's long-term viability. This short-term infusion would ensure that the Trust's managers, including the Department of the Interior, continue the Trust's mission of preserving the environmental and historic beauty of the Island of Puerto Rico.

STATEMENT OF THE TAX COUNCIL

INTRODUCTION

Mr. Chairman and Members of the Committee: The Tax Council is pleased to present its views on the Administration's Budget proposals and their impact on the international competitiveness of U.S. businesses and workers. The Tax Council is an association of senior level tax professionals representing over one hundred of the largest corporations in the United States, including companies involved in telecommunications, manufacturing, mining, energy, electronics, transportation, public utilities, consumer products and services, retailing, accounting, banking, and insurance. We are a nonprofit, organization that has been active since 1967 and are one of the few professional organizations that focus exclusively on federal tax policy issues for businesses. The Tax Council supports sound federal tax policies that encourage both capital formation and capital preservation in order to increase the real productivity of the nation.

The Tax Council applauds the Senate Finance Committee for scheduling this hearing on the Administration's budget proposals involving taxes. We do not disagree with all of these proposals. For example, we support (1) extending the tax credit for research, (2) accelerating the effective date of the rules regarding look-through treatment for dividends received from "10/50 Companies," and (3) making

permanent the ability to currently deduct certain environmental expenditures. These provisions will go a long way toward increasing our declining savings rate and improving the competitive position of U.S. multinational companies.

Many of the revenue raisers found in the latest Budget proposals introduced by the Administration lack a sound tax policy foundation and primarily are based on a search for more revenue. Although they may be successful in raising revenue, they do nothing to achieve the objective of retaining U.S. jobs and making the U.S. economy stronger. For example, provisions are found in the Budget to (1) extend Superfund taxes without attempting to improve the cleanup programs, (2) repeal the use of "lower of cost or market" inventory accounting, (3) arbitrarily change the sourcing of income rules on export sales by U.S. based manufacturers, (4) impose overly broad rules and draconian penalties on so-called "corporate tax shelters" giving unprecedented power to the IRS to disallow legitimate tax planning, (5) inequitably limit the ability of so-called "dual capacity taxpayers" (i.e., multinationals engaged in vital petroleum exploration and production overseas) to take credit for certain taxes paid to foreign countries, and (6) restrict taxpayers from having the ability to mark-to-market certain customer trade receivables.

In its efforts to balance the budget, the Administration has targeted publicly held U.S. multinationals doing business overseas, and the Tax Council urges that such proposals be seriously reconsidered. The predominant reason that businesses establish foreign operations is to serve local overseas markets so they are able to compete more efficiently. Investments abroad provide a platform for the growth of exports and indirectly create jobs in the U.S., along with improving the U.S. balance of payments. The creditability of foreign income taxes has existed in the Internal Revenue Code for over 70 years as a way to help alleviate the double taxation of foreign income. Replacing such credits with less valuable deductions will greatly increase the costs of doing business overseas, resulting in a competitive disadvantage to U.S. multinationals versus foreign-based companies.

In order that U.S. companies can better compete with foreign-based multinationals, the Administration should instead do all it can to make the U.S. tax code more friendly and consistent with the Administration's more enlightened trade policy. Rather than engaging in gimmicks that reward some industries and penalizes others, the Administration's budget should be written with the goal of reintegrating sounder tax policy into decisions about the revenue needs of the government. Provisions that merely increase business taxes by eliminating legitimate business deductions should be avoided. Ordinary and necessary business expenses are integral to our current income based system, and arbitrarily denying a deduction for such expenses will only distort that system. Higher business taxes impact all Americans, directly or indirectly. For example, they result in higher prices for goods and services, stagnant or lower wages paid to employees in those businesses, and smaller returns to shareholders. Those shareholders may be the company's employees, or the pension plans of other middle class workers.

Corporate tax provisions such as the research tax credit have allowed companies to remain strong economic engines for our country, and have enabled them to fill even larger roles in the health and well being of their employees. For these reasons, sound and justifiable tax policy should be paramount when deciding on taxation of business—not mere revenue needs.

Positive Tax Proposals

The Administration has proposed several tax provisions that will have a positive impact on the economy. Four good examples are:

Accelerating Effective Date of 10/50 Company Change

One proposal would accelerate the effective date of a tax change made in the 1997 Tax Relief Act affecting foreign joint ventures owned between ten and fifty percent by U.S. parents (so-called "10/50 Companies"). This change will allow 10/50 Companies to be treated just like controlled foreign corporations by allowing "look-through" treatment for foreign tax credit purposes for dividends from such joint ventures. The 1997 Act, however, did not make the change effective for such dividends unless they were received after the year 2003 and, even then, required two sets of rules to apply for dividends from earnings and profits ("E&P") generated before the year 2003, and dividends from E&P accumulated after the year 2002. The Administration's proposal will, instead, apply the look-through rules to all dividends received in tax years after 1998, no matter when the E&P constituting the makeup of the dividend was accumulated.

This change will result in a tremendous reduction in complexity and compliance burdens for U.S. multinationals doing business overseas through foreign joint ventures. It will also reduce the competitive bias against U.S. participation in such ven-

tures by placing U.S. companies on a much more level playing field from a corporate tax standpoint. This proposal epitomizes the favored policy goal of simplicity in the tax laws, and will go a long way toward helping the U.S. economy by strengthening the competitive position of U.S. based multinationals.

Extending the Research Tax Credit

The proposal to extend the research tax credit for another year is also to be applauded. The credit, which applies to amounts of qualified research in excess of a company's base amount, has served to promote research that otherwise may never have occurred. The buildup of "knowledge capital" is absolutely essential to enhance the competitive position of the U.S. in international markets—especially in what some refer to as the "Information Age." Encouraging private sector research work through a tax credit has the decided advantage of keeping the government out of the business of picking specific winners or losers in providing direct research incentives. The Tax Council recommends that both the Administration and Congress work together to make the research tax credit a more permanent part of the tax laws.

Making Permanent the Expensing of Remediation Costs

The Administration's proposal to make permanent the current deductibility of costs for so-called "brownfields" remediation under Code section 198 is a welcome extension of a change contained in the 1997 Taxpayer Act, which allowed certain remediation costs incurred with qualified contaminated sites (so-called "brownfields") to be currently deductible as long as they are incurred by December 31, 2000. Extension of this treatment on a permanent basis removes any doubts among taxpayers as to the future deductibility of these expenditures and promotes the goal of encouraging environmental remediation.

Extending the NOL Carryback Period for Steel Companies

The Administration's proposal to extend the carryback period for net operating losses ("NOLs") of steel companies from two to five years is both fair and equitable due to the financial troubles that many steel companies are experiencing. The benefit provided by this longer carryback period would feed directly into a financially troubled steel company's cash flow, providing immediate and necessary relief. Our only suggestion is that this longer carryback period be extended to other troubled industries, such as the petroleum, chemical, and aerospace industries, to name a few.

Provisions That Should Be Reconsidered

The Tax Council offers the following comments on certain specific tax increase proposals set forth in the Administration's budget:

Foreign Oil and Gas Income Tax Credits

The Tax Council's policy position on foreign source income is clear—"A full, effective foreign tax credit should be restored and the complexities of current law, particularly the multiplicity of separate "baskets," should be eliminated.

The President's budget proposal dealing with foreign oil and gas income moves in the opposite direction by limiting use of the foreign tax credit on such income. This selective attack on a single industry's utilization of the foreign tax credit is not justified. U.S. based oil companies are already at a competitive disadvantage under current law since most of their foreign based competition pay little or no home country tax on foreign oil and gas income. The proposal increases the risk of foreign oil and gas income being subject to double taxation which will severely hinder U.S. oil companies in the global oil and gas exploration, production, refining and marketing arena.

Repeal of the Export Source Rule

Since 1922, regulations under Code § 863(b) and its predecessors have contained a rule which allows the income from goods that are manufactured in the U.S. and sold abroad (with title passing outside the U.S.) to be treated as 50% U.S. source income and 50% foreign source income. This export source rule has been beneficial to companies who manufacture in the U.S. and export abroad because it increases their foreign source income and thereby increases their ability to utilize foreign tax credits more effectively. Because the U.S. tax law restricts the ability of companies to get credit for the foreign taxes which they pay (e.g., through the interest and R&D allocations), many multinational companies face double taxation on their overseas operations, i.e., taxation by both the U.S. and the foreign jurisdiction. The export source rule helps alleviate this double taxation burden and thereby encourages U.S.-based manufacturing by multinational exporters.

The President proposes to eliminate the 50/50 rule and replace it with an "activities based" test, which would require exporters to allocate income from exports to foreign or domestic sources based upon how much of the activity producing the income takes place in the U.S. and how much takes place abroad. The justification given for eliminating the 50/50 rule is that it provides U.S. multinational exporters operating in high tax foreign countries a competitive advantage over U.S. exporters that conduct all their business activities in the U.S. The Administration also notes that the U.S. tax treaty network protects export sales from foreign taxation in countries where we have treaties, thereby reducing the need for the export source rule. Both of these arguments are seriously flawed.

The export source rule does not provide a competitive advantage to multinational exporters vis-à-vis exporters with "domestic-only" operations. Exporters with only domestic operations never incur foreign taxes and, thus, are not even subjected to the onerous penalty of double taxation. Also, domestic-only exporters are able to claim the full benefit of deductions for U.S. tax purposes for all their U.S. expenses, e.g., interest on borrowings and R&D costs, because they do not have to allocate any of those expenses against foreign source income. Thus, the export source rule does not create a competitive advantage; rather, it helps to "level the playing field" for U.S.-based multinational exporters. Our tax treaty network is certainly no substitute for the export source rule since it is not income from export sales, but rather foreign earnings, that are the main cause of the double taxation described above. To the extent the treaty system lowers foreign taxation, it can help to alleviate the double tax problem, but only with countries with which we have treaties, which tend to be the most highly industrialized nations of the world. We have few treaties with most of the developing nations, which are the primary targets for our export growth in the future.

Exports are fundamental to our economic growth and our future standard of living. Over the past three years, exports have accounted for about one-third of total U.S. economic growth. The export source rule also operates to encourage companies to produce their goods in their U.S. plants rather than in their foreign facilities. Repeal on cutbacks in the export source rule will reduce exports and jeopardize high paying jobs in the United States. Given the danger that the current Asian crisis poses to our exports, repeal of the rule would be especially unwise and counterproductive.

Superfund Taxes

The three taxes that fund Superfund (i.e., the corporate environmental tax, petroleum excise tax, and chemical feed stock tax), as well as the Oil Spill Liability Trust Fund, all expired on December 31, 1995. The President's budget would reinstate the two excise taxes, along with the five-cents per barrel Oil Spill Tax, at their previous levels for the period after the date of enactment through September 30, 2009. The corporate environmental tax would be reinstated at its previous level for taxable years beginning after December 31, 1998 and before January 1, 2010. Moreover, the funding cap for the Oil Spill Tax would be increased from the current $1 Billion amount to the *obscenely* high level of $5 Billion.

These taxes, which were previously dedicated to Superfund and the Oil Spill Fund, would instead be used to generate revenue to balance the budget. This use of taxes for deficit reduction purposes, when historically dedicated to funding specific programs should be rejected. The decision whether to re-impose these taxes should instead be made as part of a comprehensive examination of reforming the entire Superfund program.

Corporate Tax Planning

The Treasury Department's sweeping attack on corporate tax planning is alarming and unwarranted. The Administration's decision to seek a harsh new penalty regime and to impose Treasury and Internal Revenue Service judgements on taxpayers is disturbing. Merely labeling everything that it does not like as "corporate tax shelters" does not justify Treasury's attempt to tilt the tax playing field steeply and permanently in its favor.

Since 1982, many new penalties, disclosures, confiscatory rates of interest, and endless amounts of reporting have been added to the Internal Revenue Code. More than 75 sections of tax laws enacted since 1982 directly address corporate compliance from a penalty or procedural perspective. Today, if a corporate taxpayer enters into a transaction it believes is less-likely-than-not to result in the claimed tax benefits, that taxpayer faces substantial exposure on examination. The resulting deficiency could carry a 20 percent understatement penalty. Both the deficiency and the penalty would accrue interest at penalty rates. An advisor selling the transaction

would be subject to registration, possible promoter and aiding and abetting penalties, and discovery by other clients.

Nevertheless, Treasury has proposed five new rules built from a new concept: the "tax avoidance transaction." A tax avoidance transaction is defined as one in which the reasonably expected pre-tax profit of the transaction (on a present value basis) is insignificant relative to the reasonably expected net tax benefits of the transaction (on a present value basis). A transaction also is deemed to be a tax avoidance transaction if it involves "improper elimination or reduction of tax on economic income." In turn, a "corporate tax shelter" is defined as any entity, plan, or arrangement in which a direct or indirect corporate participant attempts to obtain a tax benefit in a tax avoidance transaction.

This seemingly bright-line definition of a tax avoidance transaction is simply an invitation to an entirely new realm of ambiguity. Disputes would emerge over the general rules for measurement of profits; the treatment of non-deductible expenses and tax-free income; the reasonableness of expectations, discount rates, forecasting parameters; the allocation of general and administrative costs; the choice of applicable tax rates; assumptions about the state of the tax law; and dozens of other issues. As every member of the tax-writing committees knows from dealing with revenue estimates, it is much easier to know that an idea makes sense than to estimate its economic consequences with precision.

The provision imposing a 20-percent strict liability penalty on any underpayment associated with a tax avoidance transaction is wrong. Taxpayers should have the freedom to take reasoned, reasonable and supportable positions on their tax returns. Increasing the penalty to 40 percent if the taxpayer failed to report its participation in the transaction within 30 days of entering into it is simply setting a trap for ordinary businesses. Tax lawyers and accountants are not at every business meeting ready to file reports to the IRS.

Treasury's request for blanket regulatory authority to extend section 269 to disallow any deduction, credit, exclusion, or other allowance obtained in a tax avoidance transaction is nothing more or less than a request that the Congress turn over a substantial portion of its tax-writing responsibilities to un-elected executive branch officials.

Treasury also wants Congress to deny corporate taxpayers any deduction for fees paid in connection with the purchase or implementation of a tax avoidance transaction or for related tax advice. Advisors also would be subject to a 25 percent excise tax on such fees. Corporate tax directors and their outside advisors are not criminals. By denying a deduction and imposing an excise tax, this proposal would provide harsher treatment under the tax code for legitimate tax-planning activity than that applicable to illegal bribes, kickbacks, penalties for violations of the law, and expenditures in connection with the illegal sale of drugs.

Purchasers of a corporate tax shelter who also acquire a full or partial guarantee of the projected benefits would be subject to an excise tax equal to 25 percent of the benefits that were guaranteed. Congress ought to stay out of the private market place. In truth, insurance of a tax result is merely the expression of someone's opinion that the transaction will work. The Administration would say that if a taxpayer purchases insurance against a tax adjustment in a specific transaction for $10,000 and the limit on the policy is $1,000,000, the proposal would subject the corporate client to a $250,000 tax. This is absurd. The insurer obviously has a lot of faith in the transaction to be willing to take a risk premium equal to 1 percent of the exposure.

The proposals would also tax otherwise tax-exempt entities when they are parties to a corporate taxpayer's tax avoidance transaction. The law is already filled with rules to prevent arbitrage with exempt entities. Taxing hospitals, universities, and pension funds because some IRS agent found a tax shelter on the other side of one of their transactions is not a solution to any problems that may still exist. The proposal targets exempt organizations, Native American tribal organizations, foreign persons, and domestic corporations with expiring net operating losses. The corporate parties would be jointly and severally liable for this tax if unpaid by the exempt taxpayer. In addition, in the case of a foreign person properly claiming the benefit of a treaty, or a Native American tribal organization, the tax on the income allocable to such persons in all cases would be collected from the corporate parties.

An additional provision would preclude taxpayers from taking tax positions inconsistent with the form of their transactions if a tax-indifferent party was involved in the transaction. A taxpayer could take an inconsistent position by disclosing the inconsistency. In effect, the rule is a reporting requirement (chiefly with respect to hybrid transactions) masquerading as a deduction limitation.

In summary, the Administration's attempt to tilt the playing field in favor of the IRS would make it very difficult for taxpayers to engage in legitimate transactions

to (1) reduce U.S. tax with foreign losses, (2) reposition companies for better loss utilization, (3) undertake tax reducing stock sales across internal corporate ownership chains, (4) use hybrid financing techniques, (5) sell assets at reduced tax rates, and/or (6) create mergers that streamline corporate structures. These actions would hurt the ability of U.S. corporations to operate economically and to compete effectively against their foreign-based competitors. Congress should reject this overreaching by the IRS and Treasury.

Eliminating the Deductibility of Punitive Damages

Another provision that clearly lacks any policy foundation (and appears to be included purely for revenue-raising purposes) is the proposal to deny all future payments associated with "punitive" damages incurred in civil law suits, effective for damages paid or incurred after the date of enactment. Civil punitive damages are a risk that virtually all companies are susceptible to in our present litigious society. They are often based on arbitrary and capricious jury awards and should be distinguished from the primarily criminal-type punitive damages currently denied deductibility under the Code. Punitive damages generally are subject to tax in the hands of the recipient under the changes made to those rules in 1996. In effect, Treasury seeks a windfall from punitive damage payments by denying their deduction while taxing their receipt. We oppose what would be a material change in the tax law.

Providing Consistent Amortization Periods for Intangibles

Under current law, start-up and organizational expenditures are amortized at the election of the taxpayer over a period of not less than 60 months. Certain acquired intangible assets (goodwill, trademarks, franchises, patents, etc.) held in connection with the conduct of a trade or business or an activity for the production of income must be amortized over 15 years. Under the budget proposals, start-up and organizational expenditures would be amortized over a 15-year period. Small businesses would be allowed a $5,000 expensing of such costs. The Tax Council believes that the proper treatment of many start-up and organizational expenses in a neutral tax system would be expensing. Moving in the opposite direction, toward a longer artificial recovery period for such expenses, is simply increasing taxes on companies that are growing and expanding.

Modifying the "Substantial Understatement" Penalty

The Administration proposes to make any tax deficiency greater than $10 million "substantial" for purpose of the Code § 6662 substantial understatement penalty, rather than applying the existing test that such tax deficiency must exceed ten percent of the taxpayer's liability for the year. The penalty is twenty percent of the tax underpayment, unless the taxpayer had "substantial authority" for the position producing the underpayment, or the relevant facts are disclosed on the return and there is a reasonable basis for the position.

There is no basis for the Administration's assertion that large corporate taxpayers are "playing the audit lottery" because of the purportedly high threshold amount at which the substantial understatement penalty applies. Large publicly-held corporations spend enormous amounts on tax related advice and, for security law and other reasons, generally document the basis for every major tax return position. Unfortunately, because of the complexity of both modern business transactions and the tax laws, as well as the relative dearth of regulatory or other guidance, the proper tax treatment of many items in a large corporation's return is far from clear. Also unclear is whether the "substantial authority" standard is met where a position is supported by well-reasoned legal analysis but there are no relevant cases, rulings, or other precedents, a situation encountered all too frequently by the corporate taxpayers targeted by this proposal. Indeed, the standard's vagueness is apparently evidenced by the continuing failure of Treasury to comply with the mandate of Code § 6662(d)(2)(D), requiring it to publish and periodically update a list of positions for which it is believes substantial authority is lacking.

We believe that the ultimate impact of this proposal to expand the substantial understatement penalty will be an expansion of lengthy and costly litigation to properly interpret the substantial authority standard. Taxpayers seeking protection from this penalty by disclosing uncertain positions will face almost certain proposed adjustments from IRS agents, no matter how reasonable their position, resulting in lengthy administrative controversy and litigation. Moreover, there is no evidence that the existing penalty and interest provisions are inadequate, so we strongly urge Congress to reject this ill-advised proposal.

Increased Penalties for Failure to File Returns

The Administration proposes to increase penalties for failure to file information returns, including all standard 1099 forms. IRS statistics bear out the fact that com-

pliance levels for such returns are already extremely high. Any failures to file on a timely basis generally are due to the late reporting of year-end information or to other unavoidable problems. Under these circumstances, an increase in the penalty for failure to timely file returns would be unfair and would fail to recognize the substantial compliance efforts already made by American business.

Taxing Issuance of Tracking Stock

"Tracking stock" is an economic interest that is intended to relate to, and track the economic performance of, one or more separate assets of the issuer. It gives its holder a right to share in the earnings or value of less than all of the corporate issuer's earnings or assets. Under the proposal, upon issuance of tracking stock, gain would be recognized in an amount equal to the excess of the fair market value of the tracked asset over its adjusted basis. Treasury views the issuance of tracking stock as tantamount to a spin-off and accordingly wants to impose tax. In fact, issuance of tracking stock is not a spin-off. The stockholder's value is still subject to the claims of the creditors of the parent corporation, and has liquidation or redemption rights only in the parent company, not the tracked assets. The Tax Council opposes this attempt by Treasury to trigger a double tax on corporate income.

Modifying Tax Treatment of Downstream Mergers

Under this provision, where a target corporation does not satisfy the stock ownership requirements of section 1504(a)(2) (generally, 80 percent or more of vote and value) with respect to the acquiring corporation, and the target corporation combines with the acquiring corporation in a reorganization in which the acquiring corporation is the survivor, the target corporation must recognize gain, but not loss, as if it distributed the acquiring corporation stock that it held immediately prior to the reorganization to its shareholders. The Tax Council opposes elimination of this longstanding and well-recognized ability to reorganize in a tax-free manner.

Prevent Trafficking in Built-In Losses and Other Tax Attributes

Under current law, a person that becomes subject to U.S. tax for the first time determines the basis of property and other tax attributes as though the person had always been subject to U.S. tax. This has been the rule since the beginning of the income tax. As a result, a taxpayer coming under the U.S. system may take advantage of built-in losses and would be taxed on built-in gains. Treasury wants to replace the current rule with a "fresh start" that eliminates all tax attributes (including built-in losses and other items) and marks the taxpayer's assets to market when they become subject to U.S. tax. The proposal could benefit some taxpayers that would be entitled to a tax-free step-up in basis in their appreciated property at the time they become subject to U.S. tax. This far-reaching proposal would add much complexity to the tax laws.

The Administration argues that although current rules limit a U.S. taxpayer's ability to avoid paying U.S. tax on built-in gain, similar rules do not exist that prevent built-in losses from being used to shelter income otherwise subject to U.S. tax. Treasury's proposal, which is extremely broad, is unnecessary. Existing anti-abuse provisions such as sections 269, 382, 446(b), and 482 address this issue. Congress should resist the temptation that Treasury has placed before it to make an ad hoc, yet very fundamental, change to our international tax rules.

Payments To 80/20 Companies

Currently, a portion of interest or dividends paid by a domestic corporation to a foreign entity may be exempt from U.S. withholding tax provided the payor corporation is a so-called "80/20 Company," i.e., at least eighty percent of its gross income for the preceding three years is foreign source income attributable to the active conduct of a foreign trade or business. The Administration believes that the testing period is subject to manipulation and allows certain companies to improperly avoid U.S. withholding tax on certain distributions attributable to a U.S. subsidiary's U.S. source earnings. As a result, it proposes to arbitrarily change the 80/20 rules by applying the test on a group-wide (as opposed to individual company) basis. However, there is little evidence that these rules have been manipulated on a broad scale in the past and we do not believe such a drastic change is needed at this time.

Repealing Lower of Cost or Market Inventory Method

Certain taxpayers can currently determine their inventory values by applying the lower of cost or market method, or by writing down the cost of goods that are not salable at normal prices, or not usable because of damage or other causes. The Administration is proposing to repeal these options and force taxpayers to recognize income from changing their method of accounting, on the specious grounds that writing down unusable or non-salable goods somehow "understates taxable income."

We strongly disagree with this unwarranted proposal. In addition, we believe that in the least, the lower of cost or market method should continue to be permissible when used for financial accounting purposes, to avoid the complexity of maintaining separate inventory accounting systems.

Deferral of OID on Convertible Debt

The Administration has included a number of past proposals aimed at financial instruments and the capital markets, which were fully rejected during the last session of Congress. These reintroduced proposals should again be rejected out of hand. One proposal would defer deductions by corporate issuers for interest accrued on convertible debt instruments with original issue discount ("OID") until interest is paid in cash. The proposal would completely deny the corporation an interest deduction unless the investors are paid in cash (e.g., no deduction would be allowed if the investors convert their bonds into stock). Investors in such instruments would still be required to pay income tax currently on the accrued interest. In effect, the proposal defers or denies an interest deduction to the issuer, while requiring the holder to pay tax on the interest currently.

The Tax Council opposes this proposal because it is contrary to sound tax policy and symmetry that matches accrual of interest income by holders of OID instruments with the ability of issuers to deduct accrued interest. There is no justifiable reason for treating the securities as debt for one side of the transaction and as equity for the other side. There is also no reason, economic or otherwise, to distinguish a settlement in cash from a settlement in stock.

Moreover, the instruments in question are truly debt rather than equity. Recent statistics show that over 70 percent of all zero-coupon convertible debt instruments were retired with cash, while only 30 percent of these instruments were convertible to common stock. Recharacterizing these instruments as equity for some purposes is fundamentally incorrect and will put American companies at a distinct disadvantage to their foreign competitors, who are not bound by such restrictions. These hybrid instruments and convertible OID bond instruments have allowed many U.S. companies to raise tens of billions of dollars of investment capital used to stimulate the economy. Introducing this imbalance and complexity into the tax code will discourage the use of such instruments, limit capital raising options, and increase borrowing costs for corporations.

Modify Rules for Debt-Financed Portfolio Stock

This proposal would effectively reduce the dividends-received deduction ("DRD") for any corporation carrying debt—virtually all corporations—and would specifically target financial service companies, which tend to be more debt-financed. The Tax Council vigorously opposes this proposal, as it has opposed more straightforward proposals to reduce the DRD in the past.

The purpose of the DRD is to eliminate, or at least alleviate, the impact of potential multiple layers of corporate taxation. Under current law, the DRD is not permitted to the extent that relevant "portfolio stock" is debt financed. Portfolio stock is defined as stock in which the corporate taxpaying owner holds less than 50 percent of the vote or value. Portfolio stock has generally been treated as debt financed when acquired with the proceeds of indebtedness, or when it secures the repayment of indebtedness. The Administration's proposal would expand the DRD disallowance rule of current law for debt financed stock by assuming that all corporation debt is allocated to the company's assets on a pro-rata basis. The proposal would, thus, partially disallow the DRD for all corporations based on a pro-rata allocation of its corporate debt.

We believe the proposal would exacerbate the multiple taxation of corporate income, penalize investment, and mark a retreat from efforts to develop a more fair, rational, and simple tax system. Just as troubling is the notion that the DRD should be dramatically reduced for companies, including financial service companies, that are highly leveraged. The proposal is particularly problematic for the securities industry, which maintains large quantities of equity investments in the ordinary course of its business operations. The Tax Council believes that multiple taxation of corporate earnings should be reduced, rather than expanded. The Administration's proposal clearly moves in the wrong direction.

Eliminating the "DRD" for Certain Preferred Stock

Another proposal would deny the DRD for certain types of preferred stock, which the Administration believes are more like debt than equity. Although concerned that dividend payments from such preferred stock more closely resembles interest payments than dividends, the proposal does not simultaneously propose to allow issuers of such securities to take interest expense deductions on such payments. Again, the

Administration violates sound tax policy and, in this proposal, would deny these instruments the tax benefits of both equity and debt.

The Tax Council opposes this proposal as not being in the best interests of either tax or public policy. Currently, the U.S. is the only major western industrialized nation that subjects corporate income to multiple levels of taxation. Over the years, the DRD has been decreased from 100% for dividends received by corporations that own over 80 percent of other corporations, to the current 70% for less than 20 percent owned corporations. As a result, corporate earnings have become subject to multiple levels of taxation, thus driving up the cost of doing business in the U.S. To further decrease the DRD would be another move in the wrong direction.

Increasing Deferred Acquisition Cost (DAC) Capitalization Percentages

This proposal would increase the percentage of life insurance and annuity premiums subject to DAC capitalization. House Ways and Means Committee Chairman Bill Archer, R-Texas, already has publicly announced that the DAC proposal will not be included in any package put forth by his committee. We are in full agreement with him. The current DAC rates are more than appropriate in light of the other rules that apply to life insurance companies that tend to overstate their income for tax purposes.

Further Modifying Corporate-Owned Life Insurance Rules

Treasury continues its four-year assault on COLI programs by proposing to repeal an exception to the present law proportionate interest disallowance rules for contracts on employees, officers or directors, other than 20 percent owners of the business that are the owners or beneficiaries of an annuity, endowment, or life insurance contract. This exception was designed to allow employers to create key-person life insurance programs, fund non-qualified deferred compensation with the advantages of life insurance, and meet other real business needs. The effect of this proposal would be to tax the inside build up in cash value life insurance whenever it is owned by a business that also has debt. Given the very long-term nature of life insurance investments, this rule would make insurance unattractive even to companies with no debt today, because they might need to borrow at some future date.

Recapturing Policyholder Surplus Accounts (PSA)

Life insurance companies that were taxed under the old "phase II positive" regime of the 1959 Act would have their tax bills for 1959 through 1983 rewritten by Treasury's proposal to tax policyholder surplus accounts. Companies would be required to include in their gross income over 10 years (one-tenth per year) the balances of the policyholder surplus accounts accumulated from 1959 through 1983. These accounts were part of a complex, Rube Goldberg set of provisions designed to balance the tax burdens of various segments of the insurance industry. Different companies benefited from different provisions, retroactively denying one set of companies their treatment is fundamentally unfair. Companies with policyholder surplus accounts never expected to pay tax on them. Congress should not change the rules at this late date.

Subjecting Investment Income of Trade Associations to Tax

Under the proposal, trade associations including Tax Councils of commerce, business leagues, and other similar not-for-profit organizations organized under Internal Revenue Code section 501(c)(6) generally would be subject to tax on their net investment income in excess of $10,000. The Tax Council opposes this $1.4 billion tax increase on trade associations. The current-law purpose of imposing unrelated business income tax on associations and other tax-exempt organizations is to prevent such organizations from competing unfairly against for-profit businesses. Subjecting trade association investment income to UBIT is counter to this legislative purpose. The Treasury proposal mischaracterizes the benefit that trade association members receive from such earnings. If these earnings on a trade association's assets did not exist, members of these associations would have to pay larger tax-deductible dues. There simply is not a tax abuse here. Congress should leave the present law rules as they are.

Effective Dates

Before concluding, we would like to make one last comment regarding the effective dates of tax proposals. The Tax Council believes that it is bad tax policy to make significant tax changes in a retroactive manner that impose additional burdens on businesses. Businesses should be able to rely on the tax rules in place when making economic decisions, and expect that those rules will not change while their investments are still ongoing. It seems plainly unfair to encourage businesses to

make economic decisions based on a certain set of rules, but then change those rules midstream after the taxpayer has made significant investments in reliance thereon.

CONCLUSION

The Tax Council strongly urges Congress not to adopt the provisions identified above when formulating its own proposals, since they are based on unsound tax policy. Congress, in considering the Administration's budget, should elevate sound and justifiable tax policy over mere revenue needs. Revenue can be generated consistent with sound tax policy, and that is the approach that should be followed as the budget process moves forward.

STATEMENT OF TELEPHONE AND DATA SYSTEMS, INC.

[SUBMITTED BY ROSS J. MCVEY, ASSISTANT CONTROLLER AND DIRECTOR—TAX]

I am writing on behalf of Telephone & Data Systems, Inc. (TDS) to voice our concern over the Administration's "Tax Shelter" revenue raising proposals on which your committee recently held hearings. TDS is a telecommunications company with over 9,900 employees providing service to over 3,000,000 customers in 35 states.

These proposals seem to stem from the December 14, 1998 issue of Forbes in which the cover story labeled certain tax reducing transactions with movie ratings (i.e. PG–13, R and X) based upon their view of the relative degree of egregiousness. TDS also realizes the importance of effective and enforceable tax laws on the equitable administration of this country's revenue collection systems. It is certainly an honorable legislative objective to strive for such administration, and we appreciate your desire to correct "loopholes" in the application of the IRC. We maintain, however, that the already thin line between tax planning and "tax avoidance" will become even more subjective under these proposals. Further, these proposals indicate a preference toward interpretations of the intent of the law over the law itself. Where the letter of the law has been followed, it should be respected as a Constitutional right to apply the law, even if taxpayer favorable. In a 2nd Circuit Court Decision (1947), Judge Learned Hand clearly understood the concept when he stated;

> "Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Nobody owes any public duty to pay more than the law demands. Taxes are enforced extractions and not voluntary contributions. To demand more in the name of morals is mere cant."

We know that it is easier to take a simple, blanket approach to a legislative objective than to craft more complex, specific provisions that attempt to take into account all current and possible fact patterns. Our concern is that the President's proposal would provide the IRS with a new weapon which, as currently crafted, would raise the risk of serious wounds being inflicted on innocent bystanders. The following transactions could now be considered "tax avoidance transactions" subject to disallowance:

- Investing in Municipal bonds rather than fully-taxable securities.
- Charitable contributions—they have no pre-tax economics.
- Donating appreciated property rather than cash to charity—the primary purpose is viewed as tax planning by those who benefit from it, but tax avoidance by those who do not.
- Choosing to sell a business' assets rather than its stock—generally the primary motivation is to avoid tax.

The IRS has already demonstrated that it will shamelessly exaggerate the application of an IRS favorable decision on specific facts.[1] In our opinion, the IRS has taken the INDOPCO decision and is moving down a continuum toward capitalization of virtually all salaries and marketing expenses because they provide some future benefit beyond the current year. The only deductible costs will be for unsuccessful efforts and employees who provide no benefits to the company—why employ them?

We recognize that it is difficult to be patient. Difficult to wait for the wheels of common law jurisprudence to turn out a sufficiently accurate and enveloping body of case law, such that "justice is done" to all parties. All of these things prompt you, as a body, to strike quickly and soundly. We urge you to take the more difficult path. To take the path of patience. To take the path of methodical judgment.

In addition, we have two technical concerns with the President's proposed Tax Shelter legislation that we hope you will consider. First, it unnecessarily duplicates existing law, and it will inappropriately subrogate the enacted language of the In-

ternal Revenue Code beneath "legislative history." Second, we are bothered by the perpetual shift of authority, away from the courts and Congress and towards the IRS.

The President's proposals unnecessarily duplicate existing law in several key areas, two of which are "form vs. substance" and tax fraud.

FORM VS. SUBSTANCE

In the *Description of Revenue Provisions Contained in the President's Fiscal Year 2000 Budget Proposal (hereinafter, "the Description"), Substance over Form Section,* the drafters characterize the "Danielson rule"[2] and the "strong proof" rule as set forth in Ullman[3] as providing "relatively high standards of proof" which a taxpayer must meet before being allowed to elevate the substance of a transaction over the form that the taxpayer selected for that transaction. This is a gross understatement of the impact these cases have on a taxpayer attempting to "overturn" the form of a transaction which he or she devised. In Danielson, the court provided that a taxpayer must show "proof which in an action between the parties . . . would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc." Therefore, to prevail under the "Danielson rule" a taxpayer must not only be able to show that the form of the transaction was not the intended form but also that the parol evidence rules would allow the taxpayer to challenge the form of the transaction against the other party in a court of law. In short, this provides that the only time a taxpayer can advocate substance as controlling over form is when the binding form of the transaction is itself in substantial doubt.

The Danielson court went on to find that "the "strong proof" rule [See Ullman above] would require that the taxpayer be held to his agreement absent proof of the type which would negate it in an action between the parties to the agreement." Therefore, even under the "strong proof" rule, the taxpayer will be held to the form of his or her transaction absent substantial doubt as to the form. This section of the *Description* also states that it is important to "impose restrictions on the taxpayer's ability to argue against the form it has chosen." It is our belief that court cases such as Danielson and its successors have already imposed such restrictions. Enacting any legislation that attempts to further confine taxpayers to the "bed that they have made" would serve no useful purpose.

TAX FRAUD

In *the Description, Section on the Understatement Penalty,* the drafters discuss the President's proposed increase (from 20% to 40%) in the substantial understatement penalty. They also point out the "safe harbors" available to the taxpayer in order to avoid imposition of the "extra" 20%:

(1) Disclosure of the "transaction" to the National Office within 30 days of filing the return

(2) Attaching a statement of disclosure to the return, or

(3) Providing adequate disclosure of the book to tax differences (M–1's) on the return.

Ignoring the ambiguity of multiple court definitions of "adequate disclosure," it seems to us that any taxpayer not engaged in attempting to defraud the IRS will be exempt from the 20% "excess" penalty. After all, the only time its appears such a penalty could be imposed is when a taxpayer misrepresents M–1's that are material with an intent to deceive the IRS. There are already multitudes of penalties and punishments (some criminal) for this kind of behavior. It does not seem necessary to us to "arm" the IRS with another "weapon" sure to be threatened against all taxpayers but which could only be used on those already penalized by myriad other regulations.

The President's proposals inappropriately subrogate the enacted language of the IRC beneath "legislative history." In doing so, these proposals will not only make it more difficult and time-consuming for trial judges but it will also effectively turn over years of Common Law precedent.

In *the Description, Section on Tax Avoidance Transactions,* the drafters state that under the President's proposed expansion of IRC § 269, the Secretary will be able to "disallow a deduction, credit, exclusion, or other allowance obtained in a tax avoidance transaction." *The Description* continues by providing, by reference to the *Section on Understatement Penalties,* the definition of a "tax avoidance transaction;"

> Any transaction in which the reasonably expected pre-tax profit . . . of the transaction is insignificant relative to the reasonably expected net tax benefits . . . of such transaction. In addition, a tax avoidance transaction would be de-

fined to cover certain transactions involving the improper elimination or significant reduction of tax on economic income.

Our concern with this proposal lies in the definition of "improper." If enacted, this proposal would give the Secretary the authority to disallow the "tax benefits" of a transaction if the Secretary deemed the transaction merely "improper." This is not only a drastic change from the current law's standard but it puts the courts in a new predicament if the taxpayer challenges the Secretary's determination.

Current case law supports the Secretary's disallowance of tax benefits generated from transactions, the principle purpose of which is the avoidance of tax. Interpretation of this standard, as well as similar legislative breakwaters,[4] certainly requires a complex measurement of the pre-tax economics and tax benefits of the transaction, but is a measurement that is possible to make within the letter of the law. If the standard is changed from "principal purpose" to merely "improper," the courts, obviously, must look to what is proper and what is improper. Whenever the courts must look to proper and improper they must look to legislative intent. There becomes no path open to a court that does not lead down this treacherous and ambiguous slope of original legislative mindset. When Treasury and the IRS challenge a taxpayer's tax benefit as improper, a court will have no choice but to delve into the history of the section rather than interpreting it on its face. The language of a statute will cease to be decisive, even if unambiguous, as the propriety or impropriety judged by the historic intent and focus of Congress becomes the only relevant question.

Obviously, this would turn a large amount of case law on it's collective head. The current Common Law requirement is not to look to legislative history unless the statute is patently ambiguous. As the court stated in *Pope* v. *Rollins Protective Services Co.*, 703 F.2d 197, 206 (5th Cir. 1983)[5]; "[i]t is axiomatic that where a statute is clear and unambiguous on its face, a court will not look to legislative history to alter the application of the statute except in rare and exceptional circumstances." Forcing a court to consistently weigh all "improper" benefit cases by this standard not only overrides centuries of stare decisis but also puts the intent of the lawmakers, as presumed by the judiciary, in higher regard than the plain face of the law itself. It is the legislature's responsibility to draft statutes that do not require this sort of "revisionism" by the judicial benches of this country. Accordingly, if there are specific provisions you wish to change, then change them, leaving not a legacy that needs IRS and judicial interpretation to decide propriety, but rather one that speaks loudly and independently.

As we have already alluded to, many of the President's proposals seem to give broad and unregulated authority to the IRS. This is particularly true in the areas of substantial underpayment penalty and denial of benefits associated with "tax avoidance transactions." It is generally unclear to us what would justify this broadened authority. It was not that long ago that your body had hearings to disclose and discuss abusive IRS practices; certainly increasing their already broad power without a corresponding increase in Congressional oversight will not prove worthwhile. As we have previously mentioned it also seems unlikely for this expansion of IRS power to result in less litigation, as an IRS sword sharpened legislatively can only be dulled by repeated judicial admonition.

We acknowledged in our introduction the importance of this legislation. It is certainly good public policy to have a fair and rationale tax code. As in all things, fairness in the tax code is a balancing act and one must strive for equilibrium. Making the IRS, an enforcement agency and one party in an adversarial system, an omnipotent arbiter of your present intent does not seem likely to strike an appropriate balance between taxpayer and IRS. Take the difficult path now, craft your proposals wisely so that the judiciary can interpret the letter of the law, and the IRS can enforce it. Do not take the "low road" and plague the court system and "good faith" taxpayers with an over-armed, trigger happy, out of control IRS.

ENDNOTES

[1] *INDOPCO*, 503 U.S. 79 (1992).

[2] See, *Danielson* v. *Commissioner*, 378 F.2d 771 (3d Cir. 1967) *cert. denied*, 389 U.S. 858 (1967).

[3] See, *Ullman* v. *Commissioner*, 264 F.2d 305 (2d Cir. 1959).

[4] Such as "primary" or "significant" purpose.

[5] See also, e.g. *Dickerson* v. *New Banner Institute, Inc.*, 103 S.Ct. 986, 990, (1983); *North Dakota* v. *United States*, 103 S.Ct. 1095, 1103 (1983); *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11, 19, 100 S.Ct. 242, 246, 62 L.Ed.2d 146 (1979). "Absent a clearly expressed legislative intention to the contrary, that language must ordinarily be regarded as conclusive." *Consumer Product Safety Comm'r* v. *GTE Sylvania, Inc.*, 447 U.S. 102, 108, 100 S.Ct. 2051,

2056, 64 L.Ed.2d 766 (1980). *Rubin* v. *United States*, 449 U.S. 424, 430, 101 S.Ct. 698, 701, 66 L.Ed.2d 633 (1981);

STATEMENT OF THE U.S. CHAMBER OF COMMERCE

[SUBMITTED BY WILLIAM T. SINCLAIRE]

The U.S. Chamber of Commerce appreciates this opportunity to express its views on the revenue-raising provisions in the Administration's Fiscal Year 2000 budget proposal, and to make tax-relief recommendations. The U.S. Chamber is the world's largest business federation, representing more than three million businesses and organizations of every size, sector and region. This breadth of membership places the Chamber in a unique position to speak for the business community.

REVENUE RAISERS IN ADMINISTRATION'S BUDGET PROPOSAL

On February 1, 1999, the Administration released its budget proposal for Fiscal Year 2000. The proposed budget would increase taxes on businesses by approximately $80 billion over five years (according to the Joint Committee on Taxation). Moreover, by the Administration's own admission, it would keep tax receipts, as a percentage of gross domestic product, at or above 20 percent for the foreseeable future.

The Chamber believes the Administration's budget proposal is fraught with revenue raisers that would impinge on or replace sound tax policy with a shortsighted call for additional tax revenue. The federal budget surplus in FY 2000 will be larger than at any time since 1951, and a strong economy with substantial tax payments from the business community have played a significant role in this budgetary success. It would make little sense to endorse $80 billion in tax increases, when considering the increase is aimed directly at those who have greatly contributed to this foremost accomplishment.

In addition, many of the revenue raisers in the Administration's budget proposal lack a sound policy foundation. The Chamber recommends that Congress reject proposals that would increase taxes on the business community and do nothing to create jobs, increase the competitiveness of American businesses, or strengthen the U.S. economy. As we prepare for the economic challenges of the next century, we must orient our current tax policies in a way that minimizes their negative impact on taxpayers, overall growth, and the ability of American businesses to compete globally.

The Administration's budget contains 16 separate proposals that are explicitly directed at so-called "corporate tax shelters." These are in addition to many others that would amend specific federal tax code provisions that the Administration believes create unwarranted tax avoidance opportunities. The corporate tax shelter proposals are undefined in scope, overlap in coverage, violate principles of income measurement and would place virtually unlimited power in the hands of the Internal Revenue Service. If enacted, they would introduce unacceptable uncertainty regarding the tax consequences of even the most basic business transactions. This is not a situation with which the business community should be subjected.

Included in, and in addition to the 16 corporate tax shelter provisions, the Administration's budget proposal contains numerous provisions that would raise revenue. By way of example, and not limitation, these objectionable provisions include the following:

Replace Export Source-Rule With Activity-Based Rule—Under current law, if inventory is purchased or manufactured in the U.S. and sold abroad, 50 percent of the income is treated as earned by production activities (U.S.-source income) and 50 percent by sales activities (foreign-source income). This law is beneficial to U.S. manufacturing companies that export overseas because it increases their ability to utilize foreign tax credits and alleviate double taxation. The Administration proposes that the allocation between production and sales activities be based on actual economic activity. This proposal, however, could increase U.S. taxes on export companies and, therefore, encourage them to produce their goods overseas, rather than in the United States.

Capitalize Acquisition Costs—Insurance companies would be required to capitalize modified percentages of their net premiums for certain insurance contracts in order to more accurately reflect the ratio of actual policy acquisition expenses to net premiums and the typical useful lives of the contracts. This provision would increase the tax liabilities of insurance companies, which in turn would be passed on to its customers.

Require Monthly Deposits Of Unemployment Taxes—Beginning in 2005, employers would be required to deposit their federal and state unemployment taxes monthly, instead of quarterly, if an employer's federal unemployment tax liability in the prior year was $1,100 or more. This provision, which would not bring in any additional revenue to the government, would impose an undue administrative burden on businesses, especially smaller businesses.

Tax Net Investment Income Of Trade Associations—Trade associations, chambers of commerce, non-profit business leagues and professional sports leagues that have annual net investment income exceeding $10,000 would be subject to the unrelated business income tax on their excess net investment income. This provision, which does not apply to labor unions and other tax-exempt entities, would groundlessly tax properly invested funds that would later be used to further the tax-exempt purposes of non-profit entities.

Increase The Proration Percentage—Property and casualty insurance companies would have to increase the proration percentage on their funding of loss reserves by income that may, in whole or part, be exempt from tax. With the property and casualty industry investing 21 percent of their financial assets in, and holding about 14 percent of all tax-exempt debt, there could be a reduction in demand for tax-exempt debt and a rise in the interest rates of tax exempt obligations.

Repeal Lower-Of-Cost-Or-Market Inventory Accounting Method—Taxpayers would no longer be able to value their inventories by applying the lower-of-cost-or-market accounting method or by writing down the cost of goods that are unsalable at normal prices or unusable in their usual way because of damage, imperfection or other similar causes. This provision would increase taxes on those businesses that use the "first-in-first-out" method or cause them to switch to the "last-in-last-out" method for both tax and financial statement purposes.

Repeal The Installment Method For Accrual Basis Taxpayers—The installment method of accounting (which allows a taxpayer to defer recognition of income on the sale of certain property until payments are received) would no longer be available for accrual basis taxpayers. This provision would cause taxpayers to either pay tax on gains which have not yet been received or convert to the cash basis.

Modify The Corporate-Owned Life Insurance Rules—The Administration would repeal the exception under the corporate-owned life insurance rules proration rules for contracts insuring employees, officers or directors (other than 20 percent owners) of a business. This provision could have a devastating effect on life insurance products that protect businesses, especially small businesses, against financial loss caused by the death of their key employees.

Deny Tax Benefits Resulting From Non-Economic Transactions—Proposals would increase the substantial understatement penalty for corporate taxpayers from 20 percent to 40 percent for items attributable to a corporate tax shelter, deny certain tax benefits obtained in a corporate tax shelter, deny deductions for certain tax advice, impose an excise tax on fees received in connection to corporate tax shelters, and impose an excise tax on certain tax benefit protection arrangements. These proposals unfairly target legitimate tax saving devices and related expenses and should be dismissed.

Deny Deductions For Punitive Damages—No deduction would be allowed for punitive damages paid or incurred by a taxpayer, whether upon judgment or in settlement of a claim. In addition, where the punitive damages are paid by an insurance company, the taxpayer would be required to include in gross income the amount of damages paid on its behalf. This provision would deny businesses the ability to deduct legitimate business expenses relating to legal claims.

Repeal Tax-Free Conversions Of Large C-Corporations To S-Corporations—Under current law, the conversion of a C-corporation to an S-corporation is generally tax-free. The "built-in" gains of a corporation's assets are not taxed if the assets are not sold within 10 years of conversion. The Administration proposes to treat the conversion of a "large" C-corporation (those with a value exceeding $5 million) into an S-corporation as a taxable event to both the corporation (with respected to its appreciated assets) and its shareholders (with respect to their stock). This provision would prevent many C-corporations that want to avoid double taxation from electing to be S-corporations.

Eliminate Non-Business Valuation Discounts—Valuation discounts on the minority interests of family limited partnerships or limited liability companies would no longer be allowed for estate and gift tax purposes unless such entities are active businesses. This provision would make it more difficult for business owners to develop estate plans that would keep their businesses intact, and their employees working, after their deaths.

Require The Recapture Of Policyholder Surplus Accounts—The Administration would require stock life insurance companies with policyholder surplus accounts to

include in the income the amount in the account. This proposal is contrary to the intent of Congress in enacting current law.

Modify Rules For Debt-Financed Portfolio Stock—This proposal by the Administration would effectively reduce the dividends-received deduction (the "DRD") for any corporation carrying debt (virtually all corporations) and would specifically target financial service companies, which tend to be more debt-financed. The purpose of the DRD is to eliminate, or at least alleviate, the impact of potential multiple layers of corporate taxation. However, this proposal would exacerbate the multiple taxation of corporate income, penalize investment, and mark a retreat from efforts to develop a more fair, rational, and simple tax system.

Deny The DRD For Certain Preferred Stock—This is another proposal that would deny the DRD for certain types of preferred stock which the Administration believes are more like debt than equity. Although concerned that dividend payment from such preferred stock more closely resemble interest payment than debt, the proposal does not include a provision to allow issuers to take interest expense deductions on such payments. Accordingly, the instruments would be denied both equity and debt tax benefits.

Reinstate Superfund Excise Taxes And The Environmental Tax On Corporate Income—Excise taxes which were levied on various petroleum products, chemicals and imported substances and dedicated to the Superfund Trust Fund would be reinstated through September 30, 2009. The corporate environmental income tax (which was also dedicated to the Superfund Trust Fund) would be reinstated through December 31, 2009. These taxes expired on December 31, 1995. These Superfund taxes should be thoroughly examined, evaluated and made part of a comprehensive plan to reform the Superfund program before they are reinstated.

Defer Interest Deduction And Original Issue Discount On Certain Convertible Debt—The Administration has proposed to defer deductions for interest accrued on convertible debt instruments with original issue discount ("OID") until the interest is paid in cash. However, these hybrid instruments and convertible OID bond instruments have allowed many U.S. companies to raise billions of dollars of investment capital. This proposal is contrary to sound tax policy that matches the accrual of interest income by holders of OID instruments with the ability of issuers to deduct accrued interest. Recharacterizing these instruments as equity for tax purposes is fundamentally incorrect and would put American companies at a distinct disadvantage to their foreign competitors, which are not bound by such restrictions.

Increase Taxes On Tobacco Sales—The Administration plans to propose tobacco legislation that would raise revenues of $34.5 billion over the next five years. Regardless of the Administration's altruistic motives to reduce teenage smoking, levying such a huge tax increase on a single industry would set a dangerous precedent for future tax increases on other industries.

Convert Airport And Airway Excise Taxes To Cost-Based User Fees—Excise taxes which are currently levied on domestic and international air passenger transportation and domestic air freight transportation and deposited in the Airport and Airway Trust Fund would be reduced as new cost-based user fees for air traffic services are phased in beginning in 2000. The excise taxes would be reduced as necessary to ensure that the amount collected each year from the user fees and excise taxes is, in the aggregate, equal to the total budget resources requested for the Federal Aviation Administration in the succeeding year. A $5.3 billion tax increase on the business community and the public-at-large, especially before the issue of whether existing excise taxes should be replaced by cost-based user fees is fully debated, is unacceptable and should be thwarted.

BUSINESS TAX RELIEF IS NEEDED

Instead of asking for the adoption of proposals that would add to the federal tax burden on the business community, the Administration should be leading the way in reducing the encumbrance in a meaningful manner especially when the federal government is collecting more taxes than it needs. Accordingly, the Chamber recommends that there be tax relief in at least the following areas:

Alternative Minimum Tax—Both the individual and corporate alternative minimum tax ("AMT") negatively affect American businesses, particularly those that invest heavily in capital assets. The Taxpayer Relief Act of 1997 (the "1997 Act") exempts "small business corporations" from the corporate AMT, however, unincorporated businesses are still subject to the individual AMT, and larger corporations remain subject to the corporate AMT.

While the Chamber supports the full repeal of both the individual and corporate AMT, to the extent complete repeal is not feasible, significant reforms should be enacted. Such reforms include providing a "small business" exemption for individual

taxpayers; eliminating the depreciation adjustment; increasing the individual AMT exemption amounts; allowing taxpayers to offset their current year AMT liabilities with accumulated minimum tax credits; and making the AMT system less complicated and easier to comply with.

Capital Gains Tax—Lower capital gains tax rates for both individuals and corporations would help maintain our growing economy by promoting capital investment and mobility. Although the 1997 Act reduced the maximum capital gains tax rate for individuals from 28 percent to 20 percent (10 percent for those in the 15-percent income-tax bracket), it should be reduced even further. In addition, capital gains tax relief is still needed for corporations, whose capital gains continue to be taxed at regular corporate income tax rates (to a maximum of 35 percent).

Estate and Gift Tax—The federal estate and gift tax is an inefficient, distortive tax that discourages saving, investment and job growth, unfairly penalizes small businesses, and accounts for little more than one percent of total federal revenues. It can deplete the estates of those who have saved their entire lives and force successful small businesses to liquidate or lay off workers. With a maximum rate of 55 percent, the tax is confiscatory, and its compliance, planning and collection costs are extremely high in relationship to the tax collected (according to the Joint Economic Committee).

The Chamber supports legislation introduced by Senator Kyl (R–AZ) and Representative Cox (R–CA), the Family Heritage Preservation Act (S. 56; H.R. 86), which would immediately repeal the estate and gift tax, as well as legislation introduced by Senator Campbell (R–CO), and Representatives Dunn (R–WA) and Tanner (D–TN), the Estate and Gift Tax Rate Reduction Act of 1999 (S. 38; H.R. 8), which would phase-out the tax over 11 years by annually reducing each rate of tax by five percentage points.

Equipment Expensing—In order to spur additional investment in income-producing assets, businesses should be able to fully expense the cost of their equipment purchases in the year of acquisition. In particular, the small business equipment expensing allowance—which is $19,000 for 1999, and scheduled to increase to $25,000 by 2003—and the amount at which the phase-out begins—currently $200,000—should be increased. The Chamber supports legislation (H.R. 1602) introduced by Representative English (R–PA), which would increase both the expensing allowance and the phase-out threshold.

Foreign Tax Rules—The jobs of many U.S. workers are tied to the exports and foreign investments of U.S. businesses and job growth is becoming increasingly dependent on expanded, competitive, and strong foreign trade. The current federal tax code restrains U.S. businesses from competing most effectively abroad—which in turn reduces economic growth in the U.S. While the 1997 Act contained some foreign tax relief and simplification measures, our foreign tax rules need to be further simplified and reformed so American businesses can better compete in today's global economy.

The Chamber supported the International Tax Simplification for American Competitiveness Act of 1998 (S. 2231; H.R. 4173), introduced by Senators Hatch (R–UT) and Baucus (D–MT), and Representatives Houghton (R–NY) and Levin (D–MI), in the 105th Congress, and its substantively similar predecessors in the 105th and prior Congresses. The Chamber also supports legislation (S. 892; H.R. 681), introduced by Senators Hatch (R–UT) and Baucus (D–MT), and Representatives McCrery (R–LA) and Neal (D–MA), which would permanently extend the active financing income exception to Subpart F, and the Defense Jobs and Trade Promotion Act of 1999 (H.R. 796), introduced by Representative S. Johnson (R–TX), which would repeal the limitation on the amount of receipts that defense product exporters may treat as exempt foreign trade income.

Independent Contractor/Worker Classification—The reclassification by the Internal Revenue Service of workers from independent contractors to employees can be devastating to business owners, as it can subject them to large amounts of back federal and state taxes, penalties and interest. Existing classification rules must be simplified and clarified so disputes with the IRS are minimized. The Chamber has supported legislation that would provide more objective "safe harbors" for determining the status of a worker.

Research and Experimentation Tax Credit—The research and experimentation ("R&E") tax credit encourages companies to invest additional resources into the research, development and experimentation of products and services that benefit society as a whole. While the 1998 Omnibus Budget Bill extended this credit through June 30, 1999, it needs to be extended permanently, and further expanded, so businesses can better rely on and utilize the credit. The Chamber supports legislation (S. 680; H.R. 835) introduced by Senators Hatch (R–UT) and Baucus (D–MT), and

Representatives Johnson (R–CT) and Matsui (D–CA), which expands and permanently extends the R&E tax credit.

S-Corporation Reform—The existing federal tax laws relating to S-corporations need to be updated, simplified and reformed so small businesses can access more funds and better compete in today's economy. While various relief provisions were enacted in 1996, other reforms still need to be implemented, including the allowance of "plain vanilla" stock, elimination of "excess passive investment income" as a termination event, and modification of how certain fringe benefits are taxed to S corporation shareholders. The Chamber supports legislation introduced by Representative Shaw (R–FL), the Subchapter S Revision Act of 1999 (H.R. 689), which contains these and other measures.

Self-Employed Health Insurance Deduction—Self-employed individuals can only deduct a portion of their health insurance costs each year (60 percent in 1999, 2000, 2001, 70 percent in 2002, and 100 percent in 2003 and thereafter). The Chamber believes that the self-employed should be able to fully deduct their health insurance expenses in the year incurred.

CONCLUSION

Our country's long-term economic health depends on sound economic and tax policies. The federal tax burden on American businesses is too high and needs to be reduced. Our federal tax code wrongly favors consumption over savings and investment. As we continue to prepare for the economic challenges of the next century, we must orient our tax policies in a way that encourages more savings, investment, productivity growth, and economic growth.

The revenue-raising provisions contained in the Administration's Fiscal Year 2000 budget proposal would further increase taxes on businesses and reduce savings and investment. The U.S. Chamber urges that these provisions be rejected, and not included in any legislation.

STATEMENT OF THE WASHINGTON COUNSEL, P.C.[1]

[SUBMITTED BY LABRENDA GARRETT-NELSON AND MARK WEINBERGER, ATTORNEYS-AT-LAW]

INTRODUCTION

At a time when the Administration and the Congressional Budget Office are predicting an "on budget" surplus, Treasury has proposed yet another corporate tax increase in the form of a proposal to tax the issuance of "tracking stock." In effect, this proposal would increase the cost of capital to corporations by inhibiting the use of "tracking stock" as a financing option. Apart from proposing a new tax and granting broad regulatory authority to Treasury, the Administration's proposal fails to offer any tax policy reason for the change. Moreover, it is not at all clear that the issuance of tracking stock is an appropriate time to impose a tax, because there is no bail out of corporate earnings. For these and other reasons set forth below, the "tracking stock" proposal should be rejected.

SUMMARY OF THE ADMINISTRATION'S "TRACKING STOCK" PROPOSAL

The Administration's proposal would impose a new tax "upon issuance of racking stock or a recapitalization of stock or securities into tracking stock." The tax would be based on a hypothetical "gain," determined by reference to "an amount equal to the excess of the fair market value of the tracked asset over its adjusted basis." For purposes of this rule, "tracking stock" would be defined as stock that relates to, and tracks the economic performance of, less than all of the assets of the issuing corporation," if either (1) dividends are "directly or indirectly determined by reference to the value or performance of the tracked entity or assets," or (2) liquidation rights are "directly or indirectly determined by reference to the tracked entity or assets." "General principles of law would continue to apply to determine whether tracking stock is stock of the issuer or not stock of the issuer." Treasury would be authorized to prescribe regulations treating "tracking stock as nonstock (e.g., debt, a notional principal contract, etc.) or as stock of another entity as appropriate to prevent tax avoidance, and to provide for increased basis in the tracked assets as a result of gain recognized." The "issuance of tracking stock [would] not result in another class

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[1] Washington Counsel, P.C. is a law firm based in the District of Columbia that represents a variety of clients on tax legislative and policy matters.

of the stock of the corporation becoming tracking stock if the dividend and liquidation rights of such other class are determined by reference to the corporation's general assets, even though limited by the rights attributable to the tracking stock." The provision would be effective for "tracking stock" issued on or after the date of enactment.

I. THE ADMINISTRATION'S PROPOSAL WOULD INHIBIT THE USE OF A VALUABLE CORPORATE FINANCING TOOL

Over the last 15 years, corporations have utilized "tracking stock" as a vehicle for raising capital and to meet a variety of non-tax, business needs. By limiting the financing options of U.S. corporations, the Administration's "tracking stock" proposal would impinge on the ability of corporations to raise low-cost capital in an efficient manner, and thereby have an adverse impact on economic growth, job creation, and the international competitiveness of U.S. businesses. The "tracking stock" proposal would also inhibit the ability of businesses to use "tracking stock" in several other beneficial situations, such as issuing the stock in employee incentive programs to attract and retain key employees and to better align management and shareholders interests.

A. Corporations Have Issued Tracking Stock For a Variety of Business Reasons

"Tracking stock" is issued by corporations that have multiple lines of business that the marketplace would value at different prices if each line of business were held by a separate corporation. By issuing "tracking stock," a corporation can raise capital in a manner that improves the attractiveness of the issuer's stock to the public. The valuation of the entire enterprise increases, because "tracking stock" provides a mechanism for "tracking" the performance of individual businesses. There is, however, no actual separation of a tracked subsidiary or other asset. The corporate issuer continues to benefit from operating efficiencies that would be lost if different lines of business became independent. These efficiencies include economies of scale, sharing of administrative costs, and reduced borrowing rates based on the issuing corporation's overall credit rating. Thus, it is clear that corporations issue "tracking stock" for the business purpose of obtaining the highest values for the separate tracked businesses, while maintaining legal ownership and other operating synergies.

Tracking stock has also been used as "acquisition currency," issued to the former shareholders of an acquired subsidiary. A commonly cited example of the use of tracking stock as acquisition currency is GM's 1984 acquisition of EDS, in which GM Class E tracking stock was issued. In this context, tracking stock can serve a variety of business purposes, including (for example) providing an incentive for managers of a newly acquired business to remain with the company; or allowing former shareholders of the acquired business to continue participation in the business's growth.

As another example, tracking stock has been issued in wholly internal transactions. These internal issuances are undertaken to maintain separate business reporting for rating agency and SEC regulatory accounting purposes, while achieving local tax consolidation in various foreign countries.

B. The Essential Elements of "Tracking Stock" Are Consistent With the Form of the Transaction as Stock of The Issuer

Typically, "tracking stock" is issued as a class of common stock, the return on which is determined by reference to less than all of the issuer's assets. The "tracked" asset can take a variety of forms (e.g., a line of business, a separate subsidiary, or a specified percentage of a separable business). Significantly, there is no legal separation of corporate assets, and thus an investor's return is subject to the economic risks of the issuer's entire operation:

(1) Voting rights of a holder of tracking stock are in the issuer (not, for example, a "tracked" subsidiary);

(2) Dividend Rights, although based on the earnings of a tracked subsidiary or other asset, are subject to whether the parent/issuer's board of directors declares a dividend, as well as state law limitations on the parent/issuer's ability to pay (without regard to a "tracked" subsidiary's ability to pay).

(3) Liquidation Rights might be determined by reference to the value of tracked assets, but investors in tracking stock have no special right to those assets; rather they are entitled to share in all of the issuer's assets on a pro rata basis.

II. THE ADMINISTRATION'S TRACKING STOCK PROPOSAL PRESENTS SERIOUS TAX POLICY CONCERNS, IN ADDITION TO UNRESOLVED TECHNICAL ISSUES

A. Unjustified and Radical Departure From the Normal Treatment of a Stock Issuance

Section 1032[2] provides tax-free treatment to the corporation in every case where a corporation issues its own stock, without regard to whether the issuance constitutes a tax-free exchange or a transaction in which gain or loss is recognized to the recipient of the stock. The Administration's proposal represents a radical departure from this established tax principle, and inappropriately relies on the typical features of tracking stock to justify the result.

The typical dividend, voting, and liquidation rights of tracking stock supports the conclusion that such stock is stock of the issuing corporation, particularly where the holder's right to dividends are left to the discretion of the issuer's board of directors, voting rights are in the issuer, and the holder stands behind the issuer's creditors with no right to specific assets on liquidation.

Lastly, it should be said that it is simply unsound tax policy to write *ad hoc* rules, without regard to whether those rules have any basis in established tax law principles. One sure result of this approach is the creation of discontinuities in the law. For example, if "tracking stock" is singled out for a tax increase, taxpayers issuing tracking stock would be inequitably disadvantaged as compared to other taxpayers using substantially similar economic arrangements. What then would the Administration have accomplished apart from interfering with the capital markets by increasing the costs associated with issuing tracking stock?

B. Imposition of a Preemptive Tax Without Any Showing of Abuse or Other Tax Policy Concern

As observed by the staff of the Joint Committee on Taxation, "tracking stock may be structured in any number of ways that could result in holders having very different types of rights with respect to tracked assets."[3] Indeed, the Administration itself characterized the present law classification as a determination that "is dependent upon the correlation to the underlying tracked assets." Nevertheless, the Administration proposes to impose a tax on every issuance of tracking stock, even if there are no tax policy concerns.

For example, the Administration has failed to explain why a tax should be imposed where tracking stock is issued "internally"—wholly among members of an affiliated group of corporations—for the purpose of facilitating separate financial reporting or other non-U.S. tax, business goals. There is no apparent tax policy concern where tracking stock is issued in a non-divisive transaction, particularly in the case of an internal issuance. As another example, it is not clear why a tax should be imposed where tracking stock is issued to provide an incentive under an employee compensation plan, as a tool for linking compensation to the performance of a business under the recipient's management.

C. Technical Issues

Circular Definition Of Tracking Stock. The Administration recognizes that the proposed definition of"tracking stock" could include stock that has no tracking-stock features. For example, consider a corporation with one class of common stock outstanding, which then issues a new class of tracking stock, dividends on which are based on the operating results of one of the corporation's two subsidiaries. In such a case, by definition, the pre-existing common will constitute "stock that relates to . . . less than all of the assets of the issuing corporation;" similarly, dividends on the pre-existing common will (effectively) track the results of only one of the two subsidiaries.

The proposal seeks to address the circularity in the definition of tracking stock by including the statement that the "issuance of tracking stock will not result in another class of the stock of the corporation becoming tracking stock if the dividend and liquidation rights of such other class are determined by reference to the corporation's general assets, even though limited by the rights attributable to the tracking stock." The proposal fails, however, to describe the mechanics of this "savings" clause.

Absence of Guidance Regarding Collateral Consequences Resulting From Potential Application of the Definition of "Tracking Stock" to Instruments That Resemble

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[2] Except as provided, references to "sections" are to the Internal Revenue Code of 1986, as amended (referred to herein as the "Code").

[3] *Description Of Revenue Provision Contained In The President's Fiscal Year 2000 Budget Proposal*, prepared by the staff of the Joint Committee on Taxation (February 22, 1999) (referred to as "JCS-1-99") at page 224.

Tracking Stock. Reportedly, Treasury is examining the use of "exchangeable shares" (which can be thought of as "reverse tracking stock," in that the shareholder's return is based on the results of the corporate parent of the issuing corporation). Exchangeable shares have been used in acquisitions in which U.S. companies have acquired Canadian subsidiaries.[4] Very generally, these acquisitions take the form of recapitalizations in which shareholders of the acquired company exchange their stock for exchangeable shares, with the U.S. acquirer holding the balance of the company's outstanding stock. Among the many issues presented if the Administration's tracking stock proposal is intended to sweep in securities such as exchangeable shares, is whether dividend payments to Canadian shareholders in these cases is subject to U.S. withholding (on the grounds that the exchangeable shares are stock of the "tracked" U.S. acquirer).

Failure To Provide Any Substantive Guidance. Apart from the imposition of a new tax, the Administration's proposal fails to provide any substantive guidance on the treatment of tracking stock under the Code. Although the treatment of tracking stock as stock of the issuer/parent is characterized as problematic, the proposal includes the statement that "[g]eneral principles of law would continue to apply to determine whether tracking stock is stock of the issuer or not stock of the issuer." Similarly, rather than providing operating rules to deal with identified issues, the Administration proposes to grant new and exceedingly broad regulatory authority for Treasury to prescribe rules treating tracking stock as nonstock, etc. Presumably, regulatory guidance would be applied prospectively; however, it is not at all clear whether Treasury contemplates a grant of authority to recast a transaction on a retroactive basis.

Unprecedented Basis Adjustment For Tracked Assets. The absence of careful analysis is highlighted by the Administration's suggestion that regulations could provide for increases of "inside" basis as the result of gain recognition. As the staff of the Joint Committee on Taxation has pointed out, however, "present law generally does not increase the basis of assets as a result of gain recognition on the distribution or sale of stock, unless an election is made under section 338" (relating to stock sales treated as deemed asset sales). Thus, there is uncertainty regarding the circumstances (if any) in which Treasury would exercise regulatory authority to increase basis.[5]

Uncertainty Regarding The Identity Of The Taxpayer. The Administration's proposal does not expressly state that the tax would be imposed on the issuing corporation (as opposed to a recipient of tracking stock). The imposition of tax on a recipient would make for incongruous results; particularly, for example, where the recipient receives the stock in exchange for cash and realizes no economic gain.

Tax Consequences of After-acquired Shares. The proposal would tax an issuance of tracking stock only to the extent that there is a gain measured by reference to the difference between the tracked asset's value and basis. Consider, however, a hypothetical case where there is no gain on the original issuance of a tracking stock (e.g., because the tracked asset is either a recently purchased business or stock with respect to which a section 338 election was made to step up the basis). Presumably, no tax would be imposed when the tracking stock is first issued. What if additional appreciated property is contributed three years later, in exchange for shares out of the same issue of tracking stock. Would all of the tracked assets be marked to market because the additional shares are tied to the entire (fungible) pool of tracked assets?

Characterization of the Deemed Taxable Event For Purposes of Other Code Sections. Little thought seems to have been given to the effect of the gain recognition event. Would it constitute a deemed sale of the tracked assets? If so, would the sale be viewed as a transaction with a related person or an unrelated person? Where a controlled foreign corporation is involved, the answers to these questions could affect whether the deemed gain is currently taxable under subpart F of the Code.

III. THE ADMINISTRATION HAS FAILED TO ESTABLISH A REASON TO SINGLE OUT TRACKING STOCK FOR CONGRESSIONAL ACTION

The Administration has failed to set forth a basis for either legislative action or the delegation of additional regulatory authority to Treasury. Tracking stock is not a new concept in the tax law. Even under the Administration's proposal, general principles would continue to apply to require that the terms of tracking stock be

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[4] *See IRS Officials Consider Cross-border Exchangeable Stock Deals,"* Tax Notes Today (January 29, 1999)

[5] The Tax Reform Act of 1986 provided similar authority in section 336(e), relating to certain stock sales and distributions treated as asset transfers, but Treasury has never issued regulations.

consistent with treatment of such stock as stock of the issuer.[6] Moreover, the enactment of the proposal would effectively put an end to the market for tracking stock, and thus little if any revenue would be raised.

A. Over Fifty Years of Tax Law Contradicts the Administration's Statement that "Tracking Stock is . . . Outside the Contemplation of Subchapter C and Other Sections of the . . . Code."

The stated rationale for the Administration's proposal begins with the bald conclusion that the "use of tracking stock is clearly outside the contemplation of subchapter C and others sections of the . . . Code." On the other hand, the Administration proposes to rely on "general principles of tax law" to resolve the rather fundamental issue regarding whether tracking stock is stock in the issuing corporation. It is quite clear, that present law is adequate to the task, particularly in view of the existence of case law that pre-dates the Internal Revenue Code of 1954.

Judicial Authority Relating to Tracking Stock Dates Back Fifty Years. As early as 1947, the U.S. Tax Court had occasion to consider the federal income tax consequences of the issuance of tracking stock in the case of *Union Trusteed Funds, Inc.* v. *Commissioner.*[7] That case involved a regulated investment company ("RIC") organized as a single corporation with several series of stock, each of which series represented an interest in the income and assets of a particular fund. Union Trusteed Funds held that the RIC would be treated as a single corporation.

Again, in 1965, the Ninth Circuit Court of Appeals reviewed a case where a corporation issued a new class of nonvoting preferred stock to new shareholders, in exchange for funds that the corporation used to establish a new line of business.[8] After a six-year period, if the new line of business was terminated or the preferred shareholders sold their stock, the corporation was obligated to redeem the preferred stock by the distribution of 90 percent of the assets in the new line of business. Here, again, notwithstanding the liquidation preference of the preferred stock, the court upheld the treatment of the corporation as a single company.

Similarly, the Congress has Dealt With Tracking Stock, When Deemed Appropriate in View of the Particular Purpose of Specific Tax Provisions. The Congress has taken account of the existence of tracking stock, as appropriate for purposes of particular tax provisions. For example, in 1986 the Congress reversed the result in the *Union Trusteed Funds* case (described above), by adding section 861(h) and thereby providing specifically for the separate application of the RIC qualification tests to each series in a series fund, based on the rationale that each such series functions as a separate RIC.[9] Significantly, the drafters of the 1986 RIC change did not appear to view the law as unsettled with respect to a series fund organized as a corporation. Rather, the amendment was enacted to resolve discontinuities that resulted where a series funds was organized as a single business trust (the treatment of which was uncertain).[10]

As another example, in the original enactment of the Passive Foreign Investment Company ("PFIC") regime, the Congress anticipated the possibility that tracking stock might be used to circumvent those rules, and thus included regulatory authority to treat "separate classes of stock . . . in a corporation . . . as interests in separate corporations."[11] Interestingly, the Congress did not suggest that all tracking stock should be so treated, thus allowing for circumstances in which the form of an issuance of tracking stock should be respected.

More recently, in 1990, the Congress specifically addressed a tracking stock issue in the legislative history of Section 355(d), a provision added to deny tax-free treatment to a "disguised sale" of a subsidiary. Very generally, section 355(d) triggers a tax on the distributing corporation in a divisive reorganization where 50 percent

[6] To date, however, the Administration has all but abdicated its authority to address tracking stock under current law. *See* Rev. Proc. 99–3, 1999–1 I.R.B. 109, sec. 3.01(44) (stating that the Internal Revenue ("IRS") will not issue rulings regarding the classification of tracking stock). *But see* Treas. reg. sec. 1.367(b)–4 (1998 regulations in which the IRS did address the treatment of stock that entitles the holder to participate disproportionately in the earnings generated by particular assets, in the context of prescribing circumstances in which gain will be triggered on the exchange of stock in foreign corporations).

[7] 8 T.C.1133 (1947), acq. 1947–2 C.B. 4.

[8] *Maxwell Hardware Co.* v. *Commissioner,* 343 F.2d 713 (9th Cir. 1965).

[9] *General Explanation of the Tax Reform Act of 1986,* prepared by the staff of the Joint Committee on Taxation (May 4,1987) at page 377.

[10] *Id.* At 376 (describing the need to clarify the treatment of a series fund organized as a business trust).

[11] *General explanation of the Tax Reform Act of 1986* at page 1032 (positing that, without this regulatory authority, a foreign corporation engaged in an active business, which would not be a PFIC, could issue a separate class of stock and use the proceeds to invest in a PFIC or to invest directly in passive assets).

or more of the corporation's stock was acquired by purchase during the preceding five years. In measuring the five-year window, section 355(d)(6) reduces the holding period for stock for any period during which the holder's risk of loss is substantially diminished by any device or transaction. In this regard, the Conference Report on the 1990 legislation specifically cites the use of "so-called 'tracking stock' that grants particular rights to the holder or the issuer with respect to the earnings, assets, or other attributes of less than all the activities of a corporation or any of its subsidiaries."[12]

B. Treasury Has Sufficient Authority Under Present Law To Address Tracking Stock

As detailed below, the Administration's request for expanded regulatory authority should be rejected because current law already provides sufficient tools for Treasury to deal with the tracking-stock issues identified as "reasons for change."

The General Utilities Issue. The Administration avers that the treatment of tracking stock as stock of the issuer allows a corporation to "sell an economic interest in a subsidiary without recognizing any gain." This, the Administration suggests, is inconsistent with the 1986 legislation that reversed the *General Utilities* rule, so called after the case that provided an exception for liquidating distributions to the rule imposing two levels of tax on corporate earnings.

In the first instance, the Code does not impose a tax in every case where a corporation sells an economic interest in a subsidiary—the tax consequences depend on the nature of the "economic interest" (e.g., the sale of an option to buy stock in a subsidiary generally treated as an open transaction until the option is exercised or expires, although the existence of such an option could have consequences under provisions such as constructive ownership rules). Moreover, the Administration's proposal does not even purport to resolve the *General Utilities* issue. In any event, some would argue that Section 337(d) already provides the Administration with ample authority to prevent the circumvention of *General Utilities* repeal.[13]

Inclusion of Tracked Subsidiary in a Consolidated Group. The Administration cites the fact that a subsidiary may remain a member of the parent's consolidated group after the issuance of tracking stock, as if this result is bad *per se.* It is not immediately clear why the issuance of subsidiary tracking stock should result in deconsolidation, as long as the parent corporation retains the 80-percent-of-vote-and value level of control prescribed by section 1504. In any case, similar to Treasury's existing authority to deal with *General Utilities,* Section 1504 already grants regulatory authority for Treasury to prescribe rules necessary or appropriate to carry out the purposes of the statutory definition of an affiliated group.

Tax-free Distribution of Tracking Stock. The Administration's "reasons for change" also notes the concern that "a distribution of the shares is tax-free to the shareholders and to the issuer, and the issuer can achieve separation from the tracked assets or subsidiary without satisfying the strict requirements for tax-free distribution." This statement assumes without analysis, that tracking stock effects a true separation in all cases. To the contrary, even where the terms of the tracking stock contemplates the payment of dividends based on the tracked assets,[14] the holder still participates in the economic benefits and burdens of the issuer as a whole. Thus, the insolvency of the issuer/parent would preclude the payment of dividends and render subsidiary tracking stock worthless, without regard to the stand-alone value of the tracked subsidiary.

Consistent with the theory that underlies the tax-free treatment of stock dividends and reorganizations, the issuance of tracking stock is not an appropriate time to impose a tax, to the extent that a taxpayer's investment remains in corporate solution, and the stock represents merely a new form of participation in a continuing enterprise.[15] Nevertheless, the Administration's proposal would trigger a tax on the issuance of tracking stock, even in a case where a distribution of the tracked subsidiary would satisfy "the strict requirements for tax-free distribution."

Additionally, even where the correlation between the tracking stock and a tracked subsidiary is such that there is a separation in "substance," Treasury's existing authority under section 337(d) (the *General Utilities* anti-abuse rule) would be avail-

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[12] H.R. Conf. Rep. No.5835 p. 87.

[13] Indeed, a senior Treasury official was reported to have announced that Treasury would exercise its section 337(d) authority to prevent the use of tracking stock (presumably, to address abusive situations where general principles of law would be violated) "to sell a business without triggering . . . a tax." Tax Notes Today (March 20, 1989).

[14] As the staff of the Joint committee on Taxation observed, "holders of tracking stock may not actually be entitled to the dividends, even though the tracked assets are profitable, if the parent corporation does not declare dividends." JCS–1–99 at page 224.

[15] *See generally* Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders,* par. 12.01[3] regarding the theory underlying tax-free treatment.

able. In any event, it should also be noted that the issuer of tracking stock remains liable for any tax attributable to appreciation in the tracked assets, thus preserving two levels of tax.

C. It is Questionable Whether the Administration's Proposal Would Increase Tax Revenues

It is arguable that the use of tracking stock *increases* tax revenues. This view is based on the availability of financing options such as the issuance of debt, an alternative that would generate interest deductions and thereby eliminate tax on corporate earnings. By comparison, the issuance of tracking stock does not reduce a corporation's tax liability because dividends are paid out of after-tax income. In any case, one likely consequence of the Administration's proposal is that few (if any) corporations will issue tracking stock.

CONCLUSION

In curtailing the availability of financing options, the Administration's tracking stock proposal would force companies to abandon an efficient means of raising low-cost capital, and to turn instead to higher-cost alternatives. This runs counter to the long-term interests of the American economy. Moreover, there are numerous unanswered questions regarding the applicability and administrability of the tracking stock proposal. For these reasons, the Congress should reject the Administration's tracking stock proposal.