TAXATION OF CERTAIN ANNUITY CONTRACTS AND NORMALIZATION REQUIREMENTS FOR CERTAIN PUBLIC UTILITY PROPERTY

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-SIXTH CONGRESS

SECOND SESSION

ON

S. 3082

A BILL TO REINSTATE THE TAX TREATMENT WITH RESPECT TO ANNUITY CONTRACTS WITH RESERVES BASED ON A SEGREGATED ASSET ACCOUNT AS THEY EXISTED PRIOR TO ISSUANCE OF REVENUE RULING 77-85

S. 3094

A BILL TO REINSTATE THE TAX TREATMENT WITH RESPECT TO ANNUITY CONTRACTS WITH RESERVES BASED ON A SEGREGATED ASSET ACCOUNT AS THEY EXISTED PRIOR TO ISSUANCE OF REVENUE RULING 77-85

AND

H.R. 6806

NOVEMBER 19, 1980

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TAXATION OF CERTAIN ANNUITY CONTRACTS AND NORMALIZATION REQUIREMENTS FOR CERTAIN PUBLIC UTILITY PROPERTY

WEDNESDAY, NOVEMBER 19, 1980

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

The subcommittee met, pursuant to call, at 1:55 p.m., in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr., presiding.

Present: Senator Byrd.

[The press release announcing this hearing and the bills S. 3082, S. 3094, and H.R. 6806 follow:]

[Press Release No. H-59 for Immediate Release Nov. 13, 1980]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARING FOR S. 3082, S. 3094, AND H.R. 6806

Senator Harry F. Byrd, Jr. (I., VA.), Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance announced today that the Subcommittee will hold a hearing on bills relating to the taxation of certain annuity contracts and the normalization requirements for certain public utility property.

The hearing will be held on Wednesday, November 19 in Room 2221 of the Dirksen Senate Office Building, and will begin at 2:00 p.m.

S. 3082, introduced by Senator Tower, and S. 3094 introduced by Senator Hatch, are substantially identical and would provide that the tax treatment of certain annuity contracts be determined without regard to revenue ruling 77-85. H.R. 6806 would provide that in certain instances, violations of the normalization requirements of present law would not result in a public utility's loss of eligibility for the investment tax credit or accelerated depreciation. H.R. 6806 would benefit Pacific Telephone and Telegraph Company, General Telephone Company of California, and Southern California Gas Company. Revenue estimates on these measures will be available at the hearing.

Witnesses who desire to testify at the hearing must submit a written request, including a mailing address and phone number, to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, by no later than the close of business on November 17, 1980.

Consolidated testimony.—Senator Byrd also stated that the Committee urges all witnesses who have a common position or the same general interest to consolidate their testimony and designate a single spokesman to present their common viewpoint orally to the Committee. This procedure will enable the Committee to receive a wider expression of views than it might otherwise obtain.

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

Witnesses scheduled to testify should comply with the following rules:

(1) All witnesses must include with their written statements a one-page summary of the principal points included in the statement.

(2) The written statements must be typed on letter-size (not legal size) paper and at least 100 copies must be delivered to Room 2227, Dirksen Senate Office Building, not later than noon of the last business day before the witness is scheduled to appear.

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

Written statements.—Witnesses who are not scheduled to make an oral presentation, and others who desire to present their views to the Subcommittee, are urged to prepare a written statement for submission and inclusion in the printed record of the hearing. These written statements should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510, not later than December 1, 1980.

II

96TH CONGRESS
2D SESSION

S. 3082

To reinstate the tax treatment with respect to annuity contracts with reserves based on a segregated asset account as they existed prior to issuance of Revenue Ruling 77-85.

IN THE SENATE OF THE UNITED STATES

SEPTEMBER 4 (legislative day, JUNE 12), 1980

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

---

A BILL

To reinstate the tax treatment with respect to annuity contracts with reserves based on a segregated asset account as they existed prior to issuance of Revenue Ruling 77-85.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That in the case of annuity contracts which have related
4 amounts based on a segregated asset account, the tax treat-
5 ment of such contracts under section 61 of the Internal Reve-
6 nue Code of 1954 (defining gross income) and section
7 801(g)(1)(B) of such Code (relating to contracts with reserves
8 based on a segregated asset account) shall be determined—

1 (1) without regard to Revenue Ruling 77–85 (and
2 without regard to any other regulation, ruling, or deci-
3 sion reaching the same result as, or a result similar to,
4 the result set forth in such revenue ruling); and
5 (2) with full regard to the rules in effect before
6 Revenue Ruling 77–85.

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II

96TH CONGRESS
2D SESSION

S. 3094

To reinstate the tax treatment with respect to annuity contracts with reserves based on a segregated asset account as they existed prior to issuance of Revenue Ruling 77-85.

IN THE SENATE OF THE UNITED STATES

SEPTEMBER 4 (legislative day, JUNE 12), 1980

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

---

A BILL

To reinstate the tax treatment with respect to annuity contracts with reserves based on a segregated asset account as they existed prior to issuance of Revenue Ruling 77-85.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That in the case of annuity contracts which have related
4 amounts based on a segregated asset account, the tax treat-
5 ment of such contracts under section 61 of the Internal Reve-
6 nue Code of 1954 (defining gross income) and section
7 801(g)(1)(B) of such Code (relating to contracts with reserves
8 based on a segregated asset account) shall be determined—

1 (1) without regard to Revenue Ruling 77-85 (and
2 without regard to any other regulation, ruling, or deci-
3 sion reaching the same result as, or a result similar to,
4 the result set forth in such Revenue Ruling); and

5 (2) with full regard to the rules in effect before
6 Revenue Ruling 77-85.

Senator BYRD. The committee will come to order.

The Senate is considering the budget resolution. I think the budget resolution is an unwise one. It provides for much too much spending. I will need to be in the Senate until this measure is disposed of. I think it will be disposed of prior to 3 o'clock.

The Senate also will be voting on a motion to make possible, through the budget process, a reduction in taxes as proposed by President-elect Reagan during the campaign. President Carter ridiculed him for his proposal, but the American people seem to have reacted somewhat favorably, shall we say, so I think that the new President should have an opportunity.

I regret that I have to recess this subcommittee at this time, but I know it is necessary that I be in the Senate while this matter of taxes and spending is under consideration. With that in mind, and with apologies to all of you, I plan to recess this meeting until 3 o'clock.

If another member or members of the committee should come in, I have asked the staff to suggest that if they wish to do so they could reconvene the committee in my absence. That would be satisfactory to me. Otherwise, the committee will stand in recess until 3 o'clock, and hopefully we can proceed at that point.

[Recess.]

Senator BYRD. The committee will come to order. Again, the Chair regrets the delay. Actually, with the Senate in session, the committee is not fully authorized to proceed, but I think we will proceed anyway.

The subcommittee will consider today two Senate bills, S. 3082 sponsored by Senator Tower, and S. 3094 sponsored by Senator Hatch, dealing with the taxation of investment annuities.

[Statement of Senator Hatch follows:]

PREPARED STATEMENT OF SENATOR ORRIN G. HATCH ON S. 3094

Mr. Chairman, I greatly appreciate the opportunity to testify at this important hearing. I congratulate you, Mr. Chairman, in bringing this matter before your Committee in order that action may be taken to correct a gross injustice in the administration of our tax laws.

I am here not only to represent my constituency, but also as a member of the Judiciary Committee and Senate Select Committee on Small Business. I join many others in expressing extreme concern with the brazen and outrageous manner in which unelected bureaucrats, who know all the ropes, use their omnipotent power to crush legal business activities just because those activities do not fit the bureaucrat's current perception as to how they prefer to run our government regardless of clear law, and their own precedents, that they so freely violate.

S. 3094 and my Congressional Record statement concerning it clearly present my strong views and my urgent request for immediate remedial action. Not long after S. 3094 was introduced to correct the injustice of Revenue Ruling 77-85 the IRS issued Revenue Ruling 80-274 that has no legal rationale and merely states a conclusion based upon Revenue Ruling 77-85. By this action another segment of the annuity industry has been crippled to the detriment of our nation.

Clearly, there is only one proper action for the Congress to take and that is to restore the mode of annuity taxation to that which existed prior to the IRS issuance of Revenue Ruling 77-85. This action is long overdue and is of critical, immediate importance to protect the vital interest of those taxpayers impacted by the very recent Revenue Ruling 80-274.

These revenue rulings, and the IRS' and the Treasury's actions related thereto, constitute a documentable case of arbitrary, capicious and illegal acts that can not be acceptable nor tolerable to the Senate. This situation warrants immediate approval of this proposed legislation; an action that will also restore the authority of the Congress in the writing of our tax laws—a most important matter.

Senator BYRD. In addition, the subcommittee will consider H.R. 6806, a measure dealing with the tax treatment of accelerated depreciation and investment tax credit for public utilities.

A copy of an analysis of these measures was prepared by the Joint Committee on Taxation, and will be inserted in the record of these hearings.

[Document follows:]

INTRODUCTION

This pamphlet provides an explanation of H.R. 6806, relating to the treatment of pubilc utility property under sections 46(f) and 167(l) of the Internal Revenue Code, scheduled for a public hearing on November 19, 1980, by the Senate Finance Subcommittee on Taxation and Debt Management Generally. This bill was passed by the House of Representatives on September 25, 1980.

The first part of the pamphlet is a summary of the bill. This is followed by a more detailed explanation of the bill, setting forth present law, background, the issues involved, an explanation of the provisions of the bill, and the estimated revenue effect.

I. SUMMARY

The bill (H.R. 6806) would clarify the rules relating to the normalization requirements for public utility property eligible for the investment tax credit and accelerated depreciation. The bill also would provide a special rule which, in general, excuses violations of these requirements for certain past periods where such violations were a result of certain orders entered by a public utility commission prior to March 13, 1980.

With certain exceptions for companies that are grandfathered, public utilities are eligible to use the investment credit and to elect accelerated depreciation for tax purposes only if the tax benefits from accelerated depreciation and the investment credit (or, in some cases, a portion of the credit) are normalized for ratemaking purposes. Normalization generally requires that the tax benefits of accelerated depreciation and the investment credit not be treated for ratemaking purposes as a reduction in current Federal income tax expense, which is an element of a utility's cost of service, since that treatment would generally result in a direct reduction in the utility's revenues. Instead, the tax benefits are to be treated as investment capital that is supplied, in effect, by the Federal government to the utility through the tax system. The normalization rules for accelerated depreciation require that the utility retain the use of the deferred taxes but permit the deferred taxes to be treated as zero-cost capital on which the utility need not be allowed to earn an investment return; the normalization rules for the investment credit require a similar allocation of benefits between utility shareholders and utility customers. The normalization rules relating to accelerated depreciation were imposed in 1969, and the normalization rules relating to the investment credit, for the most part, were imposed in 1971 and 1975.

The bill would provide that violations of the normalization requirements of present law (and of the bill) will not result in a public utility's loss of eligibility for the investment tax credit or accelerated depreciation if such violations involved the use of estimates, projections, or rate of return adjustments (1) that applied for any period ending prior to March 1, 1980, and (2) that were included in certain orders of a public utility commission which were entered prior to March 13, 1980. This special rule is designed to benefit Pacific Telephone and Telegraph Company (a subsidiary of A.T. & T.), General Telephone Company of California (a subsidiary of General Telephone & Electronics), and Southern California Gas Company.

The bill would amend the present normalization rules relating to accelerated depreciation and the investment tax credit to make it clear that certain ratemaking procedures involving the use of inconsistent estimates or projections do not comply with such rules. It also would give the Treasury Department specific authority to provide regulations setting forth conditions under which ratemaking adjustments are inconsistent with normalization. The amendments to the normalization rules generally would apply to taxable years beginning after December 31, 1979.

II. EXPLANATION OF THE BILL

A. Present Law

Accelerated depreciation

In general

Accelerated methods of depreciation, i.e., methods of depreciation that are faster than straight-line depreciation over the useful life of an asset, were enacted in the Revenue Act of 1954 (Code sec. 167). Congress made this form of depreciation available because it believed that accelerated depreciation would increase investment in new equipment and processes.[1]

Accelerated depreciation for public utilities

When accelerated depreciation was provided under the 1954 Code, there were no special provisions relating to the treatment of accelerated depreciation for regulated utilities. The stated congressional intent was to stimulate the economy by fostering capital formation. However, because Federal income tax expense represents an element of cost of service for ratemaking purposes, some regulatory agencies treated the reduction in current tax liability resulting from accelerated depreciation as a reduction in current cost of service and therefore flowed through the resulting tax benefit to customers currently by reducing rates. This practice, which is known as "flow-through" ratemaking, meant that accelerated depreciation would provide no direct investment incentive to public utilities.

In response to what Congress saw as an undesirable trend toward flow-through ratemaking, Code section 167 was amended as part of the Tax Reform Act of 1969. Under Code section 167(l), except for utilities with respect to which prior flow-through treatment for certain types of property was grandfathered, a utility could thereafter use accelerated depreciation for Federal tax purposes only (1) if the utility used a "normalization" method of accounting in its books of account and (2) if the regulatory agency used a normalization method of setting rates.[2]

Code section 167(l)(3)(G) provides that:

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[1] Subsequent congressional action with respect to depreciation generally has involved approval of a method to reduce the useful lives of assets so that depreciation may be calculated over a shorter period (such as the Asset Depreciation Range (ADR) system adopted in 1971 and various special 5-year amortization provisions). This is a different form of accelerated depreciation, but it tends to produce the same effect as a faster rate of depreciation in the calculations of a potential investor.

[2] In general, these rules apply to public utility property used in a public utility activity. Property is public utility property if, during any period, it is used predominantly in a public utility activity. Public utility activities to which the depreciation method limitations apply mean the trade or business of furnishing or selling:

(1) Electrical energy, water, or sewage disposal services;
(2) Gas or steam through a local distribution system;
(3) Telephone services;

"In order to use a normalization method of accounting with respect to any public utility property—

"(i) the taxpayer must use the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

"(ii) if, to compute its allowance for depreciation under this section, it uses a method of depreciation other than the method it used for the purposes described in clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from the use of such different methods of depreciation."

The Treasury Regulations (§ 1.167(l)-1(h)) have interpreted this section to require that: (1) a utility's tax expense for ratemaking purposes must be computed as though straight-line depreciation were being used for tax purposes; (2) the full amount of the deferred taxes (i.e., the difference between tax expense computed using accelerated and using straight-line depreciation) must be reflected in a reserve and thus be available for capital investment; and (3) the regulatory agency may not exclude from the rate base an amount greater than the amount of the reserve for the period used in determining the tax expense as part of cost of service. The Treasury Regulations (§ 1.167(a)-11(b)(6)) also interpret section 167(l) as requiring that, in addition to the benefits of accelerated methods of depreciation, the benefits of shortened useful lives under the ADR system must be normalized.

Thus, a normalization method of accounting results in the temporary tax reductions from accelerated depreciation being retained by the utility as a source of cost-free capital for which the utility customers need not pay the utility an investment return.

By allowing utilities to use accelerated depreciation only if normalization were followed, Congress had two principal objectives: first, to assure that the deferred taxes resulting from accelerated depreciation would be available to the utilities as investment capital until paid to the Treasury and, second, to avoid the possible loss of Federal tax revenues that it believed would result because flow-through ratemaking would reduce the taxable income of utilities.

Investment tax credit

In general

The investment tax credit was enacted initially in the Revenue Act of 1962 (generally at 7 percent, except as noted below for public utilities). In 1964, Congress repealed a provision in the 1962 Act which required that the basis for depreciation of eligible property be reduced by the amount of the credit. In 1966, the credit was suspended during a period of rapid investment growth, and the credit was restored in 1967 when the rate of investment growth subsided.

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(4) Other communication services (whether or not telephone services) if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701); or

(5) Transportation of gas or steam by pipeline,

if the rates for the furnishing or sale are established or approved by certain regulatory bodies.

The investment credit was repealed as of April 18, 1969, in the Tax Reform Act of 1969, but was reenacted in the Revenue Act of 1971. In 1975, the investment credit was increased to 10 percent temporarily, and the 10-percent credit rate was made permanent in the Revenue Act of 1978.

The Energy Tax Act of 1978 enacted a 10-percent energy investment tax credit for various kinds of energy-related property. This credit was expanded, and increased to 15 percent in certain cases, in the Crude Oil Windfall Profit Tax Act of 1980.[3]

Investment tax credit for public utilities

Congress initially made a partial investment credit (3 percent instead of 7 percent) available to regulated public utilities. The reduced rate was a compromise between those who argued that utilities should be treated like other industries and those who argued that because the rates charged by regulated public utilities were intended to provide them with the opportunity to earn a satisfactory rate of return, they did not need Federal tax incentives to encourage capital investment.

In the Revenue Act of 1964, Congress provided that no Federal regulatory agency could flow through the tax saving from the investment credit to customers more rapidly than ratably over the useful life of the property. In addition, no Federal regulatory agency could require flow-through of any part of the credit in the case of any other property of a regulated company. Neither of these prohibitions would apply if the company consented.

When Congress restored the investment tax credit at a 7-percent rate in the Revenue Act of 1971, the investment credit for public utilities was increased from 3 percent to 4 percent. The increased credit was provided because many utilities were encountering problems in raising capital for modernization and expansion. An additional reason for the credit was to improve the competitive position of regulated utilities against unregulated companies which provide some of the same services. (The 1971 Act also reduced the credit allowable to unregulated taxpayers to 4 percent for certain property used in competition with public utility property.)

When Congress restored the investment credit in 1971, it generally provided that the investment credit would not be available to regulated public utilities unless the benefits of the credit were normalized under one of the two normalization options in the Code. However, utilities that were on a flow-through method of accounting for accelerated depreciation were generally allowed to flow through the investment credit. (In the 1975 Act, the limit on the amount of tax liability offset by investment credits also was increased temporarily for most public utilities because low earnings and tax liabilities were leaving utilities with large amounts of unused credits to carryforward.) When the investment credit for public utility property was

[3] Public utility property is not eligible for the energy investment credit except for small-scale hydroelectric property, equipment used to produce oil shale or gas from geopressured brine, and perhaps specially defined energy conserving property.

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increased to 10 percent in 1975, it was provided that flow-through could not be utilized by these grandfathered utilities with respect to the additional 6 percent credit (or the additional credit allowable by reason of increased limitation based on tax liability) unless the company made a specific election. This rule was retained when the 10-percent rate was made permanent in 1978.

In general, present law (Code sec. 46(f)) denies the investment tax credit (both the regular credit and any allowable energy credits) with respect to public utility property if a public utility regulatory commission requires that the credit be immediately flowed through to customers or if the benefits of the utility's retention of the credit are not shared between utility customers and utility shareholders in a manner prescribed by one of the normalization options in the Code.

Under certain exceptions, however, the benefits of the investment tax credit may be flowed through immediately to customers if an election is made and if the taxpayer was on a flow-through method of accounting for depreciation purposes prior to 1969. As mentioned above, this immediate flow-through rule applies only to investment credit which would have been allowed under the rules in effect prior to 1975; the increase first provided with respect to public utility property in 1975 must be accounted for under a normalization method of accounting (Code secs. 46(f) (3) and (8)).[4]

Except for the special flow-through rules in the preceding paragraph, the investment credit is denied for public utility property if the ratemaking treatment of the credit results in the utility's shareholders receiving less than the benefit prescribed by (a) the ratable flow-through method or (b) the rate base reduction method, whichever is applicable.

Under the ratable flow-through method, the benefits of the investment credit may be shared with utility customers by passing through to them no more than a ratable portion of the investment credit during a period equal to the useful life of the asset that produced the credit. The ratable portion is equal in amount to the regulated depreciation allowance on that portion of the cost of the equipment paid for, in effect, by the credit. However, the utility shareholders must be allowed a return on the capital represented by the credit, just as with the private capital of the utility. In this manner, the benefits of the investment credit are shared by passing through to customers the equivalent of the depreciation allowance on the portion of the purchase price of the property paid for by the credit and by requiring that the utility earn a return on the investment that, in effect, has been supplied by the credit.

Under the rate base reduction method, the utility's rate base is reduced by the amount of the credit, so that the shareholders are pre-

[4] However, a public utility which had elected flow through prior to 1975 could make another election to flow through the additional credit. This additional election was structured so that it normally could be made by the company and not by direction of the regulatory commission.

Special rules are also provided to prevent flow through of the additional credit for contributions to an employee stock ownership plan (Code sec. 46(f) (9)).

vented from earning a return on that part of the cost of the equipment which is, in effect, paid for by the credit. However, under this method, the regulatory commission may not require that the utility flow through to customers any part of the credit itself, and it must allow the utility to charge customers for the depreciation expense on the entire cost of the equipment, including the part paid for by the investment credit.

B. Background

Accelerated depreciation methods and the investment tax credit were enacted in order to encourage higher rates of investment in plant and equipment. This result is achieved by increasing the estimated rate of return after taxes over the life of the asset involved through reducing the initial cost of the investment or making possible a more rapid recovery of the funds invested in capital assets.

When it considered the Tax Reform Act of 1969, Congress found that public utility regulatory agencies were adopting very different methods of flowing through to customers the tax benefit from accelerated depreciation. About half the regulatory agencies required utilities that used accelerated depreciation to flow through the tax reduction from accelerated depreciation immediately in the form of lower rates. Some agencies insisted that utilities subject to their jurisdiction use accelerated depreciation for tax purposes and, in a few rate cases, treated the utilities as though they used accelerated depreciation (and flowed through the resulting tax reduction), even though the utilities may have used straight-line depreciation on their tax returns. Other agencies permitted the utilities under their jurisdiction to normalize the deferred tax liabilities resulting from accelerated depreciation (i.e., permit the company to retain the temporary tax savings but pass through to customers the resulting cost of capital savings). The trend, however, appeared to be towards use of immediate flow-through. As a result, Congress decided, as part of the Tax Reform Act of 1969, essentially to freeze the then current situation with regard to the circumstances under which accelerated depreciation methods could be used by a regulated public utility.

The freeze applied to existing property as of August 1, 1969. It permitted most flow-through practices to continue, but provided that subsequent changes to a faster rate of depreciation for Federal income tax purposes would not be allowed.

For new (i.e., post 1969) property, a public utility generally was allowed to flow through the tax benefits from accelerated depreciation if that was the practice as of August 1, 1969. In all other cases, straight-line depreciation was required unless the tax benefits from accelerated depreciation were normalized.

When Congress restored the investment tax credit at a 7-percent rate in the Revenue Act of 1971, the investment credit for public utilities was increased from 3 percent to 4 percent. The increased credit was provided because many utilities were encountering problems in raising capital for modernization and expansion. An additional reason for the increased credit was to improve the competitive position of regulated utilities against unregulated companies which provide some of the same services.

When Congress restored the investment credit in 1971, it provided that the investment credit would not be available in cases where the

credit was immediately flowed through to customers or where some of the benefits of the utility's retention of the credit were not retained by the utility as provided under one of the normalization options in the Code. However, utilities that were on a flow-through method of accounting for accelerated depreciation were generally allowed to flow through the investment credit. When the investment credit for public utility property was increased to 10 percent in 1975, it was provided that, for the most part, flow through could not be utilized by these grandfathered utilities with respect to the additional 6 percent unless the company made an election. This rule was retained when the 10-percent rate was made permanent in 1978.

Considerable controversy has arisen over the proper application of these normalization rules, principally in California. Prior to 1969, the California Public Utilities Commission generally required utilities under its jurisdiction to flow through the tax benefits of accelerated depreciation to customers immediately. However, in accordance with Code provisions making the use of accelerated depreciation elective, Pacific Telephone and Telegraph Company and General Telephone Company of California, the telephone companies under the Commission's jurisdiction, did not elect to take accelerated depreciation for Federal tax purposes. In a 1968 decision, the Commission found that it was imprudent for the companies to use straight-line depreciation for Federal tax purposes, and the Commission set rates as if accelerated depreciation had been elected, and it flowed through the tax benefits of this imputed accelerated depreciation to the customers. This 1968 decision was modified by the Commission in 1970 to allow the companies to elect accelerated depreciation with normalization as prescribed by the Code. However, in 1971 the California Supreme Court annulled the 1970 decision on the grounds that (1) the 1968 decision did not have to be modified because of the intervening passage of the Tax Reform Act of 1969 rules requiring that public utilities (other than public utilities which had previously used accelerated depreciation and flowed it through to their customers) could elect accelerated depreciation only if the benefits of such depreciation were normalized and (2) other methods of normalization should have been considered.

After protracted litigation (including 3 more decisions of the California Supreme Court), the Commission entered an order which requires the telephone companies to use certain methods of accounting to measure the amount of the benefits from accelerated depreciation and the investment credit that are to be shared with the utility customers. Although no final determination has been made as to whether these methods comply with the Code's normalization requirements, the Internal Revenue Service has issued private rulings which take the position that the methods do not comply with such requirements. As a result, these telephone companies are faced with a situation in which they may be deemed ineligible to claim accelerated depreciation and the investment credit even though all or a portion of these benefits may have already been reflected in reduced rates or refunds for their customers. At least one other utility (Southern California Gas Company) apparently has a similar problem with respect to that portion of the investment credit which is subject to the "anti-flow-through" rules of the 1975 Act.

C. Issues

One major issue is whether it is desirable to clarify for the future the rules relating to normalization with the intention of preventing further disputes of the type which has occurred in California. The other major issue is whether it is appropriate to provide a special rule that would exempt utilities from the normalization requirements of present law for accounting periods that ended prior to March 1, 1980, if the utilities used certain accounting methods which were prescribed by an order of a public utility commission entered prior to March 13, 1980.

D. Explanation of Provisions

The bill contains two amendments to the normalization rules which would not materially change the substance of present law as that law is interpreted by Treasury regulations. It also contains a special rule applicable to periods prior to March 1, 1980, and designed to benefit Pacific Telephone and Telegraph Company (a subsidiary of A.T. & T.), General Telephone Company of California (a subsidiary of General Telephone & Electronics), and Southern California Gas Company.

1. Accelerated depreciation

The bill would add a new provision (Code sec. 167(l)(3)(H)) which clarifies the present definition of the normalization method of accounting (in Code sec. 167(l)(3)(G)) for accelerated depreciation in a manner which generally follows the interpretation of this provision now contained in Treasury regulations.

This added provision generally would provide that normalization is not complied with if, for ratemaking purposes, a procedure or adjustment is employed which uses estimates or projections of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes unless these estimates and projections are also used in determining the other two such items and the rate base.

The Treasury also would be given authority to prescribe regulations which define other procedures and adjustments which are inconsistent with normalization. This specific authority to prescribe regulations would not be intended to limit the Treasury's normal authority to interpret, by regulations or otherwise, these new Code provisions or existing Code provisions relating to normalization.

This provision would be intended to make it clear that California's so-called "AAA" method (and any other similar method) of making adjustments for ratemaking purposes does not comply with the normalization requirements of Code section 167(l)(3)(G).

2. Investment tax credit

The bill would add a new provision (Code sec. 46(f)(10)) to the rules relating to normalization of the investment tax credit. The new provision generally would provide that the normalization rules are not complied with if a procedure or adjustment is employed which uses an estimate or projection of the taxpayer's qualified investment for purposes of the investment tax credit unless such estimate or projection is consistent with the estimates and projections of property which are used, for ratemaking purposes, with respect to the taxpayer's depreciation expense and rate base.

The Treasury Department also would be given authority to prescribe regulations which define other procedures and adjustments which are inconsistent with the requirements of the rate base method

or the ratable flow-through method. This specific authority to prescribe regulations would not be intended to limit the Treasury's normal authority to interpret, by regulations or otherwise, these new Code provisions or existing Code provisions relating to normalization.

This provision would be intended to make it clear that California's so-called "AA" method (and any other similar method) of making adjustments for ratemaking purposes does not comply with the requirements of Code section 46(f).

The new Code provisions which would be added by the bill (new Code secs. 46(f)(10) and 167(l)(3)(H)) would specify only one manner in which the normalization rules may be violated. Thus, compliance with these provisions would be a necessary but not sufficient condition for eligibility for the investment tax credit and accelerated depreciation.

3. Special rule for periods prior to March 1, 1980

The bill would provide that violations of the normalization requirements of present law (and of the bill) would not result in a public utility's loss of eligibility for the investment tax credit or accelerated depreciation if (a) such violations involved the use of estimates, projections, or adjustments to the taxpayer's rate of return and (b) such estimates, projections, or adjustments only applied for any period ending prior to March 1, 1980, and were included in a qualified order. For purposes of this special rule, a qualified order would be an order of a public utility commission—(1) which was entered before March 13, 1980, (2) which used the estimates, projections, or rate of return adjustments to determine the amount of the rates to be collected by the taxpayer or the amount of a refund with respect to rates previously collected, and (3) which ordered such rates to be collected or refunds to be made (whether or not such order actually was implemented or enforced). Since the special rule would apply to rates which were determined for periods prior to March 1, 1980, an order may be a qualified order even if it requires that refunds be paid after March 1, 1980, so long as such refunds are attributable to adjustments to rates charged prior to that date.

As indicated above, this transitional rule is designed to benefit Pacific Telephone and Telegraph Company, General Telephone Company of California, and Southern California Gas Company.

4. Effective date

The provisions of the bill (other than the special rule) generally would apply to taxable years beginning after December 31, 1979. However, these provisions could be overridden by the special rule for periods prior to March 1, 1980.

The bill would explicitly provide that, in applying the normalization rules (Code secs. 46(f) and 167(l)(3)) to taxable years beginning before January 1, 1980, no inference is to be drawn from the amendments to these rules (new Codes secs. 46(f)(10) and 167(l)(3)(H)) or from the special rule. However, this no inference rule would not be intended to limit the relief provided by the special rule.

The bill also would provide that no refund or credit of any overpayment of tax attributable to the bill would be made or allowed prior to October 1, 1981.

E. Revenue Effect

It is estimated that the permanent changes made by the bill would have no revenue effect.

If the orders of the California Public Utilities Commission applicable prior to March 1, 1980, to the three utilities which would be benefitted by the special rule do *not* comply with the current normalization rules in the Code, the special rule in the bill would result in a revenue loss of approximately $1.85 billion attributable to accounting periods prior to March 1, 1980. Approximately $110 million of this amount has been paid into the Treasury and could be the subject of claim for a refund which could be filed at any time through February 1982. Since the bill provides that no refund or credit of any overpayment of tax attributable to the provisions of the bill could be made or allowed prior to October 1, 1981, the $110 million of revenue loss would probably occur in fiscal year 1982. The remainder of the $1.85 billion revenue loss generally would occur in the fiscal year or years in which determinations of tax liability for the affected companies would otherwise become final. Such losses would probably occur in fiscal year after 1981

If these orders do comply with the current normalization rules, the special rule in the bill would result in no revenue loss as long as orders in effect for periods after March 1, 1980, are in compliance with the revised normalization rules.

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

Mr. Secretary, you may proceed.

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

Mr. HALPERIN. Thank you, Mr. Chairman. I will try to be as brief as I can.

H.R. 6806 is a bill that deals with a very complicated subject. I assume that some of the future witnesses will be getting into the details of it. We have not opposed the bill, and we continue to take that position.

It is obvious to us that the California Public Utility Commission and the courts have required the taxpayers to account for the benefits of the investment credit and accelerated depreciation in a manner inconsistent with the requirements Congress has set for entitlement to such benefits.

Therefore, we welcome that part of the bill which so states that the method used in California is improper, says it in so many words, thus makes it even clearer than is existing law.

As we have indicated in our testimony on this subject in the past, we are concerned about the future consequences of the other aspect of this bill. The other aspect of this bill is to take away the penalty for the failure to follow the rules as to how to account for the tax benefits involved here.

If we are correct that the method that the California commission used is wrong, it would mean that the utility companies, telephone

companies principally, will lose the tax benefits of accelerated depreciation and investment tax credit.

Senator BYRD. You favor the legislation, do you not?

Mr. HALPERIN. We do not oppose it.

Senator BYRD. You do not oppose it.

Mr. HALPERIN. That is correct.

What this bill does is to say, let's forget about the past, and let's absolve you for any penalties that may have occurred up to now. We indicated our concern that this could be looked upon as a precedent, and that other commissions might say: "We can take some chances. We can try things that may not be consistent with the law because Congress will never let this penalty go into effect."

The House has indicated its concern about that. It has indicated as strongly as it could that this should not be looked upon as a precedent, and we would assume that if you act on this bill, you would again try to make as clear as you can that this is the last time that this kind of thing can go through.

Senator BYRD. I think that it would be well to say at this point, insofar as the chairman of this subcommittee is concerned, I think it should be considered in that light, and not be considered as a precedent.

Mr. HALPERIN. In view of that, and in view of the fact that other people have not expressed opposition to this bill from other regulated utilities that presumably would be concerned if our fears are deserved, we feel on balance that it is worth a try.

It is an extremely difficult problem. It has absorbed an enormous amount of the resources of the Internal Revenue Service, and of our office at Treasury. We, as much as the telephone companies, would like to resolve it without prolonged litigation and uncertainty.

On balance, we will not stand in the way of this bill, and let's all hope for the best, and that in the future we will not have these problems facing us.

Senator BYRD. In brief, if Congress decides to pass this legislation, you have no problem with it.

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

S. 3082 and S. 3094 are identical bills. We are opposed to these measures. We don't feel that this is a time to get into the question of freezing a 4-year-old revenue ruling, a revenue ruling that has been considered by the Congress in connection with the Tax Reduction and Simplification Act of 1977.

In fact, the Senate passed a 1-year delay on the effectiveness of the revenue ruling. That was not accepted, and was dropped in conference. The subject was discussed again in 1978, and we do not see why we are going back to it at this time.

Moreover, if we are going to get into this question, we ought to do it in terms of substantive legislation, and not merely saying a particular revenue ruling should not go into effect.

The issue we have here is not really complex. Generally, investment income from interest and dividends is taxed currently as you earn it. We have one glaring exception to that, and that is involved with annuity contracts.

If an individual goes out and buys an annuity contract at the age of 30 or 40, and there is no payout on that annuity until age 65, in

the ensuing 30 years there is no taxation on the income even though we know that the insurance company, in effect, is crediting interest on the investment made by the purchaser of the annuity contract.

What we have in this situation is an effort by the promoters of these investment annuities to make everything an annuity contract. They want the exception for annuity contracts to swallow the general role that interest and dividends are currently subject to tax.

We believe and the IRS believes that this is an artificial device and it does not work under present law. We have so indicated by the issuance of revenue ruling 77-85. I think it is even clearer that it should not work. We cannot continue to believe in the current taxation of investment income, while permitting such glaring avoidance techniques to exist.

If we are going to legislate in this area, what we do need is tightening, and not a loosening, an indication of what are the limits of the annuity exception, and apply that in a way that does not totally swallow up the taxation of investment income.

For that reason, Mr. Chairman, we are opposed to S. 3082 and S. 3094. We will be glad to answer any questions you might have.

[Statement of Daniel I. Halperin follows:]

For Release Upon Delivery
Expected at 2:00 p.m.

STATEMENT OF
DANIEL I. HALPERIN
DEPUTY ASSISTANT SECRETARY (TAX LEGISATION)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT
OF THE SENATE COMMITTEE ON FINANCE

November 19, 1980

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to appear today to present the views of the Treasury Department on S. 3082, S. 3094, and H.R. 6806.

S. 3082 and S. 3094

Both S. 3082 and S. 3094 would overturn Revenue Ruling 77-85. That ruling dealt with so-called "investment annuities," through which individuals sought to shield investment income from current tax while retaining the right to select their personal investments. The Treasury opposes these bills. They would sanction the use of paper transactions to defer the imposition of income tax on portfolio income. If such deferral is desired, it should be permitted directly, rather than by artificial means, and by specific legislation, rather than through a prohibition on a Revenue Ruling. Enactment of legislation in the form of S. 3082 or S. 3094 would irresponsibly avoid facing the issues.

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To put the issue raised by these bills in perspective it is useful to review some basic features of our income tax system. Sections 61(a)(4) and 61(a)(7) of the Internal Revenue Code specifically provide that gross income includes income from "interest" and from "dividends."

This general rule is subject to limited exceptions. Before the Windfall Profit Tax Act of 1979, section 116 of the Code allowed each individual to exclude from gross income up to $100 of dividends received. With the Windfall Profit Tax Act of 1979, Congress specifically reconsidered the treatment of dividends and interest. As a result, Congress enacted a temporary revision to section 116 which raised the exclusion from $100 to $200 and revised it to cover interest as well as dividends. Dividends and interest in excess of this amount remains taxable.

There have been a number of attempts to defer taxation of interest. For example, during the 1960's a number of corporations took to issuing debt securities at a discount. Although the increase in value of such securities as maturity approached was tantamount to interest, no income was realized until sale or surrender of the security. Congress responded in the Tax Reform Act of 1969. It required a ratable portion of the discount to be included in the investor's income as ordinary income during each month the instrument was outstanding.

As this example suggests, Congress generally has been unwilling to sanction artificial arrangements designed to defer current taxation of interest (or dividend) income. There exists one major anomaly -- the treatment of what are known as "deferred annuities." Under a deferred annuity an individual pays money to a life insurance company in exchange for a contract which at some future time may be converted into an annuity. Generally the contract holder may elect to receive benefits in one of a variety of forms, including guaranteed payments for a fixed number of years or for life. In addition, annuity contracts generally permit the contract holder to surrender the contract in return for a lump sum in cash.

The period until the contract is surrendered or converted into an annuity is referred to as the "accumulation period." During that period the insurance company credits interest to the contract. Section 72 specifically provides that, during this accumulation period the contract holder will not be taxed on interest credited to the contract. Section 72 also provides that amounts actually withdrawn

during the accumulation period will not be includible in gross income unless such amounts exceed the amounts previously paid for the contract. The tax treatment of deferred annuities cannot be reconciled with the general treatment of interest and dividends.

Thus, this Administration is on record as favoring legislative change. Absent legislation, however, the rules governing annuities remain in effect, and neither Revenue Ruling 77-85 nor subsequent developments suggests that the rules of section 72 can be altered by administrative action. Rather, Revenue Ruling 77-85 simply responds to an attempt to take artificial advantage of section 72. An investor would pay "premiums" to purchase an investment "annuity," and the proceeds of the premium would be invested in various financial assets. The contract purchaser was furnished with a list of investment securities that were approved by the life insurance company, and each purchaser could select just which investments he wished to make and how much should be invested in each selection.

What the promoters of the "investment annuity" sought to do was permit a contract purchaser to make investments using a life insurance company as a conduit. The investor directs the life insurance company to make, on the purchaser's behalf, exactly the same investments the purchaser otherwise would have made directly. However, by claiming that an "annuity" had been purchased, current taxation of the interest and dividend income was claimed to have been avoided. While the Internal Revenue Service issued several private ruling letters that tended to sanction this device, Revenue Ruling 77-85 properly reached a contrary conclusion. Specifically, Revenue Ruling 77-85 held that the purchaser of a so-called "investment annuity" was, for federal income tax purposes, the owner of the underlying investment assets; and, as with other financial assets, that the income from the assets was currently taxable to the purchaser. In so doing Revenue Ruling 77-85 revoked, prospectively only, the previously issued private ruling letters.

The issues raised by Revenue Ruling 77-85 and this legislation are not complicated. In the case of the investment annuity the purchaser did not rely on interest at rates guaranteed by the issuing life insurance, and did not, as with a traditional "variable annuity," look to the investment expertise of the life insurance company in managing a diversified portfolio of assets. Instead, purchasers simply contributed cash to a life insurance company and then selected precisely which investments they

wished to make. In substance, the life insurance company was offering the investor nothing more than a piece of paper that said the investor had purchased an annuity and could therefore claim to be free of current taxation on interest or dividends from those investments. Under those circumstances Revenue Ruling 77-85 held that the investor had, in effect, purchased the assets directly and should be taxed in exactly the same fashion as if he had. We believe that the conclusion reached in Revenue Ruling 77-85 was correct. The special tax treatment of annuities cannot be permitted to engulf the general rules for taxation of interest and dividend income.

The Treasury therefore opposes S. 3084 and S. 3092.

H.R. 6806

H.R. 6806 involves the complicated provisions of the Internal Revenue Code which require that the investment credit, and the tax savings attributable to accelerated depreciation, be "normalized" for public utility ratemaking purposes. While the provisions are complicated the basic thrust of the normalization requirements is to prohibit these tax benefits, which are in effect subsidies to capital investment delivered through the tax system, from being "flowed through" to current ratepayers as a reduction in current cost of service. Under the Code the penalty for violation of these requirements is the loss of the tax benefits.

There is a long history of dispute over the normalization provisions, especially in the State of California. The California regulatory authorities have entered orders which violate the normalization requirements of the Code, and, under existing law, the penalty to the affected utilities is the loss of investment credit and accelerated depreciation for the years for which California adopted flow-through ratemaking. H.R. 6806 would absolve those taxpayers that were subject to ratemaking orders in California from the loss of substantial tax benefits. The principal beneficiaries of the bill are Pacific Telephone Company, a subsidiary of the Bell System; General Telephone of California, a subsidiary of General Telephone and Electronics, and the Southern California Gas Company.

In addition, H.R. 6806 would amend the statute in an attempt to make clear that imaginative schemes to violate the normalization provisions will not be countenanced in the future.

On April 15, 1980, the Treasury testified in detail on H.R. 6806 before the Committee on Ways and Means. A copy of our April 15 testimony is attached. We there testified that we did not think there was generally any policy to be served by collecting some $2 billion in back taxes from three utilities in California. On the other hand, the severe penalties that flow from violation of the normalization requirements are there for the express purpose of discouraging such violations. Thus, we expressed the view that H.R. 6806 would appear to be an appropriate measure of relief if one could be reasonably confident (1) that further disputes would not arise in California, and (2) that providing relief in this instance would not encourage other states to test the Congress' will with respect to the normalization provisions.

It is still not clear to us that passage of H.R. 6806 will in fact end controversy in California. The affected taxpayers fervently hope that it will. Similarly, it is difficult for the Treasury to maintain that passage of H.R. 6806 will encourage other states to violate the normalization requirements, when regulated public utilities located in 49 other states, who stand to suffer the greatest damage if that should occur as the result of H.R. 6806, appear not to object to the bill.

On balance, then, and although the future is far from certain, the Treasury will not stand in the way of passage of this legislation.

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For Release Upon Delivery
Expected at 10:00 a.m.

Statement of
Daniel I. Halperin
Deputy Assistant Secretary (Tax Legislation)
Before the
House Committee on Ways and Means
April 15, 1980

Mr. Chairman and Members of this Committee:

I am pleased to have the opportunity to appear before this Committee to discuss H.R. 6806 and H.R. 3165. Both bills deal with aspects of the rules of the Internal Revenue Code that require the investment credit and the tax deferral attributable to accelerated depreciation to be "normalized" in establishing rates for regulated public utilities. Last year the Treasury presented extensive testimony on this subject before the Committee's Oversight Subcommittee. For the record of these hearings I am attaching a copy of our previous testimony, which I will not reiterate in detail.

As we testified last year, the Treasury regards the investment credit, and the tax deferral attributable to the excess of accelerated over economic depreciation, as subsidies to investment that are delivered through the tax system. As we also testified at those hearings, the Treasury has concluded that it is appropriate for these tax subsidies to be made available to regulated public utilities, which are among the most capital-intensive industries in the country; but that, as long as these benefits are available to regulated public utilities, they should be treated as subsidies to investment rather than as simple tax reductions.

This point should be underscored. We would not be here today if the cash equivalent of the investment credit and the loan equivalent of the tax deferral attributable to accelerated depreciation were delivered directly rather than through the tax system. We do not believe that accounting for comparable, but appropriated, subsidies would be

controversial. The fact that they are cleared through the tax system does not change -- and should not be permitted to obscure -- their essential character. Thus, in regulated ratemaking, they should be treated in the same manner as any comparable appropriated capital subsidy. Neither should be considered to reduce current regulated tax expense. The investment credit should be treated as a 10 percent reduction in the price paid for equipment, and the tax deferral attributable to accelerated depreciation as an interest-free loan. We believe that this treatment -- "normalization" -- is unquestionably the correct method of accounting for these subsidies; and that, in the long run, such treatment is in the interests of ratepayers as well as owners of equity in regulated utilities. On balance, we also concluded last year that the normalization requirements of the Internal Revenue Code constitute an appropriate means to ensure proper accounting for these subsidies.

Quite obviously there are those who do not share our point of view. Specifically, the regulatory authorities in the state of California have accounted for the subsidies in a manner that is the equivalent of their being "flowed through" to income (i.e., as a reduction of current tax expense), a result that does not comport with the rules of the Code. But we recognize that the forces that have led to the existing situation in California are both complex and politically charged. Consequently, while we believe the method of regulatory accounting adopted by California unquestionably violates the applicable provisions of the Code and regulations, the Treasury is willing to offer its cooperation in attempting to arrive at a solution to this difficult situation. But we must insist that one can expect as part of any legislative solution a reduction, if not the elimination, of further major disputes about the operation of these rules.

It is with that point of view that we approach H.R. 6806. H.R. 6806, as we understand it, has two objectives. First, under existing law, failure to normalize results in a loss of the benefits of the investment credit and accelerated depreciation. Sections 3 and 4 of H.R. 6806 would operate to absolve those companies, which have been required by California to flow through improperly the investment credit and the tax deferral attributable to accelerated depreciation, from the loss of those benefits. Second, recognizing that the improper flow-through stemmed primarily from an estimating procedure adopted by the California Public Utilities Commission, sections 1 and 2 of H.R. 6806 would amend the investment credit and accelerated depreciation rules to state specifically in the statute that such procedures are impermissible.

We believe that the statutory clarifications of sections 1 and 2 of H.R. 6806 are consistent with existing law and, therefore, are appropriate. The balance of H.R. 6806 we view

with reservation. Regulated public utilities are among the most capital-intensive industries and therefore are among the most significant recipients of capital subsidies delivered through the tax system. Consequently, retroactive disallowance of these subsidies exposes the companies subject to the California rate orders to tax deficiencies that by any measure are substantial. If, by reason of legislation, the difficult circumstances as they have developed in California could be defused and the normalization rules made to operate properly there as elsewhere, we see no policy that would be served by collecting such deficiencies.

The difficult question is whether H.R. 6806 can achieve this goal, which both we and its sponsors seek. In our judgment, legislative relief for past violations would be preferable if it preserved some measure of sanction short of collecting the full tax deficiencies or insisting on complete abatement of the rate refunds that already have been ordered by California. Such legislation might serve to defuse the existing situation while making clear that the normalization rules cannot be disregarded with impunity.

But the Treasury is not unalterably opposed to H.R. 6806. _If_, as the result of its enactment, the situation in California could be defused and the California authorities persuaded to accept normalization; and _if_ it was considered unlikely that other state regulatory authorities would be induced to start down the road taken by California; and _if_, finally, this Committee and the Congress were to make it clear that attempts to circumvent these rules in the future would meet with no sympathy on the part of the Congress, then a measure such as H.R. 6806 could be desirable.

Whether it is realistic to have such expectations -- which, Mr. Chairman, I emphasize _are_ in our judgment essential to the Treasury's acquiescing in this legislation -- it is not yet possible to say. If the California authorities, and those public lawyers whose intervention in the California rate proceedings has been an essential feature of this controversy, were prepared to accept normalization for the future, that action would go far toward alleviating our concerns. We say this recognizing that the Supreme Court of California, which we assume cannot speak to the question outside the confines of a judicial proceeding, also has played an essential role in California. But we also point out that, in considering the wisdom of H.R. 6806, this Committee must also reach a judgment about the possibility that its enactment would induce other state regulatory authorities to follow California's lead. We are not in a position to express an independent judgment on the likelihood that this will happen. Perhaps the Committee will hear from witnesses, subject to regulation by states other than California, who will make their views on this subject known.

We must point out, however, that if H.R. 6806 were enacted, and if, contrary to the Committee's expectations, California persevered in the course that it has staked out, or other public utility commissions were persuaded to follow California's lead, the consequences could be quite serious. Our testimony last year to the effect that retention of the normalization rules was appropriate rested on several fundumental premises, among them that the subsidies provided by the investment credit and accelerated depreciation were appropriate for regulated public utilities as long as they were properly accounted for through normalization; that, in general, the tax normalization rules seemed to operate properly; and that, absent such rules, benefits that are intended as subsidies to investment well might be converted into rate subsidies. But we also pointed out that these rules do <u>not</u> operate well when they are the focus of controversy. If, either as the result of California's continued pursuit of flow-through or because of efforts by other public utility commissions to follow suit, the normalization rules prove to be a source of even further controversy, the Treasury might feel constrained to recommend a review of Congressional policy toward the provision of these investment subsidies to regulated public utilities. It might prove necessary to re-examine the wisdom of retaining the normalization rules. Or, recognizing that flow-through operates to convert investment subsidies into direct rate subsidies, the inability to achieve normalization accounting might warrant reconsideration of allowing these tax subsidies to regulated utilities. We do not mean to suggest that the time for such reconsideration has arrived; only that, if these rules cannot be made to work properly, the underlying policy may have to be reconsidered.

As I mentioned at the outset, Mr. Chairman, the Treasury is prepared to work with this Committee and other interested parties in an attempt to remedy this difficult situation. At this moment we are not confident that H.R. 6806 will provide a solution. We look forward to seeing how the situation develops, and in particular to the views to be expressed before this Committee in the balance of its hearings today.

The other bill dealt with in this hearing, H.R. 3165, addresses the appropriate <u>technique</u> of normalizing the investment credit. It is <u>the Treasury's</u> view that the investment credit was intended to stimulate investment in productive capital by reducing the cost of capital goods. Such a reduction means that investments will become feasible at a lower level of expected returns than would be the case in the absence of the credit. Thus, we believe that proper normalization of the credit would result in its being accounted for in regulated ratemaking in exactly the same way as any other 10 percent reduction in capital costs. <u>First</u>, the regulated taxpayer's "rate base," to which its "fair rate of return" is applied in determining the allowable return to

equity investors, would be reduced by the amount of the credit. This would reflect the fact that a portion of the taxpayer's investment had been financed by the government. Second, the base for determining regulated depreciation expense would also be reduced by 10 percent (to reflect the actual cost of the investment), thus reducing annual depreciation charges (and, hence, regulated "cost of service") by 10 percent as well.

In its current form, section 46(f) may not quite accomplish this goal. It provides two alternative methods of normalizing the investment credit, neither of which unambiguously permits both a rate base reduction and a reduction in regulated depreciation base. Under one method -- section 46(f)(1) -- the regulatory body establishing rates may require the regulated taxpayer's rate base to be reduced by the amount of the credit. However, under section 46(f)(1), it is not clear that any other reduction, for example a reduction in depreciation expense, is permitted in the taxpayer's regulated cost of service. Under the alternative -- section 46(f)(2) -- regulated "cost of service" may be reduced by a ratable portion of the credit earned each year (the equivalent of reducing the taxpayer's base for computing regulated depreciation expense), but the taxpayer's rate base may not be reduced. Consequently, section 46(f)(2) permits the regulated taxpayer to earn a return on the portion of its investment that is paid for by the government through the credit. Most regulated utilities elect section 46(f)(2).

As we testified last year, we believe that the correct technique by which to normalize the investment credit involves a combination of the two existing methods, under which, through reduced depreciation, the regulated taxpayer's cost of service is reduced by a ratable portion of the credit each year; while, simultaneously, the taxpayer's rate base is reduced (to exclude the government's contribution) by the amount of the allowable credit. This treatment would recognize the investment credit as providing a 10 percent reduction in capital costs.

We are convinced that the arguments in support of retaining section 46(f)(2) are based on a misunderstanding of the way in which the investment credit was intended to operate. Many of those who have considered this issue agree that conceptually we are correct, but attempt to justify section 46(f)(2) on other grounds. Specifically, it has been said that allowing a regulated utility to preserve the investment credit in its rate base, as permitted by section 46(f)(2), to some extent mitigates the consequences of "regulatory lag" (i.e., the inability of current ratemaking orders to keep up with financial demands on a regulated utility), a phenomenon that is aggravated by high rates of inflation. We believe that it simply is improper to justify

improper normalization of the investment credit as an antedote to deficiencies in the ratemaking process. Those deficiencies, if they exist, should be remedied by the regulators.

In sum, Mr. Chairman, H.R. 3615 attempts to correct what we regard as a deficiency in the existing investment credit normalization rules. While we have some technical reservations, the Treasury supports the objective of H.R. 3615 and would be happy to cooperate with the Committee or its staff to work out suitable revisions.

Senator BYRD. Thank you.

The next two witnesses will be Mr. Theodore F. Brophy, chairman of the board and chief executive officer of General Telephone & Electronics Corp.; and Mr. Jay Curtis, director of taxation, Pacific Lighting Corp.

Mr. Brophy, may I ask you, you are, aside from your position as chairman of the board and chief executive officer of General Telephone & Electronics, chairman of the Business Roundtable?

Mr. BROPHY. I am cochairman of the Business Roundtable, Mr. Chairman, and chairman of the taxation task force of the Business Roundtable.

Senator BYRD. That is, of course, a very fine organization. You are the chairman of the tax committee of that as well?

Mr. BROPHY. Yes.

Senator BYRD. I think that organization can be very helpful to the Congress in legislation affecting tax schedules.

Mr. BROPHY. We certainly hope so, Mr. Chairman, and we have recently formed a subcommittee of the taxation task force on the budget, and Roy Ash will be working with me as chairman of that subcommittee.

Senator BYRD. On the budget?

Mr. BROPHY. Yes.

Senator BYRD. That is fine.

Mr. BROPHY. We have become convinced that one cannot look only at this taxation side, or from the Government's view the revenue side, but one has to become involved in the spending side if we are going to do a responsible job. So we are taking an interest in that side.

Senator BYRD. I think you are so right. I had not been aware of that, and I am so pleased you will be doing that. As I see it, a tax reduction needs to be coupled with the control of spending, and a reduction in the rate of increase in spending. I fear that the cut in taxes will be eaten up by the increased inflation so that no one benefits.

Mr. BROPHY. It is certainly a great concern we all have. We hope that we can make a contribution in that.

Senator BYRD. Thank you, sir. Would you proceed as you wish.

STATEMENT OF THEODORE F. BROPHY, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, GENERAL TELEPHONE & ELECTRONICS CORP.

Mr. BROPHY. Thank you, Mr. Chairman.

My name is Theodore F. Brophy. I am chairman and chief executive officer of General Telephone & Electronics Corp., which is known as GTE.

GTE has the second largest and operates the second largest telephone system in the United States, which serves approximately 15.6 million telephones. Our largest operating subsidiary is General Telephone Co. of California, which I will call "General." General serves approximately 4.1 million telephones in the State of California and has a net investment of about $3 billion.

I have submitted a comprehensive written statement to the subcommittee on H.R. 6806 and respectfully request that it be incorporated in the record.

Senator BYRD. Without objection, so ordered.

Mr. BROPHY. H.R. 6806 is designed to provide equitable relief to utilities in California, such as General, which have been required by order of the public service commission to flow through to their customers a part of the benefits of accelerated depreciation and the investment tax credit. This flowthrough of the tax benefits has been imposed on the utilities as a result of decisions of the California Supreme Court interpreting the normalization rules of the code as permitting such partial flowthrough.

The IRS, on the other hand, deems the flowthrough to be a violation of the code and, through no fault of the utilities, retroactively disqualifies them from taking accelerated depreciation and from having the benefits of the investment tax credits.

The end results of this disagreement on the interpretation of the code between the Supreme Court of the State of California and the Internal Revenue Service are assessments against the utilities of staggering amounts of back tax liabilities. The amounts, if paid, would dangerously decapitalize the utilities and could destroy their ability to provide service.

General's potential liability for back taxes and interest as of December 31, 1979, was $394 million, or some 42 percent of its equity capital on that date. Today, General's only option is to contest these assessments in the courts, and that option has been characterized as "Russian roulette." I would suggest that, in fact, it is Russian roulette with all of the cylinders in the gun loaded.

Because of the magnitude of the tax assessments, the utilities, as I said, have no choice but to challenge them in the courts. If the utilities, in fact, succeed in their challenge, then there is little doubt that there will be an increase in the flowthrough of the investment tax credit and the accelerated depreciation not only in California, but in other States.

This will deprive the utilities of vastly needed capital and undermine the intent of Congress in enacting the normalization rule. If, on the other hand, the challenge to the tax assessment is unsuccessful, the affected utilities will be penalized and be required to pay back tremendous amounts of back taxes which will also dangerously decapitalize the utilities.

In either event, during the period of litigation, which we estimate may take from 5 to 10 years, the utilities will be faced with continued uncertainty and inability to state their true financial condition. That, in turn, will serve as a major impediment in the ability of those utilities to finance.

The sad fact is that this game of Russian roulette is one in which the public will be a big loser.

H.R. 6806 was reported out by both the Ways and Means and Rules Committees of the House on voice votes, and passed the House on a voice vote. I believe you will conclude, as did the House, that the bill is noncontroversial and fully deserves your support. For this reason, I will try to keep my testimony very brief, but I would welcome the opportunity to answer any questions you may have.

The bill itself would clarify the normalization rules to prevent any further misunderstandings in California and elsewhere and provide a transitional rule that forgives the potential back tax liabilities of the affected utilities.

I suggest that the position in which the affected utilities find themselves presents a compelling equitable case for the forgiveness of the potential back tax liabilities that not even the IRS wants to collect. Let me mention a few of the reasons.

The utilities are caught between conflicting Federal and State interpretations of a very complex section of the Internal Revenue Code, the normalization rules. The California Supreme Court has required the utilities to use newly devised partial normalization methods, but it is the utilities and their customers, not the California Supreme Court, that would be required to pay the back taxes.

Where a State's highest court has interpreted some of the code's most complicated provisions to permit an unintended result, basic fairness requires that the provisions be clarified first and only then should a tax be exacted for noncompliance.

The tax forgiveness, if that is the correct term, does not place the utilities in any more favorable a position than any other utilities which normalize.

Forgiving the potential back tax liability does, in fact, represent a compromise, but I believe a reasonable one. It accepts the partial flowthrough methods of the California Supreme Court and the commission for the period prior to March 1, 1980, and requires, as it must, that rates after that date be established on the basis of full normalization.

The California Commission, for its part, has made what I believe are conciliatory moves to resolve the dispute. It recently issued an order permitting rates to be collected on a full normalization basis, subject to possible refunds down the road only if this issue is not resolved in a manner that effectively precludes that refund. H.R. 6806 would preclude that refund.

I cannot overemphasize the importance of enacting this bill during the current session of Congress. The recent commission order has been appealed to the California Supreme Court, and that court will undoubtedly once again annul the commission's order utilizing full normalization as it has done twice if H.R. 6806 is not enacted.

If this happens, causing the California Commission to revert to its old, partial flowthrough methods, the potential tax liabilities of the affected utilities will continue to mount and they may not be able to obtain the necessary funds to provide the telephone service their customers demand.

So far, the problem only exists in California, but other State regulatory commissions and courts are awaiting the outcome of H.R. 6806. Should it fail to become law, other States may interpret this failure as an acceptance of California's partial flowthrough methods.

We urgently request that this subcommittee and Congress give prompt approval to H.R. 6806 and end what I have characterized as a game of Russian roulette. The future viability of the utilities involved can thus be resolved, and they can get on with their business of serving the public.

Thank you very much.

[Prepared statement of Theodore F. Brophy follows:]

Summary of the

Statement of

THEODORE F. BROPHY

Chairman and Chief Executive Officer

General Telephone & Electronics Corporation

Submitted to the

Subcommittee on Taxation and Debt Management

Committee on Finance

U. S. Senate

November 19, 1980

Mr. Chairman, Members of the Subcommittee:

I will testify today on H.R. 6806, a bill designed to address a serious inequity having a very significant impact on General Telephone Company of California ("General"), GTE's largest telephone subsidiary.

H.R. 6806 was reported out by both the Ways and Means and Rules Committees on voice votes, and passed the House on a voice vote. I believe you will conclude, as did the House, that the bill is noncontroversial and fully deserves your support.

As a result of the California Supreme Court's interpretation of the normalization rules in the Code, General has been required to flow through to its customers a part of the benefits of accelerated depreciation and the investment tax credit. The IRS deems such flow-through to violate the Code, to be contrary to the intent of Congress and, <u>through no fault of General</u>, retroactively to disqualify it from taking accelerated depreciation or receiving the investment tax credit. The end result is an assessment against General of staggering amounts of back tax liability. The amounts, if paid, would dangerously decapitalize General and could destroy its ability to provide service.

General's potential liability for such back taxes (including interest), as of December 31, 1979, was $394 million, an amount equal to 42 percent of its equity capital on that date.

I believe you will agree that the position in which General finds itself is unconscionable - it is caught between conflicting federal and state interpretations of the normalization rules. H.R. 6806 would provide the equitable relief so desperately needed by forgiving the back taxes. It would also clarify the normalization rules to prevent any future misunderstandings by making clear that full normalization is the only acceptable alternative.

It is essential that this bill become law during the current session of Congress. A recent order of the California Commission is on appeal to the California Supreme Court. That Court may again annul the Commission order utilizing full normalization if H.R. 6806 is not enacted, causing General's potential tax liability to continue to mount. Furthermore, your rejection of H.R. 6806 could be considered by the California Supreme Court and other state courts and regulatory commissions as an acceptance of the partial flow-through methods.

Statement of

THEODORE F. BROPHY

Chairman and Chief Executive Officer

General Telephone & Electronics Corporation

Submitted to the

Subcommittee on Taxation and Debt Management

Committee on Finance

U. S. Senate

November 19, 1980

Mr. Chairman and Members of the Subcommittee:

My name is Theodore F. Brophy. I am Chairman and Chief Executive Officer of General Telephone & Electronics Corporation, known as GTE. GTE is the parent company of a group of companies that provide telephone service, other forms of communication service and manufacture electronic and electrical equipment and products. It is the second largest telephone system in the U. S., providing service to approximately 15.6 million telephones.

It is my pleasure to appear before you today and testify on a proposed bill, H.R. 6806. This bill has been reported out by the Ways and Means and Rules Committees of the House by voice votes, and passed the House on September 24th by a voice vote.

H.R. 6806 would correct a serious inequity having a very significant impact on GTE and its telephone operating subsidiary in California. Needless to say, I am vitally interested in the action you will take on this bill.

INTRODUCTION

The serious inequity addressed by H.R. 6806 results from conflicting federal and state positions concerning the proper method of accounting for the tax benefits of accelerated depreciation and the investment tax credit. Congress carefully

fashioned sections 46(f) and 167(l) of the Internal Revenue Code to require "normalization" of the tax benefits so as to ensure that the benefits have their intended effect of providing an incentive for capital investment. The governmental authorities in one state, namely the California Supreme Court and the California Public Utilities Commission, have seen fit to interpret those provisions to achieve an increased allocation of the tax benefits to present customers at the expense of the affected utilities and future customers, and in violation of the generally understood meaning of the statutory provisions.

As a result, the eligibility of certain California utilities for the tax benefits has been placed in jeopardy, exposing them to staggering amounts of back tax liability which, if paid, would dangerously decapitalize the utilities and have the potential to destroy their ability to provide service to the public. General Telephone Company of California ("General"), GTE's largest telephone subsidiary, is one of the affected utilities. It serves 4.1 million telephones and has a total investment of $3 billion in telephone plant and equipment in the state of California.

The problem has arisen first in California, but it is not certain that it will end there. Other state courts and regulatory commissions are awaiting your response to the interpretation placed on the normalization rules by the California authorities. Should H.R. 6806 fail to become law, other state courts and regulatory commissions may adopt California's interpretation.

NORMALIZATION REQUIREMENTS

The tax benefits of accelerated depreciation and the investment tax credit were expressly designed by Congress to provide an incentive for capital investment. If, however, the tax benefits are not available to a public utility because a regulatory commission, in setting rates, requires that the benefits be passed on (or "flowed-through") to customers in the form of current rate reductions, the stimulus for capital investment is lost.

A utility is normally entitled to recover its cost of providing service to the public. Since one component of such cost is a utility's tax expense, absent a statutory restraint, a regulatory commission could flow-through the tax benefits to present customers in the form of current rate reductions by computing a utility's tax expense net of the two tax benefits. This is a form of ratemaking known as "flow-through ratemaking."

In 1969, Congress took steps to put an end to what it viewed as an undesirable trend to flow-through ratemaking by enacting the normalization requirements for accelerated depreciation. The requirements provided, as a condition of eligibility, that the tax deferrals resulting from accelerated depreciation be "normalized," i.e., set up as a reserve rather than used currently to reduce rates, as is done under flow-through ratemaking. This rule carefully balances the interests of all concerned - it provides a stimulus to capital investment by permitting a utility to use the tax savings from accelerated depreciation and it provides a benefit to the utility's

customers in the form of lower rates since, in most cases, the deferred tax reserve is excluded from the rate base on which a utility is permitted to earn a return.

In reinstating the investment tax credit in 1971, Congress again responded to flow-through ratemaking and required, also as a condition of eligibility, that the credit be "normalized" so as to prevent the immediate flow-through of the tax benefit to the customers. In enacting these requirements, Congress again balanced the interests of the utilities, and present and future customers.*

I submit there can be no question about the wisdom of the normalization requirements. To accomplish the Congressional intent of stimulating capital investment, these requirements are unquestionably necessary. Flow-through ratemaking is completely contrary to this intent. While flow-through ratemaking may achieve current rate reductions for present customers, it is accomplished only at the expense of future customers and undermines the intent of Congress in providing the tax benefits of accelerated depreciation and the investment tax credit.

Deputy Assistant Secretary Emil Sunley reached the same conclusions in his testimony before the Oversight Subcommittee of the Ways and Means Committee last year and Deputy Assistant Secretary Daniel Halperin reaffirmed these conclusions in his

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*In putting an end to an undesirable trend to flow-through ratemaking in respect of both tax benefits, Congress permitted the continued use of flow-through ratemaking in those limited situations where a utility was subject to flow-through ratemaking in 1969. This has no application to General.

testimony on H.R. 6806 before the Ways and Means Committee on April 15, 1980. The recent action taken by the Federal Communications Commission provides further support for these conclusions. The FCC substantially revised its depreciation practices to improve the capital recovery of telephone companies for the avowed purpose of encouraging increased capital investment, with the expectation that the new investments will result in benefits to customers that far outweigh any initial increases in telephone rates.

THE UNIQUENESS OF THE NORMALIZATION REQUIREMENTS

While the normalization requirements are necessary to accomplish the intent of Congress, they do create a unique situation in which a utility's eligibility for the tax benefits is dependent not upon any action taken by it, but rather upon action taken by a third party, i.e., the action taken by a regulatory commission in setting rates. Typically, a person takes an action and is responsible for the consequences. Here, a regulatory commission can take an action, but the consequences fall upon the utility. It is this separation of action from consequences which has placed General in a terribly unfair position.

The California Public Utilities Commission, responding to mandates issued by the California Supreme Court, has adopted newly devised, partial flow-through methods designed to flow through a portion of General's tax benefits to current customers in violation of the generally understood meaning ascribed to the normalization requirements. As a consequence, General

has incurred a substantial, potential liability for back taxes (and interest) of $394 million as of December 31, 1979 and it continues to grow by more than $40 million annually. In addition, on the assumption that the partial flow-through methods satisfy the normalization requirements, the Commission has ordered General to refund to customers approximately $110 million of the tax benefits (including interest) in June, 1980 and June, 1981. Hence, if General does not satisfy the normalization requirements as a result of the action taken by the California governmental authorities, General will be required, in effect, to return the tax benefits to the federal government by paying the back tax liability, even though it will already have paid a portion of the same benefits to its customers.

The title of an article which appeared in the September 10, 1979 issue of Fortune magazine aptly describes General's plight - "The Tax Break That Turned Into a Nightmare." I submit that General's situation, caused by no action on its part, presents a compelling case for relief.

This is the reason for H.R. 6806. It is designed to prevent a similar problem from arising in California and elsewhere in the future and to provide relief to General (and others similarly situated) during a transitional period ending on March 1, 1980.

THE SITUATION IN WHICH GENERAL FINDS ITSELF

Following the enactment in 1969 of the normalization requirements pertaining to accelerated depreciation for utilities, General elected to use accelerated depreciation for federal income tax purposes. The California Commission issued an interim decision that, for the period beginning January 1, 1970, General could use accelerated depreciation and could normalize its tax expense in compliance with the generally understood meaning of the normalization requirements. Subsequently, the California Supreme Court in 1971 annulled the Commission's interim ruling on procedural grounds, stating that the Commission had erred in failing to at least consider alternatives to normalization that would be more favorable to current customers and remanded the matter to the Commission for it to consider such alternatives.

In 1974, three years later, and after a rehearing before the California Commission, the Commission again decided that General could use a full normalization method in fixing rates. At the same time, in deciding a separate rate increase application, the Commission reaffirmed that position and adopted a ratable cost-of-service reduction for the investment tax credit in compliance with the generally understood normalization requirements in section 46(f)(2) of the Code. Late in 1975, the California Supreme Court annulled the 1974 Commission orders with respect to the treatment of accelerated depreciation and the investment tax credit, remanding once more for consideration of alternatives to "normalization" on the one hand, and "flow-through" on the other.

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As a result, in 1977, the California Commission issued an order in which it interpreted the Internal Revenue Code as permitting a change from the normalization procedures theretofore used, which clearly satisfied the normalization requirements in the Code and preserved eligibility, to newly devised, partial flow-through methods of setting rates. Under these new methods, the Commission achieved an additional flow-through of General's tax benefits to current customers, requiring it to reduce rates for the future and make refunds, going back to 1971, of some $110 million. The Internal Revenue Service has ruled that the Commission's partial flow-through methods embodied in the 1977 order do not meet the statutory standards for eligibility.*

On November 8, 1977, the Commission granted a stay of the 1977 order pending judicial review. General, on December 7, 1977, appealed the order to the California Supreme Court. On July 13, 1978, the California Supreme Court denied the appeal. General then petitioned the United States Supreme Court, requesting review of the California Supreme Court decision. On December 11, 1978, the United States Supreme Court denied review, despite the urging of the Solicitor General of the United States. The Solicitor General stated to the Court that the California Commission's order caused General to lose its eligibility for accelerated depreciation and the investment tax

*Private letter rulings nos. 7845018 (August 9, 1978) and 7836048 (June 9, 1978).

credit. On January 5, 1979, General filed a petition for rehearing, which the high court denied on February 21, 1979.

Following the denial of review by the United States Supreme Court, the Commission, on March 14, 1979, ordered the filing of a refund plan and a reduced tariff, as required by the Commission's 1977 order. The United States District Court for the Central District of California subsequently denied a request by General for a preliminary injunction that would have stayed the Commission's order, which denial was affirmed by the United States Court of Appeals for the Ninth Circuit on July 18, 1979. An appeal from the latter ruling was denied by the United States Supreme Court.

Having exhausted all possible appeals, General filed a refund plan and a reduced tariff, the Commission held hearings with respect thereto and, on February 13, 1980, the Commission ordered refunds of $110 million as a result of its 1977 order to be made by General in June, 1980 and June, 1981.

The Commission also ordered that future rates be collected on a full normalization basis, subject to refund if California's partial flow-through methods are subsequently determined to satisfy the Code's normalization requirements. Various interested parties have appealed the California Commission's recent order to the California Supreme Court seeking, _inter alia_, to have future rates collected on the basis of the Commission's partial flow-through methods embodied in its 1977 order.

THE URGENT NEED FOR LEGISLATION

As of December 31, 1979, General's potential federal income tax liability is a staggering $394 million and equals approximately 42 percent of its common stock equity. The mere existence of this potential liability is already presenting difficult financial problems to General. Its outside auditors have required General to restate its financial statements to reflect the potential loss of eligibility for the tax benefits and, as a result, General's financial picture looks bleak. In late 1979, Standard & Poor's downgraded its ratings for General's securities. Such a downgrading in ratings will lead not only to increased interest costs in any financing at a time when interest rates are already at extremely high levels, but may also substantially limit the amount of potential funds available to General.

The problem is exacerbated by the demand for communications services in California which continues at unprecedented levels and requires continuing, enormous capital expenditures. General projects capital expenditures of $662 million, $704 million, $787 million, $920 million and $948 million in 1980, 1981, 1982, 1983 and 1984, respectively, an increase of 128 percent over the preceding 5-year period. With the financial cloud hanging over General's head, it is uncertain whether the necessary external funds can be found to meet this demand. If somehow the funds can be found, it will only be at an increased cost borne by the customers.

As bad as matters are now for General, they may substantially worsen. Earlier this year, the California Commission established General's rates for the future on a full normalization basis. The Commission's order is on appeal to the California Supreme Court which has twice annulled Commission orders utilizing full normalization. If H.R. 6806 does not become law during this session of Congress, the Court may well overturn the Commission's recent order, as it has in the past. Indeed, the failure to enact H.R. 6806 may strengthen the Court's apparent resolve to overturn any Commission orders based on full normalization. If its order is annulled, the Commission may conclude that it has no alternative but to revert to the use of partial flow-through methods in setting rates. Futhermore, your failure to act favorably on H.R. 6806 may be interpreted by other state courts and regulatory commissions as an acceptance of California's partial flow-through methods.

I respectfully suggest that you must act now to foreclose these possible results. Their occurrence would be a tragedy for Congress, for General and its customers, and for other utilities and their customers - for Congress because its avowed purpose in enacting the normalization requirements, i.e., to provide an incentive for capital investment to the highly capital-intensive utility industry, will be undermined at a time when increased capital investment is generally recognized as a cornerstone to our nation's economic recovery; for General

and its customers because any further increase in its already enormous potential tax liability may cause irreparable harm to be done to telephone service in California in the foreseeable future; and for other utilities and their customers because the loss of funds for capital investments would occur at a time when inflation is already seriously eroding their capital, and its replacement can be obtained only at extremely high interest rates.

Accordingly, there is a very real and urgent need for relief in this session of Congress. H.R. 6806 would provide the necessary equitable relief.

If you do not act favorably on this bill, the only available means for resolving this dispute will be tax litigation brought in the Tax Court, a district court or the Court of Claims, the resolution of which may be expected to take several years, especially if, as seems likely, an initial court determination is appealed. During these years, of course, the existence of the potential liability for back taxes will have grave effects on General and on its customers (and on other utilities and their customers if the utilities are required to adopt California's methods).

If the California Commission's partial flow-through methods are held not to satisfy the Code's normalization requirements by a final court determination, such a determination will, of course, provide no relief and may be the death-knell for General and telephone service provided by it in California.

If, on the other hand, it is determined that the partial flow-through methods satisfy the normalization requirements and the back taxes are, therefore, not payable, there is little doubt that utilities throughout the country will be required to flow through all or part of the tax benefits from the investment tax credit and accelerated depreciation. This result would clearly undermine the intent of Congress in enacting the normalization requirements, i.e., the intention to provide a stimulus for capital investment to the highly capital-intensive utility industry.

Surely, allowing this controversy to be determined by litigation would be a mistake - neither of the possible results of litigation is desirable.

THE NECESSARY RELIEF

I believe you will agree that the situation in which General finds itself is unconscionable. It is caught in the middle between conflicting federal and state positions. General is no mere bystander - at stake is some $394 million as of December 31, 1979.

H.R. 6806 would provide the equitable relief so desperately needed. It provides, in effect, that the partial flow-through methods adopted by the California Commission will not retroactively result in the loss of the tax benefits to General (and others similarly situated). The bill limits this relief, as it properly should, to a period of time ending on March 1, 1980. In other words, from that date forward, the Commission must adhere to full normalization of the tax benefits or General will

not be eligible for any post-March 1, 1980 tax benefits. This, I believe, would be clear to all. This portion of H.R. 6806 is, thus, a very limited response designed to overcome a particularly egregious problem. It goes only as far as necessary to provide a solution - and no further.

THE BILL ALSO MAKES CHANGES TO PREVENT FUTURE MISUNDERSTANDINGS

H.R. 6806 would amend the normalization requirements in sections 46(f) and 167(l) of the Code so as to prevent any future misunderstandings of the requirements. It adds specific language to make clear that the California Commission's partial flow-through methods do not satisfy those requirements. The bill also grants to the Secretary of the Treasury the explicit power to adopt regulations prescribing other procedures and adjustments that are inconsistent with the normalization requirements. I believe this accomplishes two very important objectives: first, it provides a clear signal to all that the federal government is serious about requiring adherence to full normalization; and secondly, it places the Treasury Department in a much better position to issue binding regulations explaining the meaning to be ascribed to the normalization requirements.

I believe that the changes made by the bill to sections 46(f) and 167(l) of the Code provide a complete answer to any concern that the relief provided to General (and others similarly situated) in the bill may encourage other state regulatory commissions to stray from strict adherence to full normalization with the expectation that Congress will enact a

similar relief bill for them. The general changes made by H.R. 6806 clearly, and quite forcibly, indicate just the contrary. Congress, in H.R. 6806, is reaffirming its support for full normalization. The message from Congress would be perfectly clear - full normalization is the only alternative. This will be understood by the California Supreme Court and other state courts and regulatory commissions.

Even beyond this, it seems a simple matter to make clear in the legislative history accompanying H.R. 6806 that no one should expect any further relief for failure to comply with the requirements of full normalization. Compelling equitable grounds exist for the relief afforded to General in H.R. 6806. After Congress reaffirms its support for full normalization in H.R. 6806 and makes the requirements more explicit, there can be no equitable justification for a state court or regulatory commission to adopt a partial flow-through method. The Report of the Ways and Means Committee accompanying H.R. 6806, dated July 30, 1980, accomplishes this result. It states (at page 11) that the relief provided by the bill "is designed to meet a specific, one-time problem which has arisen as a result of a misapplication of the normalization requirements ..." and that the Ways and Means Committee "does not intend that the provision of relief in this instance should be regarded as a precedent for similar relief in subsequent incidents."

THE APPROPRIATENESS OF THE RELIEF

I believe that the members of this Subcommittee will agree that the position in which General finds itself presents a

compelling equitable case for the relief provided in H.R. 6806, i.e., the forgiveness of the back taxes. Simply stated, General is caught between conflicting federal and state interpretations of the normalization rules. The California Supreme Court has required General to use newly devised, partial flow-through methods of normalization. The use of these methods is not of General's choosing. But it is General and its customers - not the California Supreme Court - that would be required to pay the back taxes.

Where a state's highest court has interpreted some of the Code's most complicated provisions to permit a result presumably unintended by Congress, basic fairness requires that the provisions first be clarified and only thereafter should a tax be exacted for noncompliance. In addition, the relief in H.R. 6806 is fair vis-a-vis other utilities. It does not treat General any more favorably than other utilities which normalize their tax benefits.

In any dispute, it is always attractive to seek a fair compromise. H.R. 6806 represents such a compromise. In forgiving the back taxes, the bill accepts the partial flow-through methods of the California Supreme Court and Commission for the period prior to March 1, 1980, but the bill requires, as it must, that after that date rates be established on the basis of full normalization. I submit that this compromise is particularly appropriate in the present circumstances. The California Commission has recently made what I believe to be a

conciliatory move to resolving the dispute. It has issued an order permitting rates to be collected on a full normalization basis, subject to a possible refund down the road only if the issue is not resolved in a manner that effectively precludes a refund. It is now time for Congress to take the final step in resolving the dispute by enacting H.R. 6806. If it does, I am confident that rates will be set in California on a full normalization basis as is done in all the other states, refunds will be precluded, and General can get on with its business of serving the public.

Senator BYRD. Thank you, Mr. Brophy.

Mr. Curtis, I assume that you approve of this legislation?

Mr. CURTIS. Yes, Mr. Chairman, I certainly do.

STATEMENT OF JOHN J. CURTIS, DIRECTOR OF TAXES, PACIFIC LIGHTING CORP.

Mr. CURTIS. My name is John J. Curtis, and I am testifying today on behalf of Pacific Lighting Corp., and its principal subsidiary, Southern California Gas Co., which is the Nation's largest gas distribution company in terms of number of customers served. We certainly favor H.R. 6806.

Since Mr. Brophy has pretty much covered all of the points that I wished to cover, I would like at this time simply to submit the remainder of my statement to this committee for the record. I am ready and willing to answer any questions you might have with regard to our situation, or with regard to the bill in general.

[Prepared statement of John J. Curtis follows:]

TESTIMONY OF JOHN J. CURTIS, DIRECTOR OF TAXES OF PACIFIC LIGHTING CORPORATION ON BEHALF OF PACIFIC LIGHTING CORPORATION AND SOUTHERN CALIFORNIA GAS COMPANY IN SUPPORT OF H.R. 6806 BEFORE THE SENATE FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

NOVEMBER 19, 1980

SUMMARY OF PRINCIPAL POINTS

PACIFIC LIGHTING CORPORATION AND SOUTHERN CALIFORNIA GAS COMPANY FAVOR ENACTMENT OF H.R. 6806 BECAUSE:

1. THE BILL CLARIFIES AND SPECIFIES NORMALIZATION REQUIREMENTS IN EXISTING FEDERAL TAX LAW WHICH HAVE BEEN THE SUBJECT OF MUCH CONFUSION AND DEBATE BEFORE THE CALIFORNIA PUBLIC UTILITIES COMMISSION AND THE CALIFORNIA SUPREME COURT.

2. THE BILL AVOIDS THE UNJUST POSSIBILITY OF SOUTHERN CALIFORNIA GAS COMPANY LOSING INVESTMENT TAX CREDITS WHILE AT THE SAME TIME CHARGING LOWER RATES ON THE ASSUMPTION THAT SOUTHERN CALIFORNIA GAS COMPANY WILL NOT LOSE CREDIT ELIGIBILITY.

3. THE BILL AVOIDS PENALIZING THE CALIFORNIA UTILITIES INVOLVED FOR PAST DECISIONS OF THE CALIFORNIA COMMISSION AND CALIFORNIA SUPREME COURT WHICH WERE UNIQUE AND WHICH ARE UNLIKELY TO BE REPEATED IN CALIFORNIA IF H.R. 6806 IS ENACTED TO CLARIFY THE FEDERAL TAX LAW.

TESTIMONY OF JOHN J. CURTIS, DIRECTOR OF TAXES OF PACIFIC LIGHTING CORPORATION ON BEHALF OF PACIFIC LIGHTING CORPORATION AND SOUTHERN CALIFORNIA GAS COMPANY IN SUPPORT OF H.R. 6806 BEFORE THE SENATE FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

NOVEMBER 19, 1980

MR. CHAIRMAN, I AM TESTIFYING TODAY ON BEHALF OF PACIFIC LIGHTING CORPORATION AND ITS PRINCIPAL SUBSIDIARY, SOUTHERN CALIFORNIA GAS COMPANY, WHICH IS THE NATION'S LARGEST GAS DISTRIBUTION COMPANY IN TERMS OF NUMBER OF CUSTOMERS SERVED. WE FAVOR H.R. 6806.

ON BEHALF OF PACIFIC LIGHTING CORPORATION AND SOUTHERN CALIFORNIA GAS COMPANY. I WANT TO COMMEND AND THANK THIS COMMITTEE AND ITS STAFF FOR HOLDING THESE HEARINGS AND ADDRESSING THIS CALIFORNIA PROBLEM.

IN CALIFORNIA, AND PERHAPS TO A LESSER EXTENT IN A FEW OTHER STATES, THE INTERPRETATION OF INTERNAL REVENUE CODE SECTION 167(L) AND 46(F) HAS BEEN THE SUBJECT OF CONSIDERABLE CONFUSION AND MUCH DEBATE. SOCAL GAS HAS BEEN INVOLVED ONLY WITH PROBLEMS SURROUNDING SECTION 46(F). CONSEQUENTLY, OUR TESTIMONY TODAY DEALS ONLY WITH SECTION 46(F) AND NOT SECTION 167(L).

IN 1975 SOCAL GAS ELECTED, PURSUANT TO SECTION 46(F)(2), RATABLE FLOWTHROUGH FOR THE ADDITIONAL INVESTMENT TAX CREDIT PROVIDED BY THE TAX REDUCTION ACT OF 1975. A TAXPAYER MAKING SUCH AN ELECTION LOSES THE CREDIT IF ITS REGULATORY AGENCY REQUIRES IT TO FLOW THROUGH THE CREDIT IN ITS RATES FASTER THAN RATABLY.

IN 1976 THE CALIFORNIA PUC REDUCED SOCAL'S RATE OF RETURN BY .25% AND ORDERED REFUNDS. THE AMOUNT OF THE REFUNDS ROUGHLY EQUALED THE AMOUNT OF THE ADDITIONAL TAX BENEFIT OBTAINED BY SOCAL FROM ITS ELECTION OF RATABLE FLOWTHROUGH.

THE CALIFORNIA COMMISSION CONCLUDED THAT ITS RATE OF RETURN REDUCTION WOULD (AND I QUOTE) "BEST RECOGNIZE SOCAL'S REDUCTION OF RISK BECAUSE OF INCREASED CASH FLOW, INCREASED INTEREST COVERAGE, AND RELIEVED FINANCIAL REQUIREMENTS RESULTING FROM THE TAX REDUCTION ACT OF 1975". (PUC DECISION #86117, 7/13/76)

THE PUC ALSO EXPRESSLY CONCLUDED THAT ITS ACTION DID NOT RESULT IN FASTER THAN RATABLE FLOWTHROUGH AND THUS WOULD NOT CAUSE SOCAL TO FORFEIT THE ADDITIONAL ITC. THE CALIFORNIA SUPREME COURT AFFIRMED THE COMMISSION'S REFUND ORDERS IN 1979 ROUGHLY 31 MONTHS AFTER THE COMMISSION'S DECISION. AS A RESULT, SOCAL'S RATES ARE CURRENTLY BEING DETERMINED ON THE ASSUMPTION THAT IT IS ELIGIBLE FOR THE ADDITIONAL ITC.

HOWEVER, IN A LETTER RULING TO SOCAL GAS, THE IRS CONCLUDED, CONTRARY TO THE CALIFORNIA PUC AND THE CALIFORNIA SUPREME COURT, THAT THE PUC'S ACTION WOULD CAUSE SOCAL TO LOSE ELIGIBILITY FOR THE ADDITIONAL CREDIT BECAUSE IT DID RESULT IN FASTER THAN RATABLE FLOWTHROUGH.

CONSEQUENTLY, SOCAL NOW FACES THE OMINOUS POSSIBILITY OF LOSING THE ADDITIONAL CREDIT WHILE AT THE SAME TIME CHARGING LOWER RATES ON THE ASSUMPTION THAT IT IS ELIGIBLE FOR THE ADDITIONAL CREDIT.

UNFORTUNATELY, THE PUC REFUND ORDERS, THE CALIFORNIA SUPREME COURT DECISION, AND THE IRS RULING WERE ISSUED PRIOR TO THE PUBLICATION OF THE TREASURY REGULATIONS INTERPRETING SECTION 46(F). THESE REGULATIONS SPECIFY WHAT RATEMAKING PRACTICES OUTSIDE THE CALCULATION OF TAX EXPENSE, INCLUDING RATE OF RETURN CONSIDERATIONS,

WILL OR WILL NOT CAUSE A UTILITY TO LOSE THE CREDIT. THE CALIFORNIA SUPREME COURT MODIFIED ITS DECISION AFTER THE REGULATIONS WERE PUBLISHED TO CONCLUDE THAT SOCAL WOULD STILL NOT LOSE ELIGIBILITY FOR THE ADDITIONAL CREDIT. AFTER THIS DECISION SOCAL REQUESTED THAT THE IRS REVOKE ITS EARLIER RULING AND RULE AS THE CALIFORNIA SUPREME COURT HAS CONCLUDED, THAT SOCAL WOULD NOT LOSE ELIGIBILITY FOR THE CREDIT. THE IRS WAS EXTREMELY RELUCTANT TO RECONSIDER ITS CONCLUSION AND SUSPENDED ITS CONSIDERATION OF SOCAL'S REQUEST WHEN H.R. 6806 WAS SCHEDULED FOR HEARING BEFORE THE HOUSE WAYS AND MEANS COMMITTEE.

TO OUR KNOWLEDGE NO OTHER REGULATED UTILITY IN THE UNITED STATES HAS EXPERIENCED SOCAL'S PROBLEM. IT IS UNIQUE. MOREOVER, TO OUR KNOWLEDGE REGULATORY AGENCIES ARE NOW CONFORMING AND WILL PROBABLY CONTINUE TO CONFORM TO THE NEW REGULATIONS INTERPRETING SECTION 46(F) IN THE FUTURE.

IN THIS REGARD, THE ACTION TAKEN IN 1976 BY THE CALIFORNIA COMMISSION IN SOCAL'S CASE WAS DONE ONLY ONCE. IN ALL SUBSEQUENT RATECASES AFFECTING SOCAL THE CPUC HAS NOT DEVIATED FROM THOSE RATEMAKING PRACTICES SET OUT AS PERMISSIBLE IN THE TREASURY REGULATIONS. THEREFORE, IT IS UNLIKELY THAT THE PROBLEM SOCAL NOW FACES WILL EVER OCCUR AGAIN.

WE BELIEVE IT WOULD BE UNFAIR TO SOCAL, ITS RATEPAYERS, AND THE PUC IF SOCAL LOST THE ADDITIONAL ITC FOR MANY YEARS BECAUSE CALIFORNIA ISSUED A RATE OF RETURN ADJUSTMENT IN 1976 WHILE THE LAW WAS UNCLEAR AND BEFORE INTERPRETIVE REGULATIONS WERE PUBLISHED.

THEREFORE, WE STRONGLY SUPPORT H.R. 6806, PARTICULARLY SECTION 4 BECAUSE IT WOULD CLARIFY THAT THE ADJUSTMENTS TO

SOCAL'S RATE OF RETURN ISSUED PRIOR TO JANUARY 1, 1980 WOULD NOT CAUSE A LOSS OF ITC.

I WANT TO THANK YOU FOR THE OPPORTUNITY TO TESTIFY HERE TODAY, AND I WOULD BE HAPPY TO ANSWER ANY QUESTIONS YOU HAVE.

Senator BYRD. Very good. Your statement will be made part of the record.

Treasury has no objection to this proposal. I will make every effort to get it on the agenda of the Finance Committee at its meeting tomorrow morning, and hope that it can be favorably reported to the Senate by the committee tomorrow.

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

Mr. CURTIS. Thank you, Mr. Chairman.

We would like to thank all the staff and the committee for holding these hearings.

Senator BYRD. We are glad to do it. I am just sorry that we had a bad time in the Senate and we had to hold up so many fine people who are in this room today.

Mr. BROPHY. Not at all. Thank you.

Senator BYRD. Mr. Thomas Kelly, president, Investment Annuities Institute, Inc.

STATEMENT OF W. THOMAS KELLY, PRESIDENT, INVESTMENT ANNUITIES INSTITUTE, INC.

Mr. KELLY. Thank you, Mr. Chairman.

My name is W. Thomas Kelly. I am here as the president of Investment Annuities Institute. This institute is basically devoted to the arduous task of continuing an uphill battle against an arbitrary and capricious democracy that illegally and callously crushed a fine innovative industry that was devoted exclusively to helping people save and invest for life's later years.

I use the phrase "continuing the uphill battle," because the life insurance company that I founded in 1963, which offered an entirely legal, innovative, variable annuity in the public interest, could not continue the battle in that it was totally destroyed by the illegal acts of the IRS and the Treasury.

In a very few days the final liquidation payment at four cents a share will be paid to our shareholders. This liquidation represents an absolute loss to our shareholders of at least $20 million of invested capital that arises solely from this illegal act, and far, far more than that in terms of wasted time and effort, and in terms of the wasted economic lives of hundreds of employees and thousands of agents who were thereby forced out of a livelihood that they totally believed in.

The whole affair, in my judgment, disgraces our Government. In my judgment, this sordid affair represents a human and economic sacrifice upon the alter of so-called tax expenditures theory as practiced by the IRS and Treasury.

I am not a lawyer nor an economist. However, my professional and business career, spanning over 30 years, has been devoted exclusively to devising sound, practical, pension and annuity programs with one of our Nation's largest and finest actuarial consult-

ing firms, and subsequently as the entrepreneurial founder and president, and chairman of a life insurance company offering a badly needed form of variable annuity.

This variable annuity, for brand name purposes only, became known as the investment annuity. This company grew from scratch to become a national organization with over $380 million of assets, and thousands of policyowners. The investment annuity is both simple and sound. Briefly, there are two kinds of annuities: Fixed dollar annuities, and variable annuities.

Everyone knows the problem of fixed dollar annuities. While benefits are paid for life, they buy less and less due to inflation. To help solve that very serious problem, the variable annuity was invented in the 1950's. With the variable annuity, the insurer may invest the annuity reserves in an equity oriented investment or investment owned by the insurer. Benefit payments are made for life, but they move up or down according to a formula based upon the market value of the investment or investments.

The variable annuity theory that equities offered the opportunity for annuity values and benefit payments to grow to keep up with inflation. The problem was that with equities the person's annuity values and benefits were tied to the roller coaster of equity values.

Obviously, the person was at risk investmentwise, but he or she could not get off the equities value roller coaster without surrendering the contract and its favorable mortality rate guarantees.

As we all know so well, equity values, and thus the annuity values and benefit payments can go down while inflation is going up. The investment annuity form of variable annuity very simply, and most attractively, cut the Gordian knot of these twin problems.

In view of the fact that the person is always at risk investmentwise under any variable annuity by definition, why should we not permit the insurer to delegate to the person a limited right to choose and change the type of investment or investments that are owned by the insurer that form the reserve underlying the person's variable annuity policy.

Thus, each person could enjoy annuity values and benefits based upon the type of investments most suiting the needs and desires of that person, and as those needs and desires may change over the decades that the annuity policy may remain in force.

The insurer owned investment or investments, thus the annuity values and benefits could be equity oriented, that is, stocks, or fixed dollar oriented, that is, bonds or CD's. The emphasis or mix of investments could be changed by the person as personal or economic conditions changed.

Think back over the last decade and consider the dramatic shifts in equity values, bond prices, and interest yields. Would you want to be locked into a fixed-dollar annuity over that period of time? Would you want to be locked into an equity oriented variable annuity over that period of time? Or would you decide that the investment annuity form of variable annuity is more suitable to your needs?

There is no question that the investment annuity is a superior annuity by far in meeting the diverse, ever-changing needs of the American public.

Senator, I had the impression that I had 10 minutes to speak. Is this 5 or 10 minutes?

Senator BYRD. You were slated for 5 minutes. Could you abbreviate your remaining remarks, and your entire statement will be placed in the record.

Mr. KELLY. Let me just go on for a second.

Without question, the annuity policy offered to the public was a variable annuity. When the national office of the IRS was requested to provide tax rulings in 1963, contemporaneously with the passage of relevant, variable annuity tax legislation in 1962, the IRS insisted, and properly so, that the mere delegation to the policyowner of a limited right of investment selection for insurer owned assets did not destroy the larger bundle of investment ownership rights held by the insurer.

That, as reflected in my one page summary, plus a synopsis of my material, from 1973 to 1976 the IRS repeatedly, over 70 times, reaffirmed their prior thoroughly thought-through tax position on the so-called investment annuity.

In 1976, new IRS personnel started to impose their clearly evident ignorance of the subject matter tax policy to the investment annuity, and this culminated in the issuance of revenue ruling 77-85 that destroyed a fine business and a fine industry.

The U.S. District Court has declared, as to the merits of this matter, that the investment assets under the investment annuity belong to the insurer, and that the IRS and the Treasury have illegally and unreasonably gone beyond the limits of their statutory authority in issuing revenue ruling 77-85.

The appellate court even invited Congress to correct this matter by listening to and acting upon the grievance and pleas of its citizens. Senate bills 3082 and 3094 provide the required relief.

On behalf of the tens of thousands of very concerned citizens, I make a plea that this committee act on these bills with dispatch.

Thank you very much.

[Prepared statement of W. Thomas Kelly follows:]

INVESTMENT ANNUITIES INSTITUTE, INC.

Statement of W. Thomas Kelly, President

Before

The Finance Sub-Committee on Taxation and Debt Management

Hearing on S-3082 and S-3094

11-19-80

One Page Summary of Principal Points Included in the Statement.

Synopsis.

What's the Investment Annuity?

Proposed Legislation and Congessional Record Statements.

The Court's Declared Opinion on the Illegality of Revenue Ruling 77-85.

The Investment Annuity Matter: A Chronological Summary and Overview.

Investment Annuity Contractual Arrangements.

The Investment Annuity Matter: Treasury Objections.

Peat, Marwick, Mitchell & Co., Insurance Newsletter.

Using the Anti-Injunction Act as a Weapon against the Taxpayer.

The Insurer's delegation of limited investment selection to the policyowner: It makes no difference "taxwise".

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INVESTMENT ANNUITIES INSTITUTE, INC.

STATEMENT OF W. THOMAS KELLY
BEFORE THE FINANCE SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT HEARING ON
S-3082 and S-3094
11/19/80

One Page Summary of Principal Points in Statement

1. In 1963 and for 13 years thereafter, the IRS insisted upon variable annuity taxation for an innovative, flexible form of variable annuity that became known as the investment annuity.

2. In 1977 the IRS reversed their own insisted upon rulings (over 70 of them) by issuing Revenue Ruling 77-85. This Ruling destroyed an industry that had to rely upon the fairness and competency of the IRS in issuing its prior rulings.

3. As has been amply demonstrated, the IRS and Treasury have no legal rationale for Revenue Ruling 77-85. The District Court denounced the IRS for its unreasonableness, illegality, ignorance of the law, and for exceeding their statutory authority. Clearly the IRS and the Treasury have usurped the power of Congress in this matter. While the District Court decision was overturned on other "jurisdictional" grounds, the District Court's decision on the "merits" of this case is still an impressive and accurate decision.

4. In very recent weeks the IRS has issued Revenue Ruling 80-274 that destroys another valid segment of the annuity industry. Revenue Ruling 80-274 has no legal rationale and bottoms its conclusion on the Court-denounced Revenue Ruling 77-85. Again, the IRS and Treasury are forcing their brand of so-called tax reform upon taxpayers via administrative fiat.

5. Remedial legislation is required swiftly. S-3082 and S-3094 (identical bills) provide such remedial legislative aid.

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SYNOPSIS

1. From 1963 until 1976 the IRS insisted upon and issued over 70 consistent, accurate private and public rulings based upon thorough, competent IRS consideration of the relevant variable annuity law. The initial IRS rulings were contemporaneous with the passage of clear, relevant variable annuity law. All rulings were issued with the full knowledge by the IRS that an important segment of the annuity industry would be founded thereon, and that such rulings must be relied upon by all taxpayers. Indeed, no such business could ever proceed without such reliance. From 1963 to 1976, and even to this day, neither the relevant law nor the facts of this matter have changed one iota.

2. In 1976 new IRS personnel conjured up a new theory of taxation that culminated in the IRS' issuance of Revenue Ruling 77-85. With this Ruling the IRS completely reversed all of its own prior, insisted upon, competent rulings. The IRS refused to be swayed by documentable evidence by recognized experts (including the IRS' former chief actuary who was an expert on variable annuities) as to the soundness and correctness under law of the IRS' prior rulings. The IRS demonstrates its own profound incompetence with the subject matter and the law when required to articulate the rationale of their new theory.

3. It became, and remains, crystal clear, as reflected in the detailed history of this matter over the last few years, that the IRS and Treasury cared little about upholding their pledge and responsibility to administer our tax laws properly and fairly. Rather, the IRS and the Treasury relentlessly pursued a course of alleged tax reform formulated to their own special liking that would, via administrative fiat, thwart relevant law and remove the legitimate tax deferral attributes of certain annuities. Even today, the IRS' and the Treasury's specious claim of authority for their actions is one that is used so often by those who try to defend illegal acts — they <u>had</u> to do it to protect the public. Thus, their breaking of the law becomes a heroic act, and that which is sound, desirable and in the public interest is pejoratively labeled by them as a tax gimmick, an abuse, a tax shelter and a tax loophole. However, never has the IRS or Treasury competently explained their new theory's rationale under the law, as is so clearly evident in their abysmal failure in District Court and in their completely barren legal analysis as found in Revenue Ruling 80-274.

4. Revenue Ruling 80-274 cites as its authority Revenue Ruling 77-85. The merits of Revenue Ruling 77-65 and its taxation rationale were thoroughly considered by the U.S. District Court, District of Columbia. That Court's resolute decision on the merits denounced Revenue Ruling 77-85 and its taxation rationale as being: unreasonable; unlawful; erroneous; beyond the IRS' and Treasury's statutory

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authority; not contemporaneous with the enactment of relevant law; inconsistent with the IRS' earlier pronouncements and even one subsequent pronouncement; motivated improperly by ideas of tax reform. The Court also concluded that substantial deference to the expertise of the IRS and the Treasury on this matter is unwarranted!

While the District Court's decision was subsequently overturned by the Appellate Court on the entirely separate "jurisdictional" question, the Appellate Court invited Congress to listen to its citizens with a grievance or plea and to provide remedial legislation.

For the IRS and Treasury to cite Revenue Ruling 77-85 as their authority for the merits of their new, and equally bizarre, Revenue Ruling 80-274 is a true travesty of law and order; it's a bootstrapping by the IRS of a separate "jurisdictional" success into an inferred court supported "meritorious" position that is patently not so.

5. Clearly, here again via Revenue Ruling 80-274, the IRS and Treasury are defiantly usurping the powers of Congress to establish the laws of our Nation.

6. The gross injustices created by these two Revenue Rulings 77-85 and 80-274 can be remedied by the passage of S-3082 and S-3094 (identical, companion bills). These bills reestablish the IRS rulings as they existed prior to Revenue Ruling 77-85 and thereby also remove the basis for Revenue Ruling 80-274.

7. Remedial legislation (S-3082 and S-3094) is imperative, and justice is long overdue.

What's an Investment Annuity?

- It's merely a brand name for a "variable annuity" as underwritten by several insurers. In trade jargon it's sometimes called a "wrap-around" annuity.

- All variable annuities have cash values and benefits that "vary" according to the market value of "segregated accounts" owned by the insurer. Thus, the policyowner takes the investment risk; while the insurer takes the longevity and expense risks.

- An insurer may have as many segregated accounts as it desires, and may delegate their investment management to anyone it desires. Policyowners may choose and change among the accounts as permitted by the insurer.

- The basis of the Investment Annuity is simple and sound. Since the policyowner always carries the investment risk under all variable annuities, a segregated account is set up for each policyowner and the investment management is delegated to him - or to his chosen investment manager. All investments must be suitable for any variable annuity pursuant to state insurance law, and must be acceptable to the insurer.

- The insurer's mere delegation of investment management does not change the insurer's ownership of the segregated account and all assets held therein. The policyowner has no access to any assets held within the account.

- This delegation does not change the tax posture of the insurer, nor of the policyowner, from that of any variable annuity. The law is clear, the law makes sense, and the District Court has so declared - as did the IRS for over a decade and over 70 rulings.

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- The Investment Annuity form of variable annuity makes sense without changing any existing elements of the Internal Revenue Code because:

  - All annuities are very long term contracts spanning many decades - 30,40,50 years and more.
  - Fixed dollar annuities lose their purchasing power due to inflation on such a lengthy period.
  - Most variable annuities lock the purchaser into the roller coaster of equity values and prohibit the policyowner getting off the roller coaster after benefits commence.
  - Everyone knows that conditions change as the years go by - equity values, bond prices, interest yields, economic conditions, inflation, personal and family circumstances and even one's perception of these events. An axiom of any long-term investment type product is "never lock yourself in" because change is constant.
  - The Investment Annuity merely gives the policyowner needed flexibility to make his annuity really do the job for him as he strives to save and invest for life's later years. He can shift the segregated account investment direction - and thus his annuity benefits - as fits his personal needs and desires as life moves on. A truly singular advantage in the public interest.
  - All annuities help people live better in retirement because they permit them to live on both capital and income with the insurer's guarantee that they can't outlive their benefit payments no matter how long they live.
  - These singular values of all annuities when combined with the simple step of merely delegating investment management to the policyowner to produce the finest annuity ever devised for the American public. A myopic bureaucratic tragedy has removed it from those who need it badly.

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Conclusion

The Investment Annuity clearly provides an innovative, very attractive, badly needed form of variable annuity underwriting for the American public. This has been proven in the marketplace.

The IRS properly insisted upon variable annuity taxation for the Investment Annuity from 1963 until 1977 and reaffirmed its own conclusions via over 70 public and private rulings prior to its arbitrary, ignorant and illegal reversal of position.

Relevant law was established in 1962 contemporaneously with the original IRS considerations. The law has not changed during the past 16 years; nor have the relevant facts changed since the IRS' basic ruling in 1965.

The Court had adjudged the IRS' Rev. Rul. 77-85 to be illegal, unreasonable, ignorant of the law, and that the IRS usurped Congress' prerogatives to establish and change the law. In spite of the Court decision, the Treasury Dept. and the IRS thwarted renewed sales due to their threat to tax purchasers retroactively if these regulatory agencies win on their appeal. FIAC, who sued the IRS and won, was sold at great loss nevertheless due to FIAC's inability to continue in business as a result of the Treasury/IRS threat.

The Ways and Means Committee rejected the Treasury's proposals to tax all annuities in the manner forced upon the Investment Annuity industry by the illegal Rev. Rul. 77-85. The Ways and Means Committee also voted strongly (22-14) to override the illegal Rev. Rul. 77-85; thereby re-establishing the Investment Annuity. This victory was negated by Committee procedural constraints.

The Appelate Court did not consider the merits of this case. The Court invites Congress to provide relief. HR-6287, S-3082, and S-3094 (identical bills) provide such relief.

An important and badly needed segment of the insurance industry stands alone as being grossly and illegally discriminated against and abused by deliberate and ignorant bureaucratic anarchy as reflected in Revenue Rulings 77-85 and 80-274.

Congress can and should correct this severe inequity and injustice by merely reinstating the tax treatment as it existed prior to the issuance of the illegal Revenue Ruling 77-85.

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Proposed Legislation and Congressional Record Statements

Senate Bills S-3082 and S-3094 as introduced by Senators Tower and Hatch respectively are identical in wording to the House of Representatives Bill HR-6287 as introduced by Representative Conable. The Congressional Record statements of Senators Tower and Hatch and of Representative Conable pertaining to their bills are included herein.

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LEGISLATION ON IRS ANNUITY RULING

HON. BARBER B. CONABLE, JR.

OF NEW YORK

IN THE HOUSE OF REPRESENTATIVES

Monday, March 17, 1980

● Mr. CONABLE. Mr. Speaker, earlier this year I introduced legislation, H.R. 6287, which is designed to remedy an injustice in the administration of our tax laws. H.R. 6287 reinstates the tax treatment of annuity contracts with reserves based on a segregated asset account as they existed prior to the issuance of Revenue Ruling 77-85. This bill is identical to one (H.R. 12173) that I introduced in the 95th Congress.

From 1963 to 1965, when the IRS issued basic rulings on this matter, all relevant departments of the national office of the Internal Revenue Service insisted that an innovative form of annuity upon which the IRS had been asked to rule was purely and simply a variable annuity pursuant to the separate account laws that had been recently enacted in 1962—for sales identification purposes, this variable annuity became known as the investment annuity.

During the ensuing 12 years after 1965, the IRS reaffirmed its basic position over 70 times, including the issuance of Revenue Ruling 68-488 pertaining to deferred annuities. On March 9, 1977, the IRS issued Revenue Ruling 77-85 that completely reversed its long-standing rulings upon which an important segment of the life insurance industry relied. That result was, and continues to be, devastating to this segment of the industry.

Many Representatives and Senators protested this action to the Treasury and the IRS. On April 29, 1977, the Senate passed by a vote of 57 to 26 amendment No. 243 to H.R. 3477, the Tax Reduction and Simplification Act of 1977, that would have deferred the effective date of Revenue Ruling 77-85 for 1 year in order to permit Congress the opportunity to study the matter and to legislate, if appropriate. Amendment No. 243 was dropped in subsequent negotiations on H.R. 3477 by the conference committee.

Immediately after the conference committee completed its deliberations, one insurance company, the originator of the investment annuity and whose entire business was destroyed by the IRS reversal, sued the Internal Revenue Service in the U.S. District Court, District of Columbia, for arbitrary, illegal, and capricious acts.

On November 9, 1977, the court ruled that Revenue Ruling 77-85 was unlawful and beyond the statutory authority of the Internal Revenue Service. The judge expressed the confident assumption that the IRS would proceed to rectify its error without the need for the issuance of an injunction.

The IRS refused and stated that it would appeal any injunction issued and would retroactively tax any annuities sold during the interim of the appellate process should the IRS win on appeal.

The President's 1978 tax program proposed the taxation of all nonqualified deferred annuities in the same way as that imposed upon the investment annuity by Revenue Ruling 77-85; it was this same way that had been declared unlawful in district court. These proposals for all annuities encompassed investment annuities subject to Revenue Ruling 77-85.

The President's 1978 tax proposals relating to all annuities was rejected by the Ways and Means Committee while H.R. 12173, to override Revenue Ruling 77-85, received a favorable committee vote of 22 to 14. However, due to procedural constraints at that time, H.R. 12173 was not included in the tax bill reported by the committee.

In October 1979, the appellate court rendered its decision upon the IRS appeal of its conviction in district court. The appellate court never addressed the merits of the investment annuity matter because that court found that the Anti-Injunction Act barred court empowered relief. The court stated in its conclusions that—

> This is not a situation where there are no remedies, however. Congress keeps a watchful eye on developments in the tax field and will listen to citizens with a grievance or plea.

The advocates of the investment annuity have a serious grievance which requires a congressional remedy. I believe that the action by the IRS in issuing Revenue Ruling 77-85 has resulted in severe inequities, and I hope that the Ways and Means Committee will consider this matter promptly in order to restore the investment annuity to its proper place under the law and to rectify the injustice that continues.●

(over)

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welfare and medicaid costs, and for other purposes; to the Committee on Finance

By Mr. HATCH:

S. 3094. A bill to reinstate the tax treatment with respect to annuity contracts with reserves based on a segregated asset account as they existed prior to issuance of Revenue Ruling 77-85; to the Committee on Finance.

By Mr. CRANSTON (for himself, Mr. BAYH, Mr. DANFORTH, Mr. DECONCINI, Mr. GARN, Mr. GOLDWATER, Mr. HAYAKAWA, Mr. JACKSON, Mr. MOYNIHAN, Mr. NELSON, Mr. PACKWOOD, Mr. STAFFORD, Mr. STEVENSON, and Mr. WILLIAMS)

S.J. Res. 201. Joint resolution to provide for the designation of a week as "National Lupus Week"; to the Committee on the Judiciary.

STATEMENTS ON INTRODUCED BILLS AND JOINT RESOLUTIONS

By Mr. TOWER:

S. 3082. A bill to reinstate the tax treatment with respect to annunity contracts with reserves based on a segregated asset account as they existed prior to issuance of Revenue Ruling 77-85; to the Committee on Finance.

● Mr. TOWER. Mr. President, I am today introducing legislation to rectify an injustice caused by the Internal Revenue Service's sudden departure from longstanding procedure in the taxation of investment annuities. This bill, identical to H.R. 6287, introduced earlier this year in the House by Congressman BARBER CONABLE, would reinstate the tax treatment of annuity contracts with reserves based on a segregated asset account as they existed prior to the issuance of Revenue Ruling 77-85. This ruling was subsequently held unlawful by the U.S. District Court, District of Columbia, on the ground that it constituted an illegal, arbitrary, and capricious act beyond the statutory authority of the IRS, based on an unreasonable interpretation of the Internal Revenue Code. The appellate court, while not addressing the merits of the district court's decision, did invite Congress to provide relief, which this bill is designed to accomplish.

From 1963 to 1965, when the IRS issued basic rulings on the subject of variable, or investment annuities, all relevant departments of the national office of the IRS insisted that an innovative form of annuity upon which the Service had been asked to rule was purely and simply a variable annuity pursuant to the separate account laws that had previously been enacted in 1962.

During the ensuing 12 years after 1965, the IRS reaffirmed its basic position over 70 times, including the issuance of Revenue Ruling 68-488 pertaining to deferred annunities. On March 9, 1977, the IRS issued Revenue Ruling 77-85, which completely reversed its longstanding rulings upon which an important segment of the life insurance industry had relied. The result was, and continues to be, devastating to this segment of the industry.

Several Members of Congress protested this action to the Treasury and the IRS. On April 29, 1977, the Senate passed, by a vote of 57 to 26, an amendment to H.R. 3477, the Tax Reduction and Simplification Act of 1977, which would have deferred the effective date of Revenue Ruling 77-85 for 1 year in order to permit Congress to study the matter and to consider any appropriate legislation. Unfortunately, this amendment was not adopted in subsequent negotiations on H.R. 3477 by the House-Senate conference committee.

Immediately after the conference committee completed its work, one insurance company, the originator of the investment annuity and whose entire business was destroyed by the IRS's sudden flip-flop of position on this matter, sued the Internal Revenue Service in Federal District Court for the District of Columbia for arbitrary, illegal and capricious acts.

On November 9, 1977, the Court ruled that Revenue Ruling 77-85 was indeed unlawful and beyond the statutory authority of the IRS. Judge Charles R. Richley expressed the "confident assumption" that the IRS would proceed to rectify its error without the need for the issuance of an injunction.

However, the IRS refused, stating that it would appeal any injunction issued and would retroactively tax any annuities sold during the interim of the appellate process, should the IRS prevail on appeal.

The President's 1978 tax program proposed the taxation of all nonqualified deferred annuities in the same way as that imposed upon the investment annuity by Revenue Ruling 77-85, which, of course, had been declared unlawful by Federal district court.

The President's 1978 tax proposals relating to all annuities were wisely rejected by the House Ways and Means Committee during its consideration of H.R. 12173, to override Revenue Ruling 77-85, which was approved by committee by a vote of 22 to 14. Due to a procedural constraint at that time, however, H.R. 12173 was not incorporated in the tax bill reported by the committee.

The appellate court declared that it did not have jurisdiction and, therefore, reached no decision on the merits of the case. The appellate court added language, however, inviting Congress to fashion appropriate relief:

> This is not a situation where there are no remedies, however. Congress keeps a watchful eye on developments in the tax field, and will listen to citizens with a grievance or plea.

Mr. President, the entire matter, quite frankly, is a clasic case of the will of Congress being frustrated and subverted by agency action in influencing the legislative process. The advocates of the investment annuity have a serious grievance which, in my mind, requires a prompt congressional remedy. I believe that the action by the IRS in issuing the manifestly unreasonable and unsupportable Revenue Ruling 77-85 deserves the attention of the Senate before adjournment this year in order to restore the investment annuity to its proper place, tax-wise, under the law and to resolve the severe inequities which have resulted from the internal revenue service's arrogant disregard for sound judicial authority.●

By Mr. BENTSEN (for himself, Mr. BOREN, and Mr. CHILES):

S. 3084. A bill to provide that a Federal agency may not require that any person maintain records for a period in excess of 5 years, and a Federal agency may not commence an action for enforcement of a law or regulation or for collection of a civil fine after 5 years from the date of the act which is the subject of the enforcement action or fine, and for other purposes; to the Committee on Governmental Affairs.

LIMITATION ON GOVERNMENT RECORDKEEPING REQUIREMENTS ACT OF 1980

● Mr. BENTSEN. Mr. President, I think it is indeed ironic that much of the criminal element in this country—our forgers, embezzlers, thieves and extortionists—are protected by a statute of limitations. If they can perpetrate a crime and remain undetected for a specified number of years, they can be assured of immunity from prosecution for that deed, no matter how strong the case against them.

But there is no statute of limitation for the honest, hardworking small businessman or entrepreneur who unwittingly violates one of the rules or regulations that spew forth from this city like volcanic ash from the summit of Mount St. Helens. The innocent taxpayer who happens to violate a dictate of DOE or the EPA is liable forever; and he would be well advised to maintain records that go back years and years just in case he is called to account by a Federal agency for an alleged misdeed sometime in the distant past.

I can really see no good reason, Mr. President, to accord the professional criminal element in this country a greater measure of protection than we offer to our law-abiding citizens. I am therefore introducing legislation today with Senators BOREN and CHILES that would place a 5-year statute of limitations on the enforcement of rules and regulations promulgated by Federal agencies. This legislation would also limit to 5 years the time period required for individual recordkeeping.

Mr. President, at a time when compliance with Federal rules and regulations creates a $100 billion annual drag on our economy, it is obvious in our national interest to reduce whenever possible and appropriate the crushing burden of Federal interference.

We should understand that this burden falls most heavily on the shoulders of small and medium-sized enterprises—those segments of our economy least able to afford it. The fortune 500 corporations can afford the lawyers, the trade associations and the accountants required to keep abreast of and in compliance with all Federal regulations. They can afford to microfilm their records and keep them indefinitely as insurance against a change, however ill conceived, that they violated a Federal regulation a decade ago.

But the small company frequently lacks the resources for this sort of monitoring and recordkeeping. These corporations are more likely to put their scarce resources into the sort of R. & D. or new

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Carcassonne, the magnificent old walled city in southern France, had its hostel in an old church, where we ended up sleeping in the choir loft.

And it all cost only 20 cents a night! It was enough to make of you forever a happy and very continental cheapskate, and there have been those who have malevolently suggested that this is indeed what came about.

But I am not only, now, reminiscing. It is a time of quintessentially bad news in the world, and yet there are all sorts of good things happening underneath. One of them is the fact that, finally, a comprehensive American Youth Hostel system is getting closer to reality.

The bill to develop a national system of hostels here passed the U.S. House of Representatives on May 19 and has been sent to the Senate for what we hope will be prompt action. Because, although there already are some 240 Youth Hostels, Inc., this is the first time the country itself will create a real structure. There are even plans to convert some historic trust properties into living monuments by making them into hostels.

But—and I can testify from my own experience roaming all over Europe those 20 years ago—youth hosteling is much, much more than just having inexpensive places to lodge with other genial cheapskates.

It is much more than a movement that allows you to "see the world." It is a kind of other wave length, which permits people, living by their own choice at a minimal cost and in a special way, to cut across the barriers that more formal ways of living place in the way of real cultural exchange.

And this brings to mind a real worry of mine—that, in the harsh exigencies of all the difficult and cruel things that have been happening in the world recently, we are forgetting the utterly crucial ingredient of culture. Yet there has never been a time when we more truly need (even for our own sanity) to know and appreciate other cultures and to reinforce our own.

There are clearly negative ways to react to the events of the world today: with fear, with withdrawal, with more exchanges of brutality. And there are positive ways: by reinforcing the strong points of cultures, by more exchange, by precisely programs like the Youth Hostel one, which will encourage Americans and visitors even to meet problems of energy and inflation in new and creative ways.

And unless the world and mind of the Youth Hostelers have changed, I remain confident that if there is a Tarantella dancer out there, they will find him.

● Mr. JACKSON. Mr. President, I want to take just a moment to join with Senator THOMAS in highlighting the merits of the bill we are introducing today—The National Hostel System Act of 1980.

The measure is intended to set in motion a systematic approach for the development of a plan for a network of American hostels which will serve millions of traveling youth in the decades ahead by providing them with a clean and habitable environment at an affordable cost. It will also assist an already burgeoning American hostel movement by providing limited funds for the renovation of existing buildings so that they may accommodate budget-minded and energy-conscious travelers with a safe and supervised overnight dwelling.

In this regard, European countries have long supported hosteling as a way of promoting inexpensive travel among their young people so that they will continue traveling throughout their lives, and have an established system which is remarkable for its growth and self-sufficiency. For instance, West Germany boasts of more than 550 hosteling facilities which are within an easy day's hike or bike trip from each other, and Britain has 269 hostels dotting the English and Welsh countrysides for the benefit of British youth. In my own home State of Washington, Mr. President, the hosteling movement is gaining great momentum as Sea Haven Hostels, a nonprofit organization, has established 7 hostels and is planning expansion of its recreational program to 30 more facilities. The cost for acquisition and renovation, however, is enormous and often inhibits or slows systematic growth. But with enactment of the bill we are introducing today, we can help to expand America's hosteling system to complement its European counterpart, and thereby help to insure that all in America who appreciate our great cultural and natural heritage, and who enjoy traveling and actively partaking in such activities as backpacking, hiking, skiing, and bicycling, can afford to do so.

Mr. President, the House of Representatives has already passed a similar measure, and therefore I urge all Members of the Senate to join us today in support of the National Hostel System Act of 1980 so that we may begin to establish a coherent youth hosteling system across America to serve America's youth in their travels and development.●

By Mr. HATCH:

S. 3094. A bill to reinstate the tax treatment with respect to annuity contracts with reserves based on a segregated asset account as they existed prior to issuance of Revenue Ruling 77-85; to the Committee on Finance.

● Mr. HATCH. Mr. President, this proposed legislation is very important not only because it rights a tremendous injustice in the administration of our tax laws, it is important to the authority and integrity of the U.S. Senate and the laws of our country. It is a matter of tax laws, but more importantly, also a matter of who makes the law. The Internal Revenue Service has in the specific instance pertaining to this matter usurped that authority in the face of opposition of the U.S. Senate, a U.S. district court decision and the expressed will of the House Committee on Ways and Means.

The specific matter at hand pertains to IRS Revenue Ruling 77-85 that reversed over 70 consistent public and private rulings that covered a time span of more than a decade. This ruling not only strangled an innovative annuity industry to the detriment of the well-being of our Nation's citizens. This ruling, and the IRS actions related thereto, constitute a documentable case of arbitrary, capricious and illegal acts that cannot be acceptable nor tolerable to the Senate.

The merits of this proposed amendment are clearly reflected in the various courts pronouncements. The U.S. District Court, District of Columbia declared that: Revenue Ruling 77-85 is an erroneous and unreasonable interpretation of this Internal Revenue Code; the ruling was unlawful and beyond the IRS' statutory authority; and that substantial deference to the IRS' expertise is unwarranted in this matter. While the appellate court never addressed the merits of this matter, because it based its findings upon a jurisdiction question, the appellate court stated:

> This is not a situation where there are no remedies, however. Congress keeps a watchful eye on developments in this tax field and will listen to citizens with a grievance or plea.

The true victims of these illegal, unreasonable IRS actions are our Nation's citizens who are being illegally denied a most innovative and useful annuity that was developed in the public interest. Thus, this is a situation that warrants remedial action by the Senate; action that will also restore the authority of the Congress in the writing of our tax laws—a most important matter that commands our immediate and resolute action.●

By Mr. CRANSTON (for himself, Mr. BAYH, Mr. DANFORTH, Mr. DECONCINI, Mr. GARN, Mr. GOLDWATER, Mr. HAYAKAWA, Mr. JACKSON, Mr. MOYNIHAN, Mr. NELSON, Mr. PACKWOOD, Mr. STAFFORD, Mr. STEVENSON, and Mr. WILLIAMS):

S.J. Res. 201. Joint resolution to provide for the designation of a week as "National Lupus Week"; to the Committee on the Judiciary.

NATIONAL LUPUS WEEK

● Mr. CRANSTON. Mr. President, today I am introducing, on behalf of myself and a bipartisan group of 13 other Senators, a resolution providing for the designation of the week of October 19 through 25, 1980, as "National Lupus Week." This resolution has been introduced each of the last 3 years. Once again, I am happy to provide my assistance to focus national attention on the serious nature of the disease lupus erythematosus.

Mr. President, I would like to explain briefly the nature of lupus erythematosus and the intent of the resolution.

Lupus erythematosus is a disease of the connective tissue of the body including the skin. Its causes are unknown. It is essentially a disorder of the body's immune system, which is the first line of defense against infection and inflammation anywhere within the body. Its main target is women in the early and young adult age bracket—age 14 to 40. There may be as many as 500,000 cases in the United States with approximately 50 000 new cases diagnosed each year. The majority of the cases can be effectively treated; however, tragically, lupus causes 5,000 deaths annually.

The intent of the resolution is to help the American Lupus Society, the volunteer organization, make the public aware of the tragedy of lupus erythematosus. The American Lupus Society is a nonprofit organization originally founded in 1973 in California. The purpose of the organization is to assist lupus patients and their families in their fight against the disease, to develop and engage in programs aimed toward making the public aware of lupus, and to raise

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96TH CONGRESS
2D SESSION

H. R. 6287

To reinstate the tax treatment with respect to annuity contracts with reserves based on a segregated asset account as they existed prior to issuance of Revenue Ruling 77-85.

IN THE HOUSE OF REPRESENTATIVES

JANUARY 24, 1980

Mr. CONABLE introduced the following bill; which was referred to the Committee on Ways and Means

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A BILL

To reinstate the tax treatment with respect to annuity contracts with reserves based on a segregated asset account as they existed prior to issuance of Revenue Ruling 77-85.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That in the case of annuity contracts which have related
4 amounts based on a segregated asset account, the tax treat-
5 ment of such contracts under section 61 of the Internal Reve-
6 nue Code of 1954 (defining gross income) and section
7 801(g)(1)(B) of such Code (relating to contracts with reserves
8 based on a segregated asset account) shall be determined—

1 (1) without regard to Revenue Ruling 77-85 (and
2 without regard to any other regulation, ruling, or deci-
3 sion reaching the same result as, or a result similar to,
4 the result set forth in such Revenue Ruling); and
5 (2) with full regard to the rules in effect before
6 Revenue Ruling 77-85

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The Court Adjudged Illegality of IRS Revenue Ruling 77-85

The United States District Court, District of Columbia, declared in Judge Charles R. Richey's Memorandum Opinion of November 9, 1977:

* "REVENUE RULING 77-85 IS AN ERRONEOUS AND UNREASONABLE INTERPRETATION OF THE INTERNAL REVENUE CODE, AND, IN VIEW OF THIS FACT THAT SUBSTANTIAL DEFERENCE TO THE AGENCY'S EXPERTISE IS NOT WARRANTED BY THE FACTS OF THE CASE, THE COURT WILL DECLARE THE RULING TO BE UNLAWFUL AND BEYOND THE SERVICES' STATUTORY AUTHORITY."

* "REVENUE RULING 77-85 IS UNLAWFUL AND BEYOND THE SERVICES' STATUTORY AUTHORITY IN THAT ITS DETERMINATION THAT THE POLICYOWNER, RATHER THAN THE ISSUING LIFE INSURANCE COMPANY, IS THE OWNER OF THE INVESTMENT ANNUITY CUSTODIAL ACCOUNT ASSETS IS ERRONEOUS AND UNREASONABLE."

* "THE SERVICES' DECISION IN REVENUE RULING 77-85 WAS NOT CONTEMPORANEOUS WITH THE ENACTMENT OF SECTION 801(g)(1)(B), DOES NOT REFLECT A LONG-STANDING AGENCY POSITION, AND IS INCONSISTENT WITH EARLIER PRONOUNCEMENTS AND EVEN ONE SUBSEQUENT ANNOUNCEMENT, OF THE AGENCY. ACCORDINGLY, SUBSTANTIAL DEFERENCE TO THE SERVICES' EXPERTISE IS UNWARRANTED IN THE INSTANT CASE.

* "SUBSTANTIAL DEFERENCE TO THE SERVICES' EXPERTISE IS ALSO UNWARRANTED BECAUSE THE SERVICE WAS IMPROPERLY MOTIVATED BY CONSIDERATIONS OF TAX REFORM WHEN IT ISSUED REVENUE RULING 77-85."

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The Investment Annuity Matter
A Chronological Summary

1962 The Internal Revenue Code was amended to permit life insurance companies to establish "separate accounts" to facilitate the underwriting of variable annuities. (Section 801(g)(1)(B))

Under all variable annuities the policy owner's cash values and benefits "vary" directly with the investment results (appreciation, depreciation and income) of the related "separate account." Therefore, while the insurer underwrites the expense and longevity (mortality) risks of the variable annuity, the policy owner assumes the investment risk regardless of whether the insurer manages the "separate accounts" portfolios or whether the insurer delegates that investment management to others.

1963 An innovative form of variable annuity was developed and a new life insurance company was organized to underwrite, sell and administer the annuity. Appropriate tax rulings for the insurer and policy owners were requested of the National Office of the IRS. Under this annuity the insurer merely established a separate account for each policy owner and delegated, under prescribed conditions established by the insurer, the investment management of the separate account to the policy owner or to the policy owner's chosen investment manager. The IRS recognized from the start that a new company and a new segment of the life insurance industry was to be bottomed upon the National Office tax ruling to be issued.

1965 From the start of its consideration of the tax ruling matter in 1963 until it issued its first basic ruling in 1965, the IRS consistently insisted that the annuity under consideration was a variable annuity falling fully within the separate account provisions of the law recently enacted in 1962. Every relevant department of the IRS contributed to the IRS' very thorough two year consideration; and it was concluded by the IRS that the delegation of investment management to the policy owner by the insurer did not change any elements of variable annuity taxation to the insurer or to the policy owner.

At about this time the brand name "Investment Annuity" was coined solely for legitimate business identification purposes and the name of the insurance company was changed to First Investment Annuity Company of America (FIAC).

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1965-1977	During this twelve-year period the National Office of the IRS issued over 70 public and private rulings covering different Investment Annuity contracts for different markets. All rulings consistently reaffirmed and reinforced the basic rulings established in 1965. Nine or ten other insurers emulated FIAC's brand of variable annuity during this period and secured appropriate and consistent National Office tax rulings.
1976	The IRS announced a reconsideration of its prior Investment Annuity rulings and requested comments from interested parties on three specific areas of importance to their reconsideration. The entire Investment Annuity industry responded with relevant facts and complete, conclusive answers to the IRS' important questions; said answers clearly showing that the IRS' historic position was correct legally, actuarially and in accord with industry practice in regards to variable annuities.
1977	The IRS issued Revenue Ruling 77-85 that completely reversed its historic, 14-year position as reflected in over 70 previous rulings! In issuing Rev. Rul. 77-85 the IRS ignored the very questions it said in 1976 were important to its reconsideration!
	Revenue Ruling 77-85 effectively and immediately closed down the entire Investment Annuity industry and thereby put FIAC completely out of business.
1977	The Senate passed Amendment 243 to HR 3477 by a strong vote of 57-26 that deferred the effective date of Revenue Ruling 77-85 for one year to protect the legitimate interests of the Investment Annuity industry and to give Congress the necessary time to consider the matter. Many members of the Senate Finance Committee as well as other members of Congress were very concerned about the precipitous and ruinous IRS action that completely reversed long standing tax law administration that had become imbued with the force of law.
	This Amendment 243 was subsequently dropped in the House/Senate Conference Committee due to Treasury Dept. lobbying and the House/Senate bargaining over resolving the House/Senate differences on HR 3477.
1977	Following the Conference Committee's dropping of Amendment 243, FIAC sued the Treasury Dept. and the IRS in the U.S. District Court, District of Columbia, for arbitrary, capricious and illegal acts in issuing Revenue Ruling 77-85.

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After thorough consideration, the Court decided that the IRS' act was illegal and unreasonable; that the IRS had exceeded its statutory authority; was motivated by theories of tax reform which is Congress' business; and that substantial deference to the expertise of the IRS in this matter was unwarranted. In plain language the Court was stating that the IRS, our nation's administrator of our tax laws, didn't know what it was talking about!

The Treasury Dept. and the IRS appealed the District Court decision and stated that anyone purchasing an Investment Annuity during the time span of their appeal would be taxed retroactively if the IRS won its appeal. The IRS threat precluded FIAC starting up its business again even though FIAC had won a very strong victory in court on the merits. The only hope the Treasury and IRS had for their appeal was upon the highly technical court jurisdiction question.

1977-78 The day after the favorable Court decision was issued a major insurer made a bid to purchase FIAC's corporate shell at liquidation value. When FIAC was unable to secure any tax assurances from the IRS and Treasury for new selling, the majority owner of FIAC (from the United Kingdom) voted to accept the liquidation value bid. All employees were terminated.

A $300 million company that had developed and marketed a fine, innovative product in the public interest has been destroyed by the illegal, arbitrary act of the IRS; over 4500 agents left without the annuity to sell; and shareholders have lost at least $20 million of values (Investment Annuity stock was selling at over $5 per share when the IRS reversal matter started, and will be liquidated at less than $1.75 per share -- at least a $3.25 per share loss x 6.3 million shares outstanding = $19.5 million.)

1978 President Carter's 1978 tax proposals included taxing all annuities generally in the manner the IRS illegally forced on FIAC. The Treasury Dept.'s rationale for those tax proposals was basically the same the Court found to be erroneous in the Investment Annuity matter. These tax proposals were rejected by the House Ways and Means Committee in April, 1978; and, by a strong 22-14 margin, the Committee voted to reestablish the Investment Annuity as it had existed for 14 years prior to the illegal IRS reversal in March of 1977 via Rev. Rul. 77-85.

The Ways and Means Committee, bogged down subsequently on other tax matters, eventually passed the Ullman/Jones/Conable Compromise Tax Bill that included very few amendments due to procedural constraints. While

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the Investment Annuity matter was not included, Chairman Ullman committed that it would be taken up again by the Committee in a subsequent tax bill.

1978 A Senate "floor Amendment" was introduced to reinstate the Investment Annuity. This Amendment was a companion bill to that voted favorably upon by the House Ways and Means Committee. The Senate Parliamentarian ruled that the Investment Annuity Amendment had no revenue impact because the court had declared that the IRS had acted illegally in issuing Revenue Ruling 77-85. Subsequently, when cloiture was invoked to limit Senate debate, the Investment Annuity matter was precluded from being brought to a vote in the Senate because of a "germaneness" point of order on the grounds that there is nothing in the bill dealing with Investment Annuity contracts."

1979 The Appellate Court declared that it did not have jurisdiction and therefore reached no decision on the merits of the case. The Appelate Court added: "This is not a situation where there are no remedies,however. Congress keeps a watchful eye on developments in the tax field, and will listen to citizens with a grievance or plea."

1980 The Appellate Court's "jurisdiction" decision was appealed to the Supreme Court. The Supreme Court did not accept the case for review.

1980 Representative Conable reintroduces a bill (HR-6287) to reinstate the tax treatment of Investment Annuities as they existed prior to the illegal IRS issuance of Revenue Ruling 77-85. Senator Tower and Senator Hatch introduce identical bills to HR-6287;namely,S-3082 and S-3094,respectively.

1980 Without giving interested parties the opportunity to be heard,the IRS issued Revenue Ruling 80-274 that:

- Wiped out certain types of annuities and destroyed another valid segment of the annuity industry.
- Provided no legal basis for the ruling;it merely stated the IRS conclusions.
- Ignored the fact that the IRS had issued favorable rulings on this very subject this same year (1980) and in prior years.
- Pulled the rug out from under many financial institutions and thousands of individuals that had relied upon the competence and fairness of the IRS in the issuance of their prior rulings.

1980 Senator Byrd's Finance Sub Committee on taxation and Debt Management holds hearings on S-3082 and S-3094.

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Chronology Overview

It is relevant to point out the following:

1) Throughout this entire "reversal of IRS position" affair (1976 to the present) the IRS and Treasury explanations and positions have been woefully ignorant of the subject matter as well as involving contradictions, misleading statements and half-truths. Not only have these been in evidence in their dealings with the taxpayer(s) but also in presenting their positions to their superiors and to Congress.

2) At least two congressmen have attempted to secure a clear, written statement of the Treasury's explanation for their Investment Annuity position. In each instance the Treasury response was unintelligible in terms of the law, logic or any other rational perspective. In short, the Treasury gave no explanation because they have none that makes sense.

3) During the Court procedings the IRS issued a favorable tax ruling to a competitor of FIAC that permitted the competitor to underwrite the Investment Annuity. When the Court demanded an explanation the IRS had none acceptable to the Court. The IRS revoked their new ruling.

4) The Treasury and IRS claimed the Investment Annuity was a "tax shelter". As demonstrated conclusively by the respected accounting firm of Coopers & Lybrand, no annuity, including the Investment Annuity, meets the definition of a "tax shelter". Even Stanley Surrey's book entitled, "Pathways to Tax Reform" states that tax deferral that includes a "market rate of interest" payment to the government is a proper mode of tax deferral. Such a payment of interest to the Government is exactly what any annuity provides.

5) The Treasury tries to imply that the Investment Annuity buyer enjoys some kind of favorable capital gains tax treatment. Nothing could be more erroneous. It so happens that realized long term capital gain is taxed <u>twice</u> under <u>any</u> variable annuity: first at the company's capital gain tax rate (28%) with <u>the balance after tax</u> then being taxed <u>again</u> at policyowner's <u>ordinary</u> tax rate when paid as a benefit to the policyowner.

6) It can be demonstrated conclusively that it makes no difference "taxwise" as to who decides how an insurer's "Segregated Asset Account" is invested. The IRS insisted this was correct over 70 times during 13 years (1963-1976) and they were correct.

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7) Our citizens and our Congress are becoming acutely aware of our nation's great need for greater savings and investment within the private sector. We must build up the "supply side of our economy". The Investment Annuity facilitates this needed development because the Investment Annuity is compatible with, and helps, all segments of the financial community including savings and loans, mutual savings banks, and credit unions. The Investment Annuity helps them attract and hold savings assets, and because annuity contracts stretch out over decades it helps these financial institutions invest "long" thereby enhancing their ability to place mortgages and finance housing. (For example, see California Federal letter attached. California Federal is our nation's largest Federal Savings and Loan.)

8) The proposed legislation (HR-6287,S-3082, S-3094) is not only a correction of a gross bureaucratic injustice. These bills are a particularly welcome piece of legislation at this time when many financial institutions and our nation can utilize a means to attract and hold personal savings and investments thereby building capital for investment, more jobs, more productivity and less inflation.

CALIFORNIA FEDERAL
Nation's Largest Federal

March 7, 1980

W. Thomas Kelly, President
Investment Annuities Institute, Inc.
Suite 1128 Bender Building
1120 Connecticut Ave., N.W.
Washington, D.C. 20036

Dear Mr. Kelly,

Our institution has been familiar with the investment annuity for several years. We understand that HR-6287 has been introduced to reinstate the tax treatment as it existed prior to the issuance of Revenue Ruling 77-85.

We support this legislation and are hopeful that this product will be reinstated as a financial service for our customers and others.

Very truly yours,

J.R. Michael Philbin
Senior Vice President

JRP:mlh

cc: John Patton Farrell,
Farrell Marketing Inc.
Don M. Muchmore,
California Federal

Investment Annuity Contractual Arrangements

- All annuities are long term contracts involving serious insurer risks.Longevity is lengthening. The trend is against the insurer. Such risks apply immediately upon contract purchase because the insurer provides benefit guarantees that can be started anytime at the election of the policyowner.

- All insurer assets must be invested pursuant to State law. No policyowner has access to any insurer assets. ALL assets of the insurer support the insurer's liabilities- namely the insurer's guarantee to provide the insurance or annuity policy's stipulated benefits.

- A segregated account of a variable annuity is merely a convenient way for the insurer to have its annuity benefits move up or down in regards to some measurable index. The segregated account can be equity oriented, or balanced, or bond oriented, or invested in certificates of deposit and savings accounts,or invested in a mutual fund(s),etc. The account is merely used to establish the index for benefit changes- all assets are entirely the insurer's as is true of all life insurance and annuity assets. If the assets prove insufficient to provide the guaranteed benefits,the deficiency must be made up from the insurer's surplus or shareholder's equity.

- Insurance law prohibits any insurer from disbursing assets from any segregated account to any policyowner. Money flow from a segregated account must always be in cash and solely to the general account of the insurer.

- Annuity policy cash values and benefits are contractual rights that must be paid when the policyowner so elects. All assets held by the insurer are fungible and no policyowner has claim to any specific assets. Insurance law and regulation and good business practice require an excess of assets over liabilities structured in such a way that all liabilities can be met.

- In no way can any portion of an insurer's assets be deemed a policyowner's. The law and the Courts are consistent on this.

How can the account assets be owned by the individual when:

a) He can't get his hands on them.

b) He's limited by the insurer as to whathe can choose as an investment of the account.

c) The insurer can remove an asset from its acceptable list and force the sale of the asset in the account.

d) The variable annuity reserve liabilities and related assets are reported on the balance sheet of the insurance company according to state law and regulations and pursuant to IRC Section 801(g)(1)(B)(i).

e) These segregated account assets of the insurer are directly related to the insurer's liability to the individual for annuity payments pursuant to the annuity policy provisions. The state insurance departments can require the insurer to bolster its stated liability if the state insurance departments believe that annuitant longevity is increasing and thus the liability is understated. Such an increase would come out of the insurer's shareowner surplus. The individual would enjoy greater benefits than that measured by the value of his account. The insurer has a very real risk from the date the policy is purchased and the insurer must have the account assets to support this liability.

f) The individual's annuity purchase contributions are reported by the insurance company as premiums or stipulated payments for annuities pursuant to state law and pursuant to IRC Section 809(c)(1). Thus, they are the insurer's, not the individual's.

g) Pursuant to the policy and the application, the individual,with full knowledge, irrevocably commits to the insurer all of his annuity purchase contributions for the annuity policy, as well as all of the income thereon.

h)The individual is under no obligation to the insurer. It is an unilateral contract.

i) All parties to the annuity policy agree to its terms.

j) The insurance company, not the individual, assumes the loss arising from any defalcation related to the account assets. This requirement was one of those required over the years by the IRS to further establish that the ownership of the assets rests with the insurer.

k) The individual cannot use the assets in the custodian account as collateral for a loan.

l) The individual cannot substitute assets within the account for assets the individual holds outside the account.

m)There is absolutely no expectation by the individual of recovering any assets as is found under a pledge arrangement. The individual hasn't pledged any assets at all; he's given them up.

n)And as a part of the transaction, the insurer assumes immediately a significant mortality risk and expense risk, as well as an investment risk that account assets upon death will not match the insurer's assumed value. All of these risks are bottomed solely on the contractual fact that all assets in the account are irrevocably committed to the insurance company.

o)Rev. Rul. 68-487 and Rev. Rul. 68-488 were specifically addressed to this identical question of setting aside monies to purchase annuities. Rev. Rul. 68-488 stated that the Investment Annuity underwriting procedure was in fact the current purchase of a variable annuity whereas Rev. Rul. 68-487 described some other arrangement that did not constitute the current purchase of an annuity.

o) A creditor of an individual can not gethis hands on any assets underlying the insurer's policy obligations. The creditor can only get his hands on the policy.

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In 1963, and for thirteen years thereafter, the IRS insisted that the mere delegation by the insurer to the policyowner of limited rights to select among investments as authorized by the insurer did not constitute transferring ownership to the policyowner. This IRS position is soundly based in law as was again reaffirmed by the U.S. District Court in the Investment Annuity matter. The IRS ignores clear fact and precedent and thwarts the law in this instance.

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INVESTMENT ANNUITIES INSTITUTE, INC.

INVESTMENT ANNUITY MATTER

TREASURY OBJECTIONS

This is the Investment Annuity matter as reflected in remedial legislation, Senate Bills S-3082 and S-3094. Those bills are identical, companion bills to override Revenue Ruling 77-85 and are identical to the House of Representatives Bill HR-8267.

Revenue Ruling 77-85 has been declared by the U.S. District Court, District of Columbia, as being unreasonable, illegal and ignorant of the law. The Court states that deference to the expertise of the IRS on this matter is unwarranted. Thus, the Treasury objects with unclean hands--with ignorance, unreasonableness and illegality-- as the Court has declared on the merits of this case.

This matter is well known to most all members of the House Ways and Means Committee and the Senate Finance Committee.

THE TREASURY'S ALLEGED OBJECTIONS

It's an Alleged "Tax Shelter"

The Investment Annuity does not meet any definition of a tax shelter. This has been documented by Coopers & Lybrand, the well respected Accounting firm. Their conclusion is: "It is evident that deferred annuities (including the Investment Annuity) lack a 'prime ingredient of tax shelters' namely, an interest-free loan from the Government in the amount of the tax deferred". (See letter attached)

It's an Alleged Abuse

The Court asked the Treasury and the IRS for evidence of their alleged abuses. None were forthcoming.

It's an Alleged Revenue Loss

The Treasury's numbers are etherial, undocumented and even bizarre in that the Treasury's numbers for a small Investment Annuity segment of the Annuity industry have on occasion exceeded their numbers for the entire Annuity industry.

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> More importantly, the Treasury's numbers ignore the pertinent fact that the Treasury is paid a market rate of interest by the taxpayer to compensate the government for the tax deferral found in all annuities.
>
> This important fact is documented by Coopers & Lybrand and meets even Stanley Surrey's* perception of reasonable governmental compensation for tax deferral. Coopers & Lybrand state: "The existing mode of deferred annuity taxation results in an interest element being charged to the taxpayer as proposed by Mr. Surrey. In fact, under most circumstances the existing mode of annuity taxation provides more tax dollars for the Government than Mr. Surrey's proposals". (See letter attached)
>
> *Stanley Surrey was Assistant Secretary of Treasury for Tax Policy during President Kennedy's and Johnson's terms. Those officials now in charge of tax policy at the Treasury and at the IRS are disciples of Surrey's theories of taxation.

The Treasury obviously relys upon the Court of Appeals decision overriding the District Court decision; or Revenue Ruling 80-274 could not have been issued.

It is a fact that the U.S. District Court, District of Columbia decided this case on its merits and denounced the IRS and Treasury for acting illegally, unreasonably and in ignorance of the law.

The Appellate Court's overriding decision was not on the merits; it was on the complex "jurisdiction of the Court" question.

The District Court decision can be cited as a precedent as reflecting the Court's decision on the merits of this matter. It was overturned on other grounds. The Treasury and the IRS are "bootstrapping" when they base the merits of Revenue Ruling 80-274 upon Revenue Ruling 77-85 that was declared on its merits as being illegal, unreasonable and ignorant of the law.

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Stanley S. Surrey

PATHWAYS TO TAX REFORM

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The tax reflection of the cost of the investment insofar as that investment is based on borrowed dollars should not be faster than the investor's repayment of the borrowed funds. Hence, the tax shelter benefits of acceleration of deductions should be confined to the taxpayer's equity investment, i.e., the initial investment, if any, of his own funds and the subsequent increase in his own investment as he repays the principal of the borrowed funds. This restraint, as in the suggestion of confining deductions to income from the investment, would be limited to the acceleration of deductions produced by the tax expenditures and not to deductions under the income tax proper.[7] The two suggested restraints are not alternatives and are compatible with each other.

The description of this proposed restraint is in terms of borrowed funds that can be directly related to the sheltered investment, such as a borrowing secured by the investment itself. This is the typical situation in these investments. But suppose the investor, to defeat the restraint, borrows funds under a general obligation or secured by other property not involved in sheltered activity, such as diversified stocks or securities. Are the dollars so borrowed now the taxpayer's "own funds" when invested in the tax shelter and thus an equity investment in that shelter, entitled in full to the accelerated deductions it produces, or are the dollars still borrowed funds? The question itself, and the problems it raises, are not enough to negate the proposal since in most cases the borrowing is related directly to the sheltered investment. Presumably any borrowing not so related would qualify as an equity investment so as to avoid the need for too detailed a tracing of dollars. The problem would then be confined to the appropriate technical treatment of the receipt of borrowed money under the income tax proper. Thus, if a taxpayer with appreciated securities needs money but instead of selling the securities and realizing a taxable gain, borrows on the securities, the present law does not find a gain. This rule could be reexamined, and if the gain were taxed, then the borrowing would properly be treated as the taxpayer's own funds — just as would funds obtained on a sale of the securities.[8]

Payment for the Ingredient of Deferral

A prime ingredient of tax shelters is the deferral of tax on current income, achieved through the acceleration of deductions provided by the shelter. This deferral, as described earlier, is an interest-free loan from the Government in the amount of the tax deferred. Here, also, the ingredient suggests an appropriate restraint — eliminate the interest-free character of the deferral loan by charging interest on the deferred tax.

Some economists have suggested, as a fundamental change in the income tax, a "cumulative averaging" or "cumulative assessment" system that would

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make the timing of tax liabilities essentially an unimportant matter.[9] Under this approach taxpayers would in effect earn interest on taxes paid and owe interest on taxes deferred. Assuming that the interest rate used reflects market rates, the deferral of taxes simply introduces another source of borrowed funds and enhances general liquidity. Early payment of taxes becomes a method of investment. This cumulative averaging would, according to its proponents, permit a taxpayer to choose any rate of depreciation or other timing of deductions and any rate of realization of income.[10] Under this approach, the present tax shelters would simply be absorbed by such optional arrangements. Cumulative averaging is of course aimed at broader goals, such as major simplification of the income tax by removing the present stress on accurate yearly timing and the provisions supporting that stress, and also achieving greater equity among taxpayers through its averaging effects. But a by-product of its adoption would be the essential elimination of the tax shelter problem, as its proponents observe,[11] since the deferral offered only to a few today at no cost would become, in effect, available to all, but at an interest cost.

We are unlikely in the immediate future to see the tax shelter problem solved this way. Cumulative averaging is a major change that still requires discussion and experimentation. Some economists dislike the use of a lifetime to average income; others are concerned about its counter-cyclical effects; others see many complexities in its operation.[12]

In the absence of such a change, the question reverts to whether the interest-free loan of specific tax shelters can be altered through charging interest in those situations on the deferral of tax obtained. The Senate version of the Tax Reform Act of 1969 sought to meet the tax benefits obtained by the use of family trusts to accumulate income for later payment to beneficiaries — which achieves a deferral of tax if the rate of tax on the trust is less than that on the beneficiary — by charging, in effect, 6 percent interest on the deferred tax.[13] The provision was not carefully prepared, and this, plus opposition by trust companies and the tax bar, led to its deletion in Conference. But the suggestion has basic validity, both for the shelter of accumulation trusts and for the tax shelters we are considering. It remains to be seen whether the idea can technically be translated into a workable arrangement that, as in the other restraints earlier discussed, would apply the interest charge to the deferral obtained by the acceleration of deductions under the tax shelter. We will return to this matter in the later discussion of the minimum tax.[14]

Removal of Ingredient of Capital Gain on Sale of Investment

The third tax shelter ingredient is that of the application of capital gain treatment on the sale of the investment to the "gain" created by the

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IN PRINCIPAL AREAS
OF THE WORLD

1900 THREE GIRARD PLAZA
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June 2, 1978

Mr. W. Thomas Kelly
R.D. 3, Box 72
Malvern, Pennsylvania 19355

Dear Mr. Kelly:

As you requested, we comment, hereinafter, upon whether the existing federal income taxation of deferred annuities allows the annuitant benefits similar to those contained in "tax shelters" or whether annuity taxation meets certain criteria set forth by Stanley S. Surrey in his book "Pathways to Tax Reform".

In Chapter VII of the book entitled "Corrective Reform Measures to Moderate Tax Expenditures Abuses" Mr. Surrey proposes that one corrective measure would be a payment for the deferral ingredient as follows:

> "A prime ingredient of tax shelters is the deferral of tax on current income, achieved through the acceleration of deductions provided by the shelter. This deferral, as described earlier, is an interest-free loan from the government in the amount of the tax deferred. Here, also, the ingredient suggests an appropriate restraint -- eliminate the interest-free character of the deferral loan by charging interest on the deferred tax."

We have prepared and attach as Exhibit I a simple illustration of Mr. Surrey's corrective measure using as a model the accelerated depreciation deferral.

Here a taxpayer obtains an interest free loan from the Government equal to the difference between accelerated and straight line depreciation tax-effected at 50 percent. The loan increases each year that the accelerated depreciation exceeds the hypothetical straight-line depreciation and then decreases when the hypothetical straight-line depreciation exceeds that claimed whether it be accelerated or straight-line. The taxpayer would pay interest to the Government each year on the deferral loan and be entitled to a deduction for the interest paid as it would for interest on any other loan. The net result would be a payment of $232 to the Government on the deferral loan.

Extending Surrey's theory to a deferred annuity we have prepared Exhibit II which compares the taxation of a certificate of deposit with the taxation of a deferred annuity to arrive at the deferral loan. Since no interest is paid currently on the deferral loan, we have added the unpaid interest to the deferral loan. The interest rate used is an after tax rate of four percent assuming the market rate of interest is eight percent and the annuitant is in the 50 percent tax bracket.

The conclusion one can draw from Exhibit II is that when the annuitant withdraws his funds the payment made to the Government ($5,794) contains an element of interest on the deferral loan since the actual taxes paid on the certificate of deposit total $4,804 and the compound interest on the deferral loan is $891 or a total of $5,695. The additional $99 paid by the annuitant results from the fact that an amount derived from compounding at eight percent and then halved is more than the amount derived from compounding at four percent.

If a period different than 10 years was used, the spread between the annuitant's payment and the deferral loan would be greater if the period was longer and less if the period was shorter, but the annuitant would always pay more to the Government than he would under Mr. Surrey's proposal. If the tax bracket of the taxpayer was greater than 50 percent the spread would also be greater since the interest rate compounding on the deferral loan is a function of the tax bracket and would decrease in proportion to the rise in tax bracket while the interest rate on the deferred annuity would remain constant. Conversely, if the tax bracket of the taxpayer was less than 50 percent, the spread would narrow and eventually the amount paid as the withdrawal of the deferred annuity would be less than that on the deferral loan.

In conclusion, it is evident that:

1. Deferred annuities (including the investment annuity) lack a "prime ingredient of tax shelters" namely, "an interest-free loan from the Government in the amount of the tax deferred;"

2. The existing mode of deferred annuity taxation results in an interest element being charged to the taxpayer as proposed by Mr. Surrey;

3. In fact, under most circumstances the existing mode of annuity taxation provides more tax dollars for the Government than Mr. Surrey's proposals;

4. The existing mode of deferred annuity taxation is similar to the Government's own "Series E" bond (unless an election is made to be taxed currently); and

5. Because of the foregoing it is quite inappropriate to lump deferred annuities (including the investment annuity) in with so-called "tax shelters."

Very truly yours,

EXHIBIT I

W. THOMAS KELLY

COMPUTATION OF INTEREST ON THE "DEFERRAL LOAN" - ACCELERATED DEPRECIATION

Year	Cost of Asset	(1) Depreciation (A) DDB/SL	(2) SL	(3) Excess (1)-(2)	(4) Tax Deferral (3) x .50	Deferral Loan	Interest on Deferred Loan @ 4% (B)
1	$10,000	$ 2,000	$ 1,000	$1,000	$ 500	$500	
2		1,600	1,000	600	300	800	$ 20
3		1,280	1,000	280	140	940	32
4		1,024	1,000	24	12	952	38
5		819	1,000	(181)	(90)	862	38
6		655	1,000	(345)	(173)	689	34
7		655	1,000	(345)	(172)	517	28
8		655	1,000	(345)	(173)	344	21
9		656	1,000	(344)	(172)	172	14
10		656	1,000	(344)	(172)	-	7
		$10,000	$10,000	-	-		$232

(A) A useful life of 10 years and no salvage value was used in computing depreciation.

(B) Interest rate of 8 percent tax-effected at 50 percent.

W. THOMAS KELLY

COMPUTATION OF INTEREST ON THE "DEFERRAL LOAN" OF A DEFERRED ANNUITY

Year		Certificate of Deposit @ 8%	Payment to Government	Deferred Annuity @ 8%	Deferral Loan
1	Principal invested	$10,000		$10,000	
	Interest	800		800	
	Tax (A)	(400)	$ 400	-	$ 400
2	Balance	10,400		10,800	400
	Interest	832		864	16(B)
	Tax	(416)	416	-	416
3	Balance	10,816		11,664	832
	Interest	865		933	33
	Tax	(433)	433	-	433
4	Balance	11,248		12,597	1,298
	Interest	900		1,008	52
	Tax	(450)	450	-	450
5	Balance	11,698		13,605	1,800
	Interest	936		1,088	72
	Tax	(468)	468	-	468
6	Balance	12,166		14,693	2,340
	Interest	973		1,175	94
	Tax	(487)	487	-	487
7	Balance	12,652		15,868	2,921
	Interest	1,012		1,269	117
	Tax	(506)	506	-	506
8	Balance	13,159		17,137	3,544
	Interest	1,053		1,371	142
	Tax	(527)	527	-	527
9	Balance	13,685		18,508	4,213
	Interest	1,095		1,481	168
	Tax	(548)	548	-	548
10	Balance	14,232		19,989	4,929
	Interest	1,139		1,599	197
	Tax	(569)	569	-	569
		$14,802	$4,804	$21,588	$2,695
	Tax ($21,588 - $10,000 x .50)			$ 5,794(C)	

Notes:

(A) All tax computations at 50 percent.

(B) Hypothetical interest to government computed at after-tax rate as per Exhibit I.

(C) Assumes complete withdrawal of funds at end of tenth year.

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Peat, Marwick, Mitchell & Co.
InsuranceNewsletter
published for insurance industry executives

General Matters

S&L Annuities Critically Wounded

Past issues of *Insurance Newsletter* have discussed savings and loan annuities and the favorable private rulings issued by the IRS. The product has been extensively marketed in the Midwest and was on the verge of being offered by S&Ls and banks nationwide.

As you recall, under the typical annuity contract, the S&L is the group annuity contract holder, and the depositors are issued individual annuity certificates. The life insurer invests in and holds legal title to a certificate of deposit (CD) issued by the S&L. The life insurer agrees to pay interest to the annuity certificate holder at the rate which the life insurer earns on the CD, less a service fee.

Revenue Ru[illegible] 80-274 [illegible] September [illegible] comp[illegible] re[illegible] IRS's previous private ruling pos[illegible]. It holds that for Federal income tax purposes, the policyholder and not the life insurer is the owner of the CD issued by the S&L. Based on this conclusion, the revenue ruling states that the policyholder is currently taxable on the interest credited under the annuity contract.

This appears to be another instance where the IRS is attempting to change the law by administrative interpretation instead of by the legislative process. It is our view that Revenue Ruling 80-274 is an erroneous interpretation of the law. We understand that life insurers involved with this product will mount a campaign to reverse the impact of Revenue Ruling 80-274 by legislative or other means.

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Using The Anti- Injunction Act As A Weapon Against The Taxpayer

Without question, some form of anti-injunction act is appropriate in order to protect the government in fulfilling its role in the collection of taxes.

However, as requested in S-1939 introduced in the 95th Congress by Senator Gravel (for himself, Mr.Thurmond, and Mr. Matsunaga), a copy of which is appended hereto, aggrieved taxpayers are not only subject to deadly economic peril, they are placed at enormous disadvantages in securing legal redress against an illegal act of the government.

The Investment Annuity matter is a chamber of horrors example of this gross imbalance of power. Based upon a flimsy theory of taxation that has no basis in law, and that was denounced by the U.S. District Court, the Treasury and the IRS have been able to impose their will on taxpayers with impunity. The government has all the time and the money in the world to impose its will. In comparison, taxpayers have very limited means in both time and money.Thus,it's clear that bureaucrats who know the ropes, and who are so inclined to use them,can easily impose their own tax theories regardless of the law by using the Anti- Injunction Act as a weapon against the taxpayer.

In this particular instance, the IRS' attack was on the more flexible form of the variable annuity.The Treasury,itself, stated that other forms of variable annuity would be removed later.Obviously, once a ruling is issued and in place for a period of time, it becomes the basis or cited precedent for the next attack as for example Revenue Ruling 80-274 is bottomed on Revenue Ruling 77-85.In this nibbling fashion the IRS and Treasury undoubtedly hope to eventually achieve that which they failed to achieve in their 1978 tax proposals to Congress; namely, the destruction of the tax deferral attributes of all annuities, and eventually cash value life insurance.

As soon as the IRS and Treasury revoke a ruling, this puts the burden of proof upon the taxpayer. Because this Anti-Injunction Act is too powerful and because the Court case process is so long, expensive and frustrating (as per the Investment Annuity matter), the Treasury and the IRS can easily proceed with Star Chamber proceedings-- and does.

Congress must address this gross imbalance of power.In this clear display of bare-knuckles, unreasonable,illegal, and ignorant attack on the taxpayer, Congress should immediately pass S-3082 and S-3094 to redress a most serious breach in the integrity and the competence of the IRS and the Treasury.

United States of America

Congressional Record

PROCEEDINGS AND DEBATES OF THE 95th CONGRESS, FIRST SESSION

Vol. 123 WASHINGTON, WEDNESDAY, JULY 27, 1977 No. 128

Senate

Mr. GRAVEL. Mr. President, the legislation which I introduce today is designed to remedy a problem in the administration of our tax laws which has vexed taxpayers for many years. In the time I have spent on the Senate Finance Committee I have seen several examples on Internal Revenue Service administrative action which has caused difficult and unnecessary problems for taxpayers. I am sure that most of my colleagues are aware of the problem of which I speak, having been approached at different times by affected taxpayers. The problem to which this legislation is directed is the periodic revision by the Internal Revenue Service of long-standing interpretations of the tax law.

The Internal Revenue Service issues revenue rulings which interpret our tax laws. These rulings are intended for the guidance of taxpayers and IRS agents in the preparation and auditing of tax returns. These rulings do not have the force or authority of law. But, they do have far-ranging influence on the daily operation of thousands of businesses in our country.

The Internal Revenue Service takes the position that revenue rulings are interpretive only and therefore subject to change at any time. The Service maintains that theoretically a ruling currently in effect reflects the law as it has always been. Of course, the concept of a ruling as correctly reflecting what the law has always been is a fiction since rulings are subject to change. Indeed, rulings are often revised as the Internal Revenue Service reinterprets the law in light of changing business climates and personnel. But, throughout this process, the revenue rulings which are current represent the Service's position as to the meaning of a particular tax law provision.

Now, since the IRS and taxpayers both rely on revenue rulings for the ordering of their affairs, a change in an existing ruling can have drastic consequences. If a taxpayer has built up a business based on existing interpretations of law and then those interpretations are revised, he may find himself suddenly out of business. Such an event has occurred recently and many of my colleagues have been approached by the affected taxpayers in the investment annuity industry. Now, I do not wish to speak here to the substance of the claim made by the investment annuity industry, but I would like to tell you something about how that industry came to seek congressional redress during the recent consideration of the Tax Reduction and Simplification Act of 1977.

In 1963 a new life insurance company was formed solely to offer investment annuities, a type of variable annuity. The company requested the IRS to rule whether the element of policyholder control of investments would cause investment income to be taxed to the policyholder or to the insurer. The company took the position that it should be taxed to the policyholder. The Service ruled that there was not sufficient investor control to require the income to be taxed to the investor and therefore the income would be taxed to the company. The decision was based on section 801(g) of the Internal Revenue Code.

The Service issued its original ruling in this area in 1965. Again in 1968 it published a ruling reaffirming the position established in 1965. The Service knew full well that investors and businessmen were basing daily decisions on these revenue rulings.

In reliance upon these rulings a significant new industry developed, the investment annuity industry. The investment annuity established itself in the market as a desirable investment on the part of many Americans. One company specializing in such annuities had over $300 million in assets under its policies. On March 9, 1977 disaster struck. The Internal Revenue Service reversed itself on investment annuities. In revenue ruling 77-85 the IRS took the position that the income from the investment annuity was taxable to the policyholder rather than to the company.

This position is just the reverse of its original holding of 11 years standing. It is a position which the Service rejected in 1965 when it issued its original ruling. Neither the facts nor the law had changed in the interim—the IRS had simply changed its bureaucratic mind.

The issuance of revenue ruling 77-85 completely and immediately stopped the sale of investment annuities. Agents were laid off, salesmen terminated, policyholders were left with investments of questionable value, and at least one company was faced with bankruptcy. The

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affected company sought to ameliorate the IRS decision first through conversations with the Service and then through action in Congress. We here in the Senate acted to give some relief to this beleaguered industry. We adopted an amendment to the Tax Reduction and Simplification Act of 1977 allowing a delay in the effective date of the ruling, but this amendment was dropped in conference. The investment annuities industry was left with no effective recourse in its disagreement with the Internal Revenue Service.

Why, you might ask, did the industry not take the IRS to court over this revenue ruling? It certainly could and I understand has now done so, but this does not solve the problem for the industry. Under the law as it now stands, even if the industry challenges the ruling it remains in effect until a court decision holds it to be invalid. It might take years for the affected taxpayer to receive redress through tax court proceedings. In the meantime the revenue ruling stands to prevent operation of the taxpayer's business. This is because an injunction against the IRS is specifically prohibited by a Federal statute, the Anti-Injunction Act.

Now, Mr. President, I am not here to champion the investment annuity industry or any other special interest. The investment annuity industry is not the only industry which has been adversely affected by a reversal of an Internal Revenue Service ruling. I was personally involved in the legislative solution to another revenue ruling reversal which affected the operators of private water companies. Some public utilities obtain a substantial portion of their capital needs through contributions in aid of construction from taxable income. Then in 1975 the IRS revoked the 1958 ruling in revenue ruling 75-557. The change in the IRS ruling increased substantially the taxes of those utilities which had treated contributions in aid of construction as nontaxable contributions to capital. These utilities had their taxes substantially increased by IRS reinterpretation of the law. But because they operated as regulated utilities, they would not be able to pass the cost of this increased tax through to their customers in a timely fashion. Since the utilities, like the investment annuities industry, could not obtain an injunction against the issuance of this new ruling, its only recourse was through the courts or the Congress. Unlike the investment annuities industry, the utilities were fortunate Congress responded to their plight and passed remedial legislation as part of the Tax Reform Act of 1976.

The two examples I have cited here are not unique. The IRS constantly reviews revenue rulings and revises or reissues them. But, rulings of long standing are relied on by taxpayers and the Service alike, and by virtue of their age take on the color of law.

Mr. President, relief through the courts from an incorrect revenue ruling reversal is a time consuming and costly process. During the entire appeals process the challenged ruling remains in effect by virtue of the antiinjunction statutes. If the ruling reversal is a real threat to the taxpayer's business or investment, that business or investment may well have disappeared before legal redress is obtained. Victory for the taxpayer in court, if victory comes, may be a hollow and bitter experience when it comes too late to save his investment.

The legislative process provides limited redress to taxpayers. Indeed, the utilities industry found solace within the Congress and a solution to its problem. But, that is rare. If the ruling reversal affects only a small group, or a group without the financial resources necessary to wage a major legislative campaign, Congress may well turn a deaf ear to the taxpayer's problem. The bill I propose today, Mr. President, will provide taxpayers with redress through the courts while at the same time allowing him to continue in the pattern established by the Internal Revenue Service in earlier rulings until the courts have determined that the IRS reversal of position was well founded in law.

Mr. President, I would like to summarize this legislation for the Senate. The bill creates a new section of the Internal Revenue Code, section 7478. The section provides that in the case of an actual controversy involving a ruling by the IRS in which the IRS has reversed a published ruling of 5 years' standing or more, an affected taxpayer may file a suit for declaratory judgment with the Tax Court to determine whether the ruling is consistent with the Internal Revenue laws to which the ruling relates. I would emphasize, Mr. President, that this law only applies to reversals of rulings which have been IRS policy for 5 years or more. The bill also provides that when the IRS issues a ruling reversing, repealing, or revising a ruling of 5 years' standing or more, the new ruling may not be effective retroactively and may not become effective until 90 days from the day of publication. During the 90-day period any taxpayer directly affected may file a suit with the Tax Court. Filing suit in the Tax Court suspends the effective date of the ruling beyond the 90 days until a determination is made by the Tax Court and any appeal of that decision is final.

Some will argue that delaying the effective date of the challenged ruling will allow taxpayers affected by the ruling to operate under a fire sale approach, filing suit only to give themselves a few more months to market a tax shelter or avoid a tax. Mr. President, if that is necessary for justice to be done under our tax laws, so be it. However, I would point out that this legislation does not apply

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by the issuance of new rulings by the IRS. It does not apply to situations where the IRS has not had the opportunity to act. Mr. President, this right of appeal with the delay of the effective date only applies where the Service, having acted in the past and established the precedent under which the taxpayer operates, then reverses its position for whatever reason. In the situation where the IRS reverses a long held position I think it only fair that the burden of proof regarding the correctness of its new position be carried by the Service before such a new position becomes effective.

And so, Mr. President, in conclusion I would like to say that I hope my colleagues here in the Senate will adopt this much needed correction in the balance between the power of the Government and the protection of our people. This bill will do a small part in helping to restore the faith of the American people in our system of raising revenues. It will, in its own small way, reconfirm that there is justice in America.

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THE INSURER'S DELEGATION OF LIMITED INVESTMENT SELECTION TO THE POLICYOWNER: IT MAKES NO DIFFERENCE "TAXWISE"

The categories of the actual investments made by all FIAC policyowners are reflected in Table 1. FIAC, the innovative insurer that delegated limited investment selection to the policyowner, was killed by the IRS' illegal Revenue Ruling 77-85. This designation by the insurer is limited in as much as all variable annuities must conform to state law limitations upon acceptable investments. Several pertinent observations may be made:

1. From the insurer's perspective, the magnitude and types of investments reflected in Table 1 are not unlike a "balanced" variable annuity "segregated account" portfolio. (ie a combination of equities and fixed income investments.) The only difference is that FIAC had an investment committee made up of all "policyowners" whereas other insurers would have a two or three person investment committee, or would have farmed out the investment management task to some investment advisor.

2. By far the largest category of actual investments is "mutual funds". Obviously, when a policyowner selects a mutual fund the net result is a so-called "mutual fund wrap-around annuity" in today's parlance. "Wrap-around annuities started and remain today, as nothing more than so called Investment Annuities but with a more limited number of mutual funds to choose from. And yet, the <u>identical</u> so-called Investment Annuity was killed by the <u>IRS.</u> The net result is an absurdity with tax policy being established and practiced according to mere "nomenclature", not substance.

3. The policyowner's choice of a <u>mutual fund</u> investment within an insurer's segregated asset <u>account</u> is just as much an investment choice as the selection of a stock, bond, savings account or certificate of deposit. The same holds true for divesting such an investment. Surely, the selection of an "open-end" fund is no different in substance "taxwise" than the selection of a "closed-end" fund, a stock. Why should any line be drawn for "tax purposes" as to what an acceptable variable annuity investment should be, and what is not. Obviously, there is no need nor sound rationale "taxwise" to draw any such line.

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4. Section-1035 of the Internal Revenue Code properly permits one annuity to be exchanged for another annuity without it being a "taxable" event. It's imperative to understand just what this means. Any annuity contract can be exchanged without involving a taxable event, for any other annuity contract offered by any insurer regardless of how different their investment objectives might be. In reality this provides an infinite variety of investment choices, and properly so. Thus again, there is no need nor sound rationale "taxwise" to limit the policyowner's choice of authorized investments within a segregated account.

5, "Qualified" thrift and profit sharing plans permit a trust (the owner of the assets) to delegate the full investment management of the participants own account to the participant. This does not create "constructive taxable income" for the plan participant. Similarly, there should be no "constructive taxable income" under annuities where the mere right of investment direction is delegated to the policyowner. The IRS insisted this was so in this matter until 1976, sound taxation precepts support this position as does the U.S. District Court. Only the current decision makers at the IRS and Treasury are out of step with the law; except that they impose their weird brand by bureaucratic fiat.

6. As reflected in Table 2, all variable annuities, including the so-called Investment Annuity, involve excessive taxation applicable to long term capital gain. No legislator, nor any other person, should believe that such annuities have tax advantages related to long term capital gain. Any perception that a policyowner's right to choose and change the investments within the insurer's segregated asset account somehow avoids or defers the tax on such capital gains is totally erroneous. See Table 2 that demonstrates that long term gain is taxed twice and excessively. The one and only favorable tax feature of all annuities (both "fixed dollar" and "variable" types) is the tax deferral of interest and dividend income that accrues to the benefit of the policyowner. There's nothing new about this; it's true of all annuities and of cash value life insurance for entirely proper reasons that are reflected in existing law.

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The annuities singled out by Revenue Ruling 77-85 and 80-274 are sound, proper annuities in every sense of those words. They are definitely in the public interest. There is nothing in the law that precludes them, and relevant law clearly covers them. The simple, entirely proper and badly needed correction of this gross abuse of regulatory agency power is to restore the IRS' own proper rulings as they existed prior to the IRS' issuance of Revenue Ruling 77-85 and 80-274. Senate Bills S-3082 and S-3094 do exactly this. Anything less than such action is a sanctioning by Congress of a Court adjudged-and clear for everyone to see- usurpation of Congress' power by the Treasury and the IRS.

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TABLE 1

March 20, 1978

INVESTMENT PORTFOLIO TAXATION
OF
FIRST INVESTMENT ANNUITY COMPANY (FIAC)
VARIABLE ANNUITY SEGREGATED ACCOUNTS

Type of Investment	12/31/76 Market Value
Cash	$ 4,968,288.55
Stocks	66,871,542.02
Bonds	51,719,405.26
Mutual Funds	128,526,716.20
Savings Accounts	12,938,747.93
Certificates of Deposit	44,783,685.85
	$ 309,808,385.81

1. The above values are spread over approximately 40,000 investments. These investments are of the type any insurer can utilize in its legally required "segregated accounts" to underwrite variable annuities. IRC 801(g) allows insurers to establish any number of Segregated Accounts. Such accounts often include mutual funds.

2. All realized gains are taxed in exactly the same way at the same tax rate under any variable annuity separate accounts, including the Investment Annuity. Thus, if AT&T stock is sold for a $1,000 long-term gain, the insurer must pay a 30% tax* to Uncle Sam. It makes no difference whether the insurer's own investment staff made the decision to "sell" AT&T, or whether the insurer had delegated investment responsibility to everyone else; e.g. an outside investment manager like Lehman Brothers, or even to the policyowner. The tax results are the same regardless as to who made the investment decisions; they should be because the insurer always owns the assets; and Uncle Sam always collects the same tax dollars.

   And, as shown in the accompanying example "realized gain" is taxed twice to the detriment of the policyowner. Surely, such taxation can't be called a "tax shelter" when in fact its "excessive taxation".

3. Investment income (NOT realized gain) is the only element of any annuity that is tax deferred; not avoided, nor tax free. Such tax deferral is entirely legal, practical, soundly based in historic legal precedents and is in the public interest.

4. The only thing that FIAC's form of variable annuity does is to make such investment shifts more feasible economically (i.e. less expensive administratively to do so), and more responsive to the individual's needs and desires as these may change over the many decades that annuity policies remain in force.

   Why must the policyowners be "locked-in" to the investment management of the insurer over the many decades an annuity policy can remain in force? Clearly the law doesn't require this "lock-in", nor should such a "lock-in" be required. The government should encourage, and not kill, this highly desirable consumerist form of variable annuity, labeled the Investment Annuity.

NO ANNUITY IS A "TAX-SHELTER"-EVER

*Currently the insurer's tax is slightly lower. The principle of taxation is the same.

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TABLE 4

COMPARISON OF INDIVIDUAL'S NET-AFTER-TAX BALANCE

ARISING FROM REALIZED LONG TERM CAPITAL GAIN

******

COMMON STOCK HELD BY INSURER IN VARIABLE ANNUITY SEPARATE ACCOUNT*

vs.

COMMON STOCK HELD INDIVIDUALLY

		Insurer Owned Stock In Variable Annuity Separate Account*	Individually Owned Stock
	1. Assumed Long Term Capital Gain Upon Sale of Common Stock	$ 1,000	$1,000
**	2. Capital Gains Tax Imposed	300	160
	3. Net After Tax Balance (1 - 2)	$ 700	$ 840
**	4. Ordinary Income Tax Imposed On Balance in (3) when Paid As Cash Value or Benefits To Annuitant	224	Not Applicable
	5. Individual's Net-After-Tax-Balance	$ 476	$ 840

6. Added tax arising from all Variable Annuity taxation, including Investment Annuities: $840 less $476 = $364 or 76% more tax.

NOTES

* All variable annuity accounts (including Investment Annuity accounts) are taxed identically.

** Tax Rate Assumptions: Individual's Tax Bracket - 32%. Insurer's Taxes - ~~48% short term gain;~~ 30% long term.*

Realized capital gain is taxed twice under all variable annuities including Investment Annuities. Obviously individuals in higher tax brackets would receive even less after-tax benefit from realized capital gains.

CLEARLY, THIS COMPARISON SHOWS THAT VARIABLE ANNUITY OWNERS, INCLUDING INVESTMENT ANNUITY OWNERS, ARE TAXED TWICE ON REALIZED CAPITAL GAIN.

ANNUITIES HAVE NO RELEVANCE WHATSOEVER TO SO-CALLED "TAX-SHELTERS".

WTK 3/16/78 *Currently the insurer's tax is slightly lower. The principle of taxation is the same.

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Senator BYRD. Thank you, Mr. Kelly.

You mentioned, during the course of your remarks, tax expenditures. I am hopeful that as a result of this last election, we will be hearing less and less around here about tax expenditures.

Mr. KELLY. I certainly welcome that comment, Senator.

Senator BYRD. It seems to me to be totally ridiculous to say that a person who pays interest on a mortgage to buy a home that it is a tax expenditure of the Federal Government, because he or she is permitted to deduct that as an expense on the income taxes.

A person gives money to his church, or to a charity, and there are people around Capitol Hill and in the Treasury Department who say that it is a tax expenditure. What they are saying, in effect, is that whatever anyone earns belongs to the Federal Government.

Mr. KELLY. You are absolutely right, Senator. I applaud your comment.

Senator BYRD. My way of thinking is that it belongs to the individual, except the Federal Government has the right to take what is essential and necessary to operate the essential functions of Government.

I believe that that so-called tax expenditure philosophy, as a result of this past election, will not be as prevalent in these halls as it has been in the past, at least I hope so.

Mr. KELLY. Sir, I would agree totally, but I must say that because of those tax expenditure theories, a very, very innovative form of industry has been wiped off the face of this earth. I would believe that it should be Congress's opportunity, and I would certainly hope that they would do so, to quickly reestablish the rules and the regulations as they existed before this illegal act by the IRS and the Treasury.

Senator BYRD. Thank you, Mr. Kelly.

Next there will be a panel consisting of Gary Corbett, Senior Vice President of SAFECO Corporation; Alexandra Armstrong, International Association of Financial Planners; Robert R. Barrow, President, International General Insurance Corporation; Forrest Burt, President-Elect, Texas Association of College Teachers; and Judith A. Hazenauer, attorney-at-law in Westport, Connecticut.

Ladies and gentlemen, welcome. You may proceed as you wish.

STATEMENT OF GARY CORBETT, SENIOR VICE PRESIDENT, SAFECO CORP.

Mr. CORBETT. Mr. chairman, my name is Gary Corbett, senior vice president of SAFECO Corp., responsible for the corporation's life and health insurance companies.

Senator BYRD. Each of you has 5 minutes. If you wish to make it less than 5 minutes, it will be satisfactory.

Mr. CORBETT. I have submitted some written remarks which I request be included in the record of the hearing.

Senator BYRD. Without objection, so ordered.

Mr. CORBETT. I would like to make some brief additional remarks, addressed primarily to the written presentation of Secretary Halperin.

First of all, Secretary Halperin's testimony is addressed to the entire subject of deferred annuities. It is an attack on the contin-

ued taxation of deferred annuities as annuities under section 72 of the Internal Revenue Code.

It certainly is true that the Treasury does oppose deferred annuities and has been trying for a number of years to get the law changed so as not to permit deferred annuities to be taxed as annuities. But they have been unsuccessful.

In this regard, Secretary Halperin's statement on page 3 of his testimony is a non-sequitur. He says: "Absent legislation, however, the rules governing annuities remain in effect, and neither revenue ruling 77-85 nor subsequent developments suggest that the rules can be altered by administrative action." But revenue ruling 77-85—and subsequently 80-274—did, in fact, administratively alter the rules governing the taxation of annuities.

Secretary Halperin's testimony concerns itself only with deferred and not with immediate annuities. The investment annuity had two forms. It was not only an investment annuity in the accumulation period, when it is a deferred annuity, but it was also an investment annuity when immediate annuity benefits were being paid during the payout period.

I have never heard the Treasury question that immediate annuities are, indeed, annuities. Without question section 72 was intended to apply to immediate annuities. With revenue ruling 77-85 the Service effectively threw the baby out with the bathwater.

Secretary Halperin discusses the investments underlying an investment annuity by claiming that the company acts only as a conduit. Life insurance companies always act as conduits. They do not take the money that people pay them for life insurance policies or annuities and use this money for their own operations. They always invest these funds in some outside investment—mortgages, corporate bonds, government bonds, et cetera. In other words all life insurance companies are investment conduits.

I take particular exception to Secretary Halperin's statement on the top of page 4: "In substance, the life insurance company was offering the investor nothing more than a piece of paper that said the purchaser had purchased an annuity."

I ask Secretary Halperin whether if mortality rates decline significantly, as they might in the 21st century, we can then go to the Service or a court and say:

> This is only a piece of paper, and we should not be required to pay these benefits that are far in excess of what we have taken in as premiums, because mortality has declined to a much greater extent than what we thought it would?

We do give mortality guarantees in an investment annuity or in any other deferred annuity. These guarantees could result in insurance companies experiencing substantial losses, with a concomitant gain to policyholders, if there are significant decreases in mortality in the future.

The last point I would like to make is with regard to State regulation. Life insurance and annuities have been, and are, governed by State laws. Investment annuities are clearly annuities under State laws. They are taxed as annuities for premium taxes. Annuity reserves based on life contingencies, must be established. Such reserve requirements could result in our companies being required to put up substantially greater funds than we have ever earned if, as is very possible, mortality rates decline significantly.

For all of these reasons, I suggest that investment annuities are clearly annuities. Annuities can be defined only with respect to their benefit structures, and not with respect to how the underlying assets are invested.

Thank you, Mr. Chairman. I would be willing to answer any questions.

[Prepared statement of Gary Corbett follows:]

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To: Senate Finance Subcommittee on Taxation
Subject: S. 3082 and S. 3094
Date: November 19, 1980
Presenter: Gary Corbett

Summary of Position

I am Gary Corbett, Senior Vice President of SAFECO Corporation, and an actuary. The position I support in my written presentation is that an Investment Annuity is identical in all material respects to other forms of Variable Annuities. The substantial mortality risk assumed by the insurance company that issues a Variable Annuity is similar to that which arises from issuing other forms of annuities.

In Revenue Rulings 77-85 and 80-274, the Internal Revenue Service has attempted to distinguish what is and what is not an annuity entirely on the basis of how the consideration is invested by the insurer. In neither ruling was the question of the benefits provided by a policy even mentioned. Prior to these rulings, I know of no body of opinion, legal, congressional or other, that looked beyond whether a policy provided annuity benefits in order to determine whether the policy was indeed an annuity.

I suggest that any legal definition of an annuity, whether for taxation or other purposes, must logically direct itself to the benefits provided and not to how the consideration paid by the policyholder is invested.

SAFECO INSURANCE COMPANY OF AMERICA
SAFECO LIFE INSURANCE COMPANY
GENERAL INSURANCE COMPANY OF AMERICA
FIRST NATIONAL INSURANCE COMPANY OF AMERICA
SAFECO NATIONAL INSURANCE COMPANY
SAFECO CREDIT COMPANY INC

SAFECOM INC
SAFECO SECURITIES INC
WINMAR COMPANY INC
SAFECARE COMPANY INC
SAFECO TITLE INSURANCE COMPANY

To: Senate Finance Subcommittee on Taxation
Subject: S. 3082 and S. 3094
Date: November 19, 1980
Presenter: Gary Corbett

Statement of Position

I am Gary Corbett, Senior Vice President of SAFECO Corporation responsible for all life and health insurance lines. Our life insurance subsidiary, SAFECO Life, did market an Investment Annuity prior to the issuance of Revenue Ruling 77-85 and we have an interest in selling this annuity again. However, I am testifying today primarily as an actuary (I am a Fellow of the Society of Actuaries and a Member of the American Academy of Actuaries). My position is that an Investment Annuity has all the attributes of an annuity, as that term is commonly understood by Congress, the public and the courts, and therefore should be taxed like all other annuities.

The provisions of an annuity contract obligate the insurer, in return for a consideration paid by a policyholder, to make periodic payments, generally for the lifetime of such policyholder. The insurance company clearly takes the risk that annuitants will not die in accord with actuarial projections. If the annuitants live longer than the company predicted the company will suffer a loss and if they die sooner the company will experience a gain.

This risk is immediate when the annuity is in the pay-out period (an Immediate Annuity) but is also present prior to the pay-out period (a Deferred Annuity). In the case of the Deferred Annuity the insurer guarantees the rates it will employ to calculate annuity benefits in the pay-out period. The insurer's actuaries have generally projected future decreases in mortality rates in establishing such guarantees but such projections are the product of informed guesses as to the probability of cures being developed for diseases, such as cancer, that cause annuitants to die before they have completed a normal life span of 80-90 years. Of possibly greater consequence is the possible extension in the normal life span to 110 or even 150 years. One way such an extension could occur is by the isolation and blocking of an "aging" hormone. What was science fiction 10 years ago is much less so today with the research going on today in DNA and related fields. If, for any reason, future annuitants live longer than we have projected in calculating rates, insurers will experience substantial losses on annuity policies. State insurance departments, who have the responsibility of assuring the solvency of insurance companies, would undoubtedly require the companies to transfer surplus to annuity reserves, whether or not the policies were in the pay-out period. There is no question that the mortality risk a company assumes upon the issuance of an annuity is substantial.

This mortality risk is present in the Investment Annuity to exactly the same degree as it is in other Variable Annuities or in Fixed-Dollar Annuities. Also, the risk that future

expenses might be greater than what the company estimates is borne entirely by the company for all types of annuities. Fixed-Dollar Annuities, Investment Annuities and other Variable Annuities are thus not distinguishable by degree of mortality risk but only by reference to how the consideration for the policy is invested and who bears the investment risk. The company bears the entire investment risk on Fixed-Dollar Annuities. The annuitant retains some elements of control over how the consideration is invested for Investment Annuities and for some other Variable Annuities.

For all types of annuities the consideration must be invested only in securities approved by the State Insurance Departments for that type of annuity. In no case does the insurer retain the funds for its own use. The only difference is that with Variable Annuities, including Investment Annuities, the amount of investment income to be passed through to the policyholder is not set at the time of issue, as is the case with Fixed-Dollar Annuities, but is rather determined by the amount of income actually earned on the invested funds.

From the points of view of benefits to the policyholder and risk to the insurer, the Investment Annuity can not be distinguished from other Variable Annuities. The only distinguishing feature of an Investment Annuity is that under such an annuity the policyholder selects from a list of eligible investments and generally may direct a change

to some other eligible investment at some time in the future. By the way, there are a number of other Variable Annuities still being issued which provide substantially the same discretion to the policyholder and which are still taxed as annuities by the Internal Revenue Service. Today we have the anomalous, and certainly inequitable, situation that even Investment Annuities with a very restricted asset list are denied annuity tax treatment while other Variable Annuities, where the policyholder retains a wider choice of investment vehicles, do continue to receive this treatment.

In Revenue Rulings 77-85 and 80-274 the Internal Revenue Service has attempted to distinguish what is and what is not an annuity entirely on the basis of how the consideration is invested by the insurer. In neither ruling was the question of the benefits provided by a policy even mentioned. Prior to these rulings I know of no body of opinion, legal, congressional or other, that looked beyond whether a policy provided annuity benefits in determining whether the policy was indeed an annuity.

In conclusion, I would like to suggest that any legal definition of an annuity, whether for taxation or other purposes, must logically direct itself to the benefits provided and not to how the consideration paid by the policyholder is invested.

Senator BYRD. Thank you, sir.

The next witness.

STATEMENT OF ALEXANDRA ARMSTRONG, INTERNATIONAL ASSOCIATION OF FINANCIAL PLANNERS

Ms. ARMSTRONG. My name is Alexandra Armstrong. I am a newly elected director of the International Association of Financial Planners. I am reading the statement that they prepared in Atlanta this weekend on this issue.

The International Association of Financial Planners is a nonprofit organization which represents 6,800 members, and is the leading association of planners and counselors who advise clients on a broad range of financial matters.

We feel the Senate subcommittee should not consider this proposed legislation in a narrow sense, as it affects one financial product or tax-policy issue. We feel we should look at the overriding issue as it is perceived by the financial service consumer and taxpayer.

We feel that the investor currently is confused by the multitude of products available, and we feel the confusion is increasing with the new legislation. Investors need clear direction and consistency in tax policy.

We feel that the investor should have incentives to provide for their own retirement with dignity. We feel that this is one of the best investment vehicles available today to private individuals, and we should have that opportunity through these annuities.

We feel that we should not discourage creative new products and innovation which is in the consumer's best interest. Give the financial services industry a chance to research and develop creative new solutions to financial problems.

Thank you.

[Prepared statement of Alexandra Armstrong follows:]

SUMMARY OF REMARKS MADE BY ALEXANDRA ARMSTRONG TO THE SENATE SUBCOMMITTEE

I am speaking for the International Association of Financial Planners, a non-profit organization which represents 6,800 members, and is the leading association of planners and counselors who advise clients on a broad range of financial matters. The Senate subcommittee should not consider this proposed legislation in a narrow sense, as it affects one financial product or tax-policy issue. It should look at the overriding issue as it is perceived by the financial service consumer and taxpayer.

1. Don't add to the confusion surrounding the rapidly changing economy and financial markets. Investors need clear direction and consistency in tax policy.

2. Give investors incentive to provide for their own retirement with dignity. Don't take away one of the best investment vehicles private individuals now have for determining their own standard of living during retirement years.

3. Don't discourage creative new products and innovation which is in the consumer's best interest. Give the financial services industry a chance to research and develop creative new solutions to financial problems.

My name is Alexandra Armstrong and I have been asked by the Board of Directors of the International Association of Financial Planners, Inc. to make the following statement. The International Association of Financial Planners is a non-profit organization which represents 6,800 members nationwide. It is the leading association of financial planners and counselors who advise clients on a broad range of matters relating to investments, insurance, budgeting, tax planning and estate planning and who in many instances are able to satisfy the client's need by selling an appropriate investment product. Some of our members are insurance agents, stock brokers or real estate brokers. Others work in the traditional professions of law and accounting. All of them believe that the client is best served if the adviser does not have vested interest in one particular product or service, or a preconceived notion of what investment philosophy works best for a client. Rather, it is the financial planning professional's role to interview the client, record important data about assets, goals and investment temperament, and help the client devise an overall plan or strategy. Only then do we believe it is appropriate to recommend specific products or services which will implement this plan.

To promote this philosophy, the IAFP sponsors regular monthly meetings in its more than 50 active chapters, and an annual convention which is regarded as the largest event of its kind in the financial services industry.

The members of the IAFP are governed by a Code of Ethics and Standards of Professional Conduct. IAFP publishes a monthly magazine, The Financial Planner, and educational newsletters. It offers a Professional Development training program through which financial planners can improve and update their knowledge.

Finally, it works to educate the public and the public's representatives in Congress upon the importance of private savings, investment, and financial planning.

Rather than speaking directly in favor of the proposed legislation, as other speakers may, the IAFP would like to speak in raising some questions which our membership feels have overriding importance. Far too often, we as financial planners believe that policymakers focus upon specific financial products or tax issues, rather than look at the situation through the eyes of the person who counts the most — the consumer and taxpayer.

Our business is to know these people and their financial needs intimately. We are only as good as our knowledge of our clients. Therefore, we want to paint a picture of this particular issue as it is seen through the eyes of our clients — and your constituents— and leave you with a policy-making challenge. You can then determine for yourselves whether the consumer's and the taxpayer's interest is served by this proposed legislation.

First, our clients look at both the economy and the financial marketplace and all they see is confusion. They read and hear contradictory advice. They do not know what to make of wildly gyrating interest rates and market prices. They would like to have faith in the future of the American economy and its financial markets, but they no longer can totally ignore the cries of the doom-and-gloom forecasters. They turn to us for help in sorting out this confusion, and we in turn look to you for clear direction in tax policy. Give us clear direction. Many of our clients depend, in part, upon our annuity recommendations for their personal endeavors to achieve adequate financial resources.

Don't tell our clients that one annuity is perfectly fine, at least temporarily, while another annuity which appears to have the same structure and characteristics is not to be granted the same tax treatment. Don't tell us that all the reading we have done on tax law and updates, and all the seminars we have attended, are suddenly made obsolete because the Internal Revenue Service has arbitrarily reversed a long series of its own rulings. You might as well tell a doctor that a patient's heart is no longer located on the left side of his chest. We are professionals, and we depend upon consistency in tax law and rulings.

Secondly, while our clients do listen to our recommendations, they often hesitate to take a risk of putting their money to work as productive capital in the American economy, since the real return they will receive after paying income taxes is not worth the risk. Our clients want to know that they can preserve their chance for retirement with dignity and give their dollars a chance to compete against inflation. But they need incentive -- the same kinds of incentives which other industrialized nations have already given to private investment capital. We recommend annuity products for our clients, when appropriate, because they are one of the important products on the market where incentives exist and where the individual has a chance to determine the amount of his contribution and eventually his retirement standard of living. Our clients are aware that Social Security is not intended to serve as more than a supplement to their personal responsibilities to provide for retirement. They, as well as many Americans, are worried about the solvency of the Social Security system, and are anxious to see how Congress will put that system back on a sound footing.

In the meantime, please reestablish one of the few investment vehicles they had available to provide for their own retirement security.

Finally, we believe that the investment needs of the average person are best served where a financial adviser has available a broad variety of possible solutions from which to choose. It is our experience that some people shy away from certain recommendations which are logical and sound, but which simply do not "feel" right to them. In these cases, it is our role as professionals to have alternatives available which may accomplish the same objectives and allow the client to sleep well at night. To continue to practice in this way, we need a diverse, creative, multi-product financial services industry.

We believe the financial services industry is on the threshold of a great boom in research and development, and new product engineering -- similar to what the automobile industry went through in its infancy. According to SRI International, a prestigious research organization, there has been a substantial increase in the amount the average American now spends on financial services. However, to make the commitment to research and development and better consumer service, the financial services industry needs an environment which encourages innovation in the consumer's best interest. It needs a consciousness which allows that many of the best new ideas in financial services are being developed not only in well known corporations but also at the grass-roots level by financial inventors like W. Thomas Kelly, founder of the investment annuity. Don't allow the best new ideas in financial services to be regulated to death without due process. Give us a chance to give our clients alternatives.

Thank you for the opportunity to speak here today.

Senator BYRD. Thank you.

Ms. ARMSTRONG. I have three pages of testimony, but this was a summation of the major points.

Senator BYRD. Thank you very much, and your entire statement will be published in the record.

Ms. ARMSTRONG. Thank you, Senator.

Senator BYRD. The next witness.

STATEMENT OF ROBERT R. BARROW, PRESIDENT, INTERNATIONAL GENERAL INSURANCE CORP.

Mr. BARROW. My name is Robert R. Barrow. I am president of International General Insurance Corp.

Our company issues annuities with the premiums being deposited in certificates of deposit of banks and savings and loan associations. We guarantee a minimum interest accumulation on the premium plus an additional accumulation based on earnings of the deposit in excess of the guarantee.

We received letter rulings in August 1977, December 1979, and January 1980, which accorded our contracts annuity tax treatment. The Internal Revenue Service had obviously concluded that revenue ruling 77-85, which it had issued earlier in March 1977, had no bearing on our contracts.

Then suddenly, without notice, on September 24, 1980, the Service, relying on revenue ruling 77-85, issued revenue ruling 80-274. Thereafter, we were advised that because of Revenue Ruling 80-274, the letter rulings we had received were revoked retroactively to the date of their issuance.

I would like to enter a copy of revenue ruling 80-274 for the record, if I might.

Senator BYRD. Without objection, it will be included in the record.

[Document furnished as follows:]

equal to the cash ... beneficiary, however, may instead elect to receive either an annuity for a term certain or a lifetime annuity, subject to a guaranteed minimum number of monthly installments.

p 3

ROBERT BARRON

LAW AND ANALYSIS

Section 61(a) of the Internal Revenue Code provides that gross income means all income from whatever source derived, including interest.

To the extent that a policyholder under an annuity contract with a life insurance company possesses substantial incidents of ownership in an account established by the insurance company at the direction of the policyholder, the policyholder may be considered the owner of the account for federal income tax purposes. See Rev. Rul. 77-85, 1977-1, C.B. 12.

Under the annuity contract, the policyholder's position is substantially identical to what the policyholder's position would have been had the investment been directly maintained or established with the savings and loan association. Prior to the annuity starting date, L is little more than a conduit between the policyholder and the savings and loan association.

HOLDING

Prior to the annuity starting date, the policyholder, and not L, is the owner of the savings and loan account for federal income tax purposes and the interest on the account is thus includible in the policyholder's gross income under section 61(a) of the Code.

p 1

News Release

Department of the Treasury
Internal Revenue Service
Public Affairs Division
Washington, DC 20224

Media Contact: Tel. (202) 566-4054
Copies: Tel. (202) 566-4054

For Release 9-26-80

IR-80-97

Washington, D.C.--The Internal Revenue Service today announced that life insurance companies will not be considered the owner of certain savings and loan association accounts held in connection with so-called "wrap-around annuity" contracts sold to depositors. The interest on these accounts is therefore includible in the gross income of the depositors.

This announcement is contained in Revenue Ruling 80-274, which is attached and will also appear in Internal Revenue Bulletin No. 1980-42, dated Oct. 20, 1980.

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Part I

Section 61. -- Gross Income Defined

26 CFR 1.61-1: Gross Income.
(Also Section 72; 1.72-1.)

Rev. Rul. 80-274

ISSUE

Is the life insurance company or the depositor the owner for federal income tax purposes of the savings and loan accounts established in accordance with the annuity plans described below?

FACTS

L, a life insurance company taxable under section 802 of the Internal Revenue Code, has developed so-called group single premium retirement annuity contracts ("annuity plans") that have been approved in several states by their respective regulatory departments. The terms "annuity" and "policyholder" as used in this revenue ruling are for descriptive convenience only and are not intended to have any substantive legal significance.

L has entered into agreements with participating federally-insured savings and loan associations. Under each agreement, the participating association is designated as the group contract-holder under an annuity plan. L sells annuity contracts under the plan to existing depositors of the participating association a. others wishing to establish accounts with the association ("depositors").

Under a plan, a depositor transfers cash, an existing passbook savings and loan account, or certificate of deposit to L in exchange for an annuity contract. The amount paid by the depositor to L is reduced by L from 2 to 5 percent for sales expenses, administrative expenses, and any premium tax imposed on L. This reduced amount is segregated by L and deposited into a separate account of the savings and loan association of the depositor. The amounts deposited are invested in a certificate of deposit for a term designated by the depositor. When the certificate of deposit expires, L is required under the contract to reinvest the proceeds in a certificate of deposit for the same duration unless an investment of the same duration would extend beyond the annuity starting date. In that event, a certificate of deposit with a maturity not extending beyond the annuity starting date will be purchased. If no such certificate of deposit is available, the funds will be invested in a passbook savings account.

At the option of the depositor (referred to in the contract as the "policyholder") additional amounts may be transferred to L that become part of the consideration for

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the contract.

Pursuant to the agreement between L and the participating savings and loan association, L may not dispose of the deposit, or convert it into a different asset, other than in accordance with the reinvestment provisions described above. L may not use the deposit for any purpose other than to benefit the particular policyholder. This arrangement is intended to afford each policyholder's deposit the maximum federal insurance coverage of $100,000 per account under federal regulations.

L does, however, retain the right to withdraw the deposits from a failing savings and loan association or from an association that terminates the plan. In the event of withdrawal, L must deposit the withdrawn amounts in another federally-insured savings and loan association.

Interest earned on the investments is credited annually to each annuity account by L after payment to L of an annual management fee of one percent of the accumulated value of the account. L guarantees that the deposit will earn interest at 4 percent per year compounded annually from the date of deposit. The current yields for certificates of deposit offered by the association range from 7% to 11% depending upon the term of the certificate. The policyholders have no contractual relationship with the association. Their rights are derived solely from their annuity contracts, and L may satisfy its obligations to the policyholders under these contracts using funds derived from sources other than the accounts held pursuant to the plans.

A policyholder may withdraw all or a portion of the cash surrender value of the contract at any time prior to the annuity starting date upon written request to L. The cash surrender value of the contract is the amount deposited plus interest credited less a charge for withdrawal. The withdrawal charge is the early withdrawal penalty charged by the savings and loan association plus any premium tax resulting from the withdrawal. The association does not have the right to distribute any assets from the savings and loan account directly to any policyholder or to any beneficiary or assignee.

The annuity contract allows the policyholder to elect one of a variety of settlement options including a lump-sum payment, a life income option, installment options for a specified amount or a specified period, and installment payments for a period certain and for life thereafter.

If a policyholder dies prior to the annuity starting date, a lump-sum is payable to the beneficiary in an amount

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Federal Home Loan Bank Board

1700 G Street, N W
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

JAY JANIS
Chairman

Recvd 10/24

October 10, 1980

Honorable G. William Miller
Secretary
Department of the Treasury
Washington, D.C. 20220

Dear Mr. Secretary:

I am writing to express my concern over the recent issuance of Revenue Ruling 80-274. The practical effect of the ruling is to preclude the use of group single premium retirement annuity contracts under which Federally insured savings and loan associations are designated as group contract holders. I believe the Internal Revenue Service should withdraw this recent ruling, and that the Treasury Department and the Internal Revenue Service should reconsider carefully the legal and policy implications of the ruling.

I am concerned about the adverse impact of the ruling on savings account funded annuity plans because these plans can be a significant incentive for increased savings by a major segment of the American public, and because these annuity plans have the potential to become a significant source of stable funds for Federally insured savings and loan associations.

Although Revenue Ruling 80-274 is limited obstensibly to the facts of a specific type of annuity contract involving savings and loan associations, as a practical matter, it raises major policy questions concerning the tax treatment of other types of annuities as well. The ruling fails to provide any reasoned legal analysis for its conclusion. In fact, strong legal arguments and precedent exist for concluding that the ruling is incorrect as a matter of law.

In view of the important policy considerations and the complex legal questions raised by the ruling, I believe it is more appropriate for a decision on the tax treatment of these annuity contracts to be the subject of a proceeding that would provide interested individuals and governmental agencies, including the Bank Board, an opportunity to participate. Therefore, I recommend immediate

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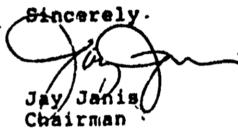
withdrawal of Revenue Ruling 80-274 and commencement of a rule-making proceeding to consider the important and difficult issues raised by this ruling.

Sincerely,



Jay Janis
Chairman

cc: Donald C. Lubick
Jerome Kurtz

In good faith reliance on the letter rulings, we transformed the nature of our operations and pioneered our annuity contract. Today, it is virtually our sole business activity. We have expended close to $1 million. We have thus far received but $230,633 in gross fees on the contracts that have been issued. Of course, we cannot issue any new contracts, and we have drastically curtailed our operations.

Moreover, in reliance on the letter ruling, we committed ourselves to obligations under our annuity contracts that will be triggered with disastrous financial consequences unless our outstanding contracts are promptly "grandfathered," by the Service. The Service has not yet advised whether it will grant this equitable relief.

Absent prompt "grandfathering," revenue ruling 80-274 will, as is to be expected, produce wholesale, if not total, termination of our contracts, with ensuing requests for withdrawals of cash surrender values.

In the case of such withdrawals, we do not, unlike the situation described in revenue ruling 80-274, charge the annuity owner with the early withdrawal penalty charged us by banks, and savings and loan associations. We uniquely bear the penalty that regulation Q requires to be charged in the event of early withdrawals. Nevertheless, the Service has refused to recognize this material distinction as a basis for not applying revenue ruling 80-274 to us.

The amount of these potential early withdrawal penalties, even when reduced by the independent withdrawal charges that we may charge under our contracts, currently approach $1.5 million. We have approximately $2.2 million of capital and surplus.

Unless our contracts are promptly "grandfathered," the severe loss we will suffer from the penalties alone because of the Service's precipitous revocation of its letter rulings is apparent and need not be belabored.

In addition, unless our contracts are "grandfathered," the collectibility of some $207,000 in fees that banks, and savings and loan associations owe us on outstanding contracts is in jeopardy.

I would like to offer for the record a copy of a letter of October 10, 1980, from Chairman Jay Janis of the Federal Home Loan Bank Board to Secretary of the Treasury G. William Miller. The letter urges withdrawal and reconsideration of revenue ruling 80-274 and states in part, if I might quote:

I am concerned about the adverse impact of the ruling on savings accounts funded annuity plans because these plans can be significant incentive for increased savings by a major segment of the American public, and because these annuity plans have the potential to become a significant source of stable funds for Federally insured savings and loan associations.

These funds, of course, provide sorely needed mortgage money for the housing market. The benefits redound not only to the prospective homeowner, but to the construction industry as well.

We urge that S. 3082 and S. 3094 be amended so that they will not only rescind revenue ruling 77-85, but also specifically provide for the rescission of revenue ruling 80-274.

Mr. Chairman, as a personal note, I would really appreciate if somebody could at least get the Service to respond to our communications, as they have done under revenue ruling 77-85, to "grandfather" the existing contracts which were issued in good faith. I wish that they would do the same here. It is a matter of a few days time period, because the State insurance company is quite concerned about it.

[Prepared statement of Robert R. Barrow follows:]

STATEMENT OF ROBERT R. BARROW, PRESIDENT, INTERNATIONAL GENERAL INSURANCE CORP., ON S. 3082 AND S. 3094

Our company issues annuities with the premiums being deposited in certificates of deposit of banks and savings and loan associations. We guarantee a minimum interest accumulation on the premium plus an additional accumulation based on earnings of the deposit in excess of the guarantee.

We received letter rulings in August 1977, December 1979, and January 1980, according our contracts annuity tax treatment. The Internal Revenue Service had obviously concluded that Rev. Rul. 77-85, which it had issued earlier in March 1977, had no bearing on our contracts.

Then suddenly, without notice, on September 24, 1980, the Service, relying on Rev. Rul. 77-85, issued Rev. Rul. 80-274. Thereafter, we were advised that, because of Rev. Rul. 80-274, the letter rulings we had received were revoked retroactively to the date of their issuance.

In good faith reliance on the letter rulings, we transformed the nature of our operations and pioneered our annuity contract. Today, it is virtually our sole business activity. We have expended close to $1,000,000. We have thus far received but $230,633 in gross fees on the contracts that have been issued. Of course, we cannot issue any new contracts, and we have drastically curtailed our operations.

Moreover, in reliance on the letter rulings, we committed ourselves to obligations under our annuity contracts that will be triggered with disastrous financial consequences unless our outstanding contracts are promptly "grandfathered" by the Service. The Service has not yet advised whether it will grant this equitable relief.

Absent prompt "grandfathering", Rev. Rul. 80-274 will, as is to be expected, produce wholesale, if not total, termination of our contracts, with ensuing requests for withdrawals of cash surrender values. In the case of such withdrawals, we do not, unlike the situation described in Rev. Rul. 80-274, charge the annuity owner the early withdrawal penalty charged us by banks and savings and loan associations. We uniquely bear the penalty that Regulation Q requires to be charged in the event of early withdrawals. Nevertheless, the Service has refused to recognize this material distinction as a basis for not applying Rev. Rul. 80-274 to us.

The amount of these potential early withdrawal penalties (even when reduced by the independent withdrawal charges that we may charge under our contracts) currently approaches $1,500,000. We have approximately $2,200,000 of capital and surplus. Unless our contracts are promptly "grandfathered", the severe loss we will suffer from the penalties alone because of the Service's precipitous revocation of its letter rulings is apparent and need not be labored.

In addition, unless our contracts are "grandfathered", the collectibility of some $207,000 in fees that banks and savings and loan associations owe us on outstanding contracts is in jeopardy.

I would also like to offer for the record a copy of a letter of October 10, 1980 from Chairman Jay Janis of the Federal Home Loan Bank Board to Secretary of the Treasury G. William Miller. The letter urges withdrawal and reconsideration of Rev. Rul. 80-274, and states in part:

"I am concerned about the adverse impact of the ruling on savings account funded annuity plans because these plans can be a significant incentive for increased savings by a major segment of the American public, and because these annuity plans have the potential to become a significant source of stable funds for Federally insured savings and loan associations."

These funds, of course, provide sorely needed mortgage money for the housing market. The benefit redounds not only to the prospective home owner, but to the construction industry as well.

We urge that S. 3082 and S. 3094 be amended so that they will not only rescind Rev. Rul. 77-85, but also specifically provide for the recission of Rev. Rul. 80-274.

Senator BYRD. It seems to me that they should respond one way or another.

Mr. BARROW. Thank you.

Senator BYRD. At this point I want to insert in the record, although this should be put in the record prior to the first witness, a statement by Senator Hatch dealing with this legislation.

Mr. Burt.

STATEMENT OF FORREST D. BURT, PRESIDENT-ELECT, TEXAS ASSOCIATION OF COLLEGE TEACHERS

Mr. BURT. Thank you, Senator.

I am Forrest Burt, State vice president of the Texas Association of College Teachers. I have submitted testimony, and I would request that it be put in the record.

Senator BYRD. Without objection, it will be.

Mr. BURT. I would like to say a few words in summary of my position.

I represent the faculty of higher education in the State of Texas. I know that every profession think they are exceptional. I believe that the faculty of higher education in the State of Texas has great responsibility to educate and train tomorrow's leaders for our State. So I am very concerned about this benefit, and the Texas Association of College Teachers has a position.

Allow me to quote the present president of the Texas Association of College Teachers:

> Public universities in Texas are in big trouble, and the root of that trouble is the salaries and benefits. Simply stated the problem is that university salaries and benefits are becoming less and less competitive with those in other employment. As usual, when an employer's compensation program begins to fall behind, the ablest people are the ones who can most easily move elsewhere.

Let me say that what we are talking about with this deferred annuity is not extra money. It is our retirement benefit. The Texas Association of College Teachers has taken the position that teachers should have as many options as possible, and this is one.

Passing Senate bill S. 3082 or S. 3094 is in the interest of the faculty of higher education in Texas. The IRS ruling 77-85 reversed a previous policy that for 12 years permitted investment annuity as a possibility for use as tax deferred annuity by faculty.

Allow me in closing to quote the executive secretary of the Texas Association of College Teachers:

> I strongly encourage you, on behalf of faculty interests in Texas, to favor sending one or other of these bills to the floor, and to work for their passage in order that this unnecessary restriction on choice of products for use in the optional retirement program and tax deferred annuity program may be removed. Such action will return the situation which existed for 12 years prior to March 1977.

Thank you.

[Prepared statement of Forrest D. Burt follows:]

PREPARED TESTIMONY OF FORREST D. BURT BEFORE THE SUBCOMMITTEE ON TAXATION OF THE SENATE FINANCE COMMITTEE ON S. 3082 AND S. 3094

SUMMARY OF TESTIMONY

Passing Senate bill S. 3082 or S. 3094 is in the interest of the faculty of higher education in the state of Texas. The IRS Revenue Ruling 77-85 reversed a previous policy that for 12 years permitted "investment annuity" as a possibility for use as a tax deferred annuity by faculty under Section 403(b) of the Internal Revenue Code. Senate Bill S. 3082 or S. 3094 would remove this unnecessary restriction on the choice of products available to Texas faculty in the Optional Retirement Program and Tax Deferred Annuity Program.

TESTIMONY ON S. 3082 AND S. 3094

The tax deferred character of "investment annuity" being considered in the hearing for identical bills S. 3082 and S. 3094 before the Senate Finance Committee is a matter of considerable interest to faculty members in Texas institutions of higher education. As state vice president of the Texas Association of College Teachers, I wish to clarify the faculty's position in this matter.

The IRS Revenue Ruling 77-85 reversed a previous policy that for 12 years had permitted "investment annuity" as a possibility for use as a tax deferred annuity by faculty under Section 403(b) of Internal Revenue Code. The Texas Association of College Teachers (TACT) has favored as wide a choice of products as possible in this field. Annually we publish an analysis of insurance company products available for faculty of higher education in Texas. We believe that one product that should be available to faculty is the "investment annuity," previously offered by First Investment Annuity Company. The unique feature of this product is the ability of annuitants to direct their payments into investments of their own choice through a bank custodian. It varies in no other essential way from many other products offered for use under 403(b) provisions.

Ruling 77-85, however, has eliminated this product in a seemingly discriminatory way with no apparent advantage to the government. The consequence for Texas faculty members, though, is that their ability to direct payment by their own decision is severely limited. But at the same time, insurance company managers are allowed to give similar direction for these funds in variable annuities.

Working in the interest of the faculty of higher education in Texas, Texas Association of College Teachers made the following policy statement on choices for Optional Retirement and Tax Deferred Annuity Programs:

The offerings should at least include:

(*a*) The TIAA-CREF program, because of its long-term service to higher education, its transferability throughout the profession, and its comparative low cost;

(*b*) Three or more of the flexible, adaptable programs offered by standard insurance companies * * *; and

(*c*) The First Investment Annuity (FIAC) program because of its unique opportunity for the participant to make his own investment decisions throughout the life of the program.

The IRS Revenue Ruling 77-85 has eliminated the latter option as a choice for Texas faculty.

Therefore, passing Senate bill S. 3082 or S. 3094 would be in the interest of the faculty of higher education in the state of Texas. In the words of the Executive Director of the Texas Association of College Teachers, Mr. Frank Wright, "I strongly encourage you, on behalf of faculty interests in Texas, to favor sending one or the other of these bills to the floor and to work for their passage in order that this unnecessary restriction on choice of products for use in the Optional Retirement Program and Tax Deferred Annuity Program may be removed. Such action will return to the situation which existed for 12 years prior to March 1977."

Senator BYRD. Thank you.

The last witness.

STATEMENT OF JUDITH HASENAUER, ESQ.

Ms. HASENAUER. Thank you, Senator Byrd.

My name is Judith A. Hasenauer. I am a partner in the law firm in Westport, Conn.

My firm represents a very large number of insurance companies, mutual funds, banks, financial institutions, money managers, and other companies of that nature. As such, we have become intimately involved with annuity programs of all kinds, including those programs that were affected by revenue ruling 77-85, and its progeny revenue ruling 80-274, which was issued in September of this year.

I am here today on behalf of my firm, and not in representative capacity of any particular organization. I am representing my firm today bocause of a very difficult situation that we find ourselves in.

As attorneys, we analyze the Internal Revenue Code, regulations, legislative history, State insurance law, and other laws that govern the issuance of annuity contracts. We find that revenue ruling 77-85 and revenue ruling 80-274 do not square with our analysis of such analysis. This was concurred in by the district court.

Section 72 of the Internal Revenue Code, as Congress adopted it, provides for the taxation of annuities to individuals. That statute governed the basic deferral of income on both interest and dividends. Section 72, in both the legislative history and in the statute itself, makes no reference whatsoever to the underlying assets. It makes no reference to how the assets should be held, invested or managed.

The corresponding section of the Internal Revenue Code is section 801, which governs taxation of separate accounts to insurance companies. Again, an analysis of the statute shows that there is no requirement that the insurance company manage the funds. There is no limitation whatsoever as to the form the assets must be invested in, how they are held, what duration, who manages the money.

In fact, Treasury Regulation 70-2 states:

> Annuity contracts shall be deemed under Section 72 as those annuity contracts in accordance with customary practice of life insurance companies.

As noted earlier, the practice in this industry, in order for an insurance company to issue an annuity contract, you must file the annuity contract and have it approved, in most States, by the insurance department in the State in which you intend to issue it. You must also have the separate account approved, which includes filing an analysis as to how the assets are to be held, and how they are to be managed.

The Federal policy to date has been that the State insurance departments would regulate insurance, not the Internal Revenue Service.

I seriously disagree with the Deputy Assistant Secretary's statement that they have not changed section 72. Heretofore, an insurance company wishing to issue an annuity contract would go to its state insurance department for determination as to whether a contract was an annuity contract, not the Internal Revenue Service.

We find ourselves in a situation as attorneys of not being able to render sound advice based on many, many years of experience, and many, many years of stated facts, legislative history, and the clear statement of congressional intention as drafted in the 1959 Revenue Act.

I am here today to urge this committee and Congress to pass the statute, to take us back to where we were, not to give us something

we have not had in the past, and to limit the Service's ability to interfere in an area in which they have not been granted any jurisdiction.

Thank you, Senator.

Senator BYRD. Thank you.

I think that all of you have presented good testimony today.

I don't know whether it will be practical to handle all this legislation in the very few days which remain. The Finance Committee has taken the view that with the session so short, if there is opposition to a proposal, there is little likelihood that it would be favorably reported by the committee.

This testimony will be helpful at whatever time the committee is able to reach this subject matter. I thank all of you very much.

Ms. ARMSTRONG. Senator, as I formerly stated, I am not familiar with the procedures. Am I to formally request that this three-page memo be included in your record for it to be included?

Senator BYRD. Your statement will be inserted in the record as if read.

Ms. ARMSTRONG. Thank you very much, sir.

Senator BYRD. The committee will stand in recess.

[Whereupon, at 4:10 p.m., the subcommittee recessed, subject to call of the Chair.]

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

PREPARED TESTIMONY OF HON. TOBY ROTH (REPUBLICAN OF WISCONSIN) ON S. 3082 AND S. 3094 BEFORE THE SENATE FINANCE COMMITTEE, SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

Mr. Chairman, I appreciate the chance to testify before this distinguished Subcommittee regarding S. 3082 and S. 3094. I commend Senator Hatch and Senator Tower for introducing these two badly needed legislative remedies.

In late September 1980, several insurance companies and saving and loan associations in the Eighth District of Wisconsin advised me that the Internal Revenue Service, relying on Revenue Ruling 77-85, had suddenly and without notice issued Revenue Ruling 80-274. This appears to be another instance where the IRS has legislated through administrative procedure. This most cavalier Revenue Ruling and the actions relating thereto constitute shabby and high-handed treatment of our citizens by the IRS. I personally corresponded with Treasury Secretary G. William Miller on October 27, 1980 regarding Rev. Rul. 80-274, which involves Revenue Ruling 77-85, and have not as yet received a reply.

Allow me now to get to the heart of the matter before us. Our country is experiencing a severe and growing shortage of capital, which is contributing to high interest rates and slowing our economic growth. Congress acknowledges this problem and speaks repeatedly of the "Reindustrialization of America". Although we have been mostly concerned about our manufacturing plants, the same concept is true for one of this nation's major industries—the housing industry. The home building industry is undergoing very difficult times, and many thousands of people directly associated with real estate and home construction find themselves without work. What is even more distressing is that forecasts for the future show that our stock of housing will not be sufficient to accommodate upcoming generations. With the need for capital to build our nation's housing stock, the savings and loan industry needs ways to attract people to save.

Savings associations finance about two-thirds of America's housing and their ability to lend depends directly on people saving at their neighborhood savings and loan. In recent years the percent of disposable income a typical American family saves has been declining steadily—a dangerous trend which must be reversed if housing is to rebound.

Further, compared with other industrialized nations, the American wage earner saves far less than their Japanese and European counterparts. It is estimated that Americans now save less than 3% of their earned income, whereas the average Japanese worker saves 25% of his income and the West German worker saves about 11%. Clearly, we in Congress must fulfill our obligation to help people save, so that

they may one day fulfill their dream of owning a home. The Tax Deferred Annuity is a model vehicle for this purpose. The Tax Deferred Annuity (TDA) is not, as some have suggested, another loophole for the rich, but it is in most cases used by a wage or salary earner—middle aged or older, who has most of his home paid for and is now concerned about retirement and his ability to build a nest-egg for that important day. He or she knows about traditional savings accounts and money market certificates and is not anxious to use these products because much of the return goes for Federal and State income taxes and often pushes total family income into higher tax brackets. The American people are crying out for tax relief and the TDA is like an answer to their prayers because of the tax deferral nature of the interest buildup. The TDA appeals to the "serious" saver, one who saves regularly, with meaningful amounts—the way experts say people should save.

I would like to summarize some of the benefit to be derived from this program. The program:

(1) Allows people who wish to participate the opportunity to accumulate funds for their own retirement. The need for this is based on a recent survey, which indicates that 83% of the population is scared to death of running out of money before they run out of breath.

(2) By issuing TDA's through financial institutions, we reverse the flow of dollars that are fleeing from the banks and savings and loans and thus compounding the inflation rate, the problems of the housing industry and unemployment.

(3) The program was designed to keep the funds in the local bank and local savings and loan. This point is very important and should not be forgotten. These funds don't go out of state for some project no one cares about. To the contrary, these funds stay within the localities to work for a better quality of life for the participants and their fellow citizens.

Mr. Chairman, let me close by saying that this capricious and arbitrary Revenue Ruling should be revoked forthwith or at the very least suspended for one year to allow Congress time to study the matter.

The Social Security Funds are facing collapse our older citizens cry out for some sense of financial security. I believe Tax Deferred Annuities are a good method by which an individual can determine his or her own future and the dignity that comes from living in a manner he or she determines, rather than a way of life determined by some federal bureaucrat at some federal agency.

Again Mr. Chairman, I thank you for the opportunity to testify before this Subcommittee.

TOBY ROTH.

Addendum: I would respectfully request that my letter to Treasury Secretary Miller be included in the record.

HOUSE OF REPRESENTATIVES,
Washington, D.C., October 27, 1980.

Hon. G. WILLIAM MILLER,
Secretary, Department of the Treasury,
Washington, D.C.

DEAR MR. SECRETARY: I am writing to express my concern over the recent publication of Revenue Ruling 80-274. This ruling prohibits tax deferral for an individual who purchases an insurance annuity from an insurance company, with the insurance company's proceeds being held at a financial institution.

All insurance companies participating in this annuity program were required to receive a private letter ruling from the Service to offer this product. It has proven to be very successful with average middle-income people because of the tax deferral aspect and the ability to work with their financial institution as a facilitator of their annuity purchase. This product is one of the few programs that encourages someone to save, and let no one doubt this country needs tax incentives to stimulate capital formation. Moreover, Tax Deferred Annuity Accounts provide a much needed service to our older citizens. That is, they are a model vehicle for building a personal retirement account, while also providing a framework for setting aside funds for the education of your child or grandchild.

In talking with my constituents who are affected by this unwise Revenue Ruling, I have determined that legislation with full Congressional investigation is needed forthwith. The issuance of Revenue Ruling 80-274 is bad policy. This ill-conceived ruling may have disastrous effects and unanticipated impacts on the insurance industry, home building industry, savings and loans and a myriad of small businesses throughout the United States. Therefore, I request the Department of the Treasury to consider the broader policy implications of the revenue ruling which would affect the rulings already given by the IRS and already accepted, in good faith, by many savings and loans and insurance companies, I recommend immediate

revocation of Revenue Ruling 80-274 until such time as an appropriate forum can be convened to allow interested individuals the opportunity to comment on this ruling.

Thanking you in advance, I am

Sincerely,

TOBY ROTH, *Member of Congress.*

REMARKS ON STATUS OF ANNUNITY CONTRACTS UNDER REVENUE RULINGS 77-85 AND 80-274

I am Judith A. Hasenauer, a partner in the Westport, Connecticut law firm of Blazzard, Grodd and Hasenauer. My firm specializes in the design and clearance of specialty financial products through the Securities and Exchange Commission, Internal Revenue Service and State regulatory agencies. I personally have concentrated in the area of representing life insurance companies, banking and thrift institutions, securities brokerage firms, mutual fund managers and similar organizations in the design and implementation of annuities. Because of this, I believe that I have the expertise to make a positive contribution to this Committee.

At the time of the adoption of Revenue Ruling 77-85 we represented many of the life insurance companies which offered or were preparing to offer the investment annuity. We were intimately involved in the discussions and negotiations with the Treasury Department and the Internal Revenue Service prior to the release of Revenue Ruling 77-85.

I wish to emphasize that I am here not in a representative capacity for any client, but as a concerned citizen who possesses a particular technical expertise about the subject. I believe this technical expertise gives me an insight into the problems and inequities which have resulted from the promulgation of Revenue Ruling 77-85 and its offspring, Revenue Ruling 80-274.

As a lawyer engaged in rendering advice to businesses, I am appalled that the Internal Revenue Service can, without benefit of Congressional action, reverse longstanding, commonly accepted and IRS approved interpretation of tax law which has stood unquestioned for more than a decade. I am sure you are aware that the development and implementation of complex financial products such as annuities by a Company is a long, painstaking and expensive proposition.

Regulatory clearances from 53 state level regulatory bodies and from the Securities and Exchange Commission usually take many months and the out-of-pocket costs can easily run into hundreds of thousands of dollars for legal, accounting and actuarial fees. In addition, complex computer programs and marketing organizations must be developed and made operational. The cost for the total installation of a new financial product, such as annuity, can reach into more than a million dollars.

New financial products such as annuities stimulate growth of capital, stabilize the savings base of our economy and provide jobs for many people. Insurance Companies and other financial institutions are willing to develop new financial products and risk the cost of such development only when there is a reasonable likelihood that such products can be sold to the public. When, in reliance on tax treatments specified in clear, unambiguous provisions of the Internal Revenue Code, a company develops a new financial product and expends the substantial funds involved, only to have the Internal Revenue Service, in effect, change the law without public hearing, prior notice of action by the duly elected representatives of the people, there results a frustration with the entire governmental process, and more importantly, the reluctance to undertake any new programs. This problem is compounded when such a company has sought and obtained a ruling from the Internal Revenue Service to the effect that the product complies with tax law.

My firm worked on many different product designs over the past several years. I would like to take this opportunity to describe just one such design and legal structure affecting it.

The product I would like you to examine is an Individual Variable Annuity Contract. This Contract guarantees annuity payments for life based on recognized mortality tables. However, the amount of each payment (as well as the surrender value of the contract) will vary according to the investment experience of the assets held in the separate account which underlie the Contract. These assets are investment instruments issued by banks and savings and loan associations.

The Purchase Payment for a Contract is made by the assignment of an investment instrument to the Insurance Company. Such instrument may have been issued by any bank or savings and loan association which is a member of the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation. However, any uncompounded interest on such investment instruments and the

maturity proceeds will be invested only in new investment instruments issued by a financial institution determined by the Insurance Company to be eligible for investment by the separate account (an "eligible financial institution"). A Contract Owner must elect an eligible financial institution at time of application for the Contract.

All uncompounded interest and maturity proceeds will be invested in investment instruments of the eligible financial institution selected by the Contract Owner. However, the Contract Owner has no say in the term of such investment instruments nor in the interest yield. The Insurance Company will invest in investment instruments of the highest available yield regardless of duration. However, all investment instruments must be of a duration consistent with the annuity starting date and the date of subsequent annuity payments. Thus, depending on the age of the annuitant, the Insurance Company may be required to select a portfolio of investment instruments of differing durations and yields to satisfy the need for annuity payments. The Insurance Company reserves the right to require the substitution of investment instruments held in the separate account under a Contract. The Insurance Company will do so when, in its exclusive opinion, any investment instrument is no longer appropriate for the purposes of the Contract or is no longer compatible with the administrative procedures established for the accounting of assets within the separate account.

This Contract and the related Separate Account were approved by the Insurance Department of the State of domicile of the Insurance Company and in all states where the Insurance Company intends to offer the product.

With the enactment of the 1954 Code, Congress provided a specific scheme for taxing annuity income to individuals, which includes any such income from a variable annuity.

Section 72(a) of the Code provides in general for the inclusion in gross income of any amount received as an annuity under an annuity contract. However, § 72(b) provides for an exclusion from gross income of the amount received as an annuity which bears the same ratio to such amount as the investment in the contract bears to the expected return thereunder, as of the annuity starting date. § 72(c)(1) provides that the investment in the contract is the aggregate premiums or other consideration paid for the annuity less any amounts received under the contract before the annuity starting date to the extent that the latter amount was excludable from gross income.

For purposes of § 72, the annuity starting date is the first day of the first period for which an amount is received as an annuity under the contract.

Under § 72(e), if an amount is received prior to the annuity starting date, it is included in gross income only to the extent that it, in the aggregate when added to amounts previously received under the contract which were excludable from gross income, exceeds the aggregate premiums or other consideration paid for the contract. Furthermore, any amount received, whether in a single sum or otherwise, in full discharge of the obligation under the contract which is in the nature of a refund of the consideration paid for the contract and any amount received under the Contract on its surrender, redemption or maturity are not treated as annuities (§ 72(e)(2)).

Under § 72(g) of the Code, Congress provided rules for determining the basis of annuity contracts transferred by assignment or otherwise for valuable consideration. § 72(h) puts forth the concept of non-constructive receipt in the case of a contract which provided for payment for a lump sum in full discharge of an obligation thereunder, subject to an option to receive an annuity in lieu of the lump sum if the option was exercised within sixty (60) days after the lump sum became payable.

Congress also added Section 1035 to the 1954 Code to enable individuals to exchange one annuity policy for another better suited to their needs without recognizing a gain or a loss.

By way of further clarification as to applicability of Section 72, Treasury issued Regulation 1.72-2(a)(1) which provides that:

"The contracts under which amounts paid will be subject to the provisions of Section 72 include contracts which are considered to be life insurance, endowment and annuity contracts in accordance with the customary practice of life insurance companies."

The Life Insurance Company Income Tax Act of 1959 (Public Law 86-69, June 25, 1959) included a provision for variable annuities. This provision (originally § 801(g) of the Code, now § 801(g)(1)(a)) was explained by the report of the Senate Finance Committee as follows:

"Your committee has added a provision to the House bill to make it clear that variable annuities are in general to be taxed in the same manner as other annuities." (86th Cong., 1st Sess., S. Rep. No. 291 (1959) 13.)

In 1962, Congress expanded the variable annuity section of the Code to include a new type of contract. Section 801(g)(1)(A) reenacted in substance the provisions of the 1959 Act and thus continued to include a variable annuity within the definition of an annuity. However, Congress also added Section 801(g)(1)(B) to the Code to deal with "contracts with reserves based on a segregated asset account", which it defined as a contract which provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to state law or regulation, is segregated from the general asset accounts of the Company, which provides for the payment of annuities, and under which the amounts paid in or the amounts paid as annuities reflect the investment return and market value of the segregated asset account. Congress also added several provisions dealing with accounting for life insurance companies which issue such Contracts, requiring generally that the companies separately account for various items of income, exclusions, deductions, assets, reserves and other liabilities attributable to such separate accounts.

The legislative history of 801(g)(1)(B), as stated in the reports of the Senate Finance Committee and of the Conference Committee indicate no concern about the nature of the investments underlying a variable annuity contract. This history merely reiterates the qualifications necessary to quality as a "contract with reserves based on a segregated asset account." These are:

1. Contributions and accumulations are applied to a separate account, the assets of which, under State law, are segregated from the general assets account of the Company.
2. The contracts must provide for the payment of annuities.
3. The amounts paid in or the amounts paid as annuities reflect the investment return and the market value of the assets held in the separate account.

There is nothing in § 801(g)(1)(B) nor in the legislative history which would show a congressional intent to limit the type of investment underlying a variable annuity contract.

In summary, the Insurance Company was offering an annuity contract which was to be issued out of a separate account. Both the separate account and the Contracts were approved by the individual state insurance departments where the Contracts were to be sold as well as the State of domicile of the Insurance Company.

In September of this year, Internal Revenue Service issued Rev. Rul. 80-274. Rev. Rul. 80-274 described a group single premium retirement annuity contract owned by a savings and loan association. Under the facts stated the policyholder transferred cash, a passbook savings account or a certificate of deposit to the insurance company for the purchase of the annuity contract. This amount is reduced from 2 to 5 percent for sales, administrative and premium tax expenses. The reduced amount is segregated, placed in a separate account of the savings and loan association and invested in a certificate of deposit. When the certificate expires, the insurance company must reinvest the proceeds in a certificate of deposit in the same savings and loan association for the same duration unless that duration would extend beyond the annuity starting date. If so, a certificate of shorter duration would be purchased. If a certificate of deposit were not available, then the funds would be invested in a passbook savings account.

Under the annuity described in Rev. Rul. 80-274, the Insurance Company retains the right to withdraw the deposits from a failing savings and loan association or from one that terminates the plan. If withdrawn, the insurance company must deposit such amount in another federally insured savings and loan association. The insurer deducts an annual management fee from the interest earned on the investments. The remaining interest is credited to each annuity account. The insurer guarantees the deposit will earn at least 4 percent per year compounded annually from the date of deposit.

The policyholder may withdraw all or a portion of the cash surrender value of the contract at any time prior to the annuity starting date. The cash surrender value is the amount deposited plus interest credited less a charge for withdrawal. The withdrawal charge is the early withdrawal penalty charged by the savings and loan association plus any premium tax resulting from the withdrawal.

The annuity contract allows the policyholder to elect one of a variety of settlement options. If a policyholder dies prior to the annuity starting date, a lump sum is payable to the beneficiary in an amount equal to the cash surrender value on the date of death. The beneficiary could also elect to receive a lifetime annuity or an annuity for a term certain.

Rev. Rul. 80-274 found that under these facts the policyholder's position is substantially identical to what the policyholder's position would have been had the investment been directly maintained or established with the savings and loan association. The insurance company is little more than a conduit between the policyholder and the savings and loan association.

Rev. Rul. 80-274 determined that due to the "substantially identical" position of the policyholder, he or she still possesses substantial incidents of ownership and therefore the policyholder and not the insurance company is the owner of the account for federal income tax purposes.

The sole legal basis of Rev. Rul. 80-274 was Rev. Rul. 77-85. Certainly the facts did not support the position that the policyholder was "substantially identical." The only substantive review of Rev. Rul. 77-85 was the FIAC litigation in the District Court. There, the Court found that Rev. Rul. 77-85 was illegal and void as an invalid usurption of Congressional power.

The Internal Revenue Service, hurt by the release of Rev. Rulings 77-85 and 80-274, changed the law as it has existed under clear Congressional mandate and as it was interpreted by the IRS for well over a decade.

There has long been an established federal policy to leave the regulation of insurance to the individual states. This policy was most recently exhibited in Congressional action with respect to the FTC. The Treasury Regulation cited above providing that an annuity which is "in accordance with the customary practice of life insurance companies", is consistent with this policy.

I urge you to adopt legislation that will clearly set limits on the IRS's ability to interfere with the regulation of insurance by the State Insurance Departments and with the legislative authority vested solely in Congress. With the imposition of such restrictions, Insurance Companies would be more willing to expend the large dollar amounts necessary to implement the new financial products necessary to meet the growing needs of insurers.

CENTRAL FEDERAL SAVINGS & LOAN ASSOCIATION,
San Diego, Calif., November 25, 1980.

Re S. 3094, Senator Hatch—S. 3082, Senator Tower.

Hon. RUSSELL B. LONG,
Chairman, Senate Committee of Finance,
Dirksen Senate Office Building Washington, D.C.

DEAR SENATOR LONG: I believe the Senate Committee on Finance is considering two bills which would have the effect of reinstating the tax treatment applied to the Investment Annuity Program as it existed prior to the issuance of Revenue Ruling 77-85. These bills are S. 3082 and S. 3094, referenced above.

Central Federal has been familiar with the Investment Annuity Program for several years. In fact, we were able to use it in financial planning for many of our customers, over 300 of whom still have existing programs. We found that it was a very useful tool in serving existing savers and in attracting new, long-term funds.

We strongly support the proposed legislation as a valuable source of money for home lending programs, as well as a worthwhile addition to the selection of savings accounts we offer to the public.

Sincerely,

RENE H. GENTRY,
Senior Vice President, Community Relations Director.

AMERICAN TELEPHONE & TELEGRAPH CO.,
New York, N.Y., November 17, 1980.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management Generally, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: This statement, in support of HR 6806, is submitted on behalf of American Telephone and Telegraph Company (AT&T) and the Associated Companies of the Bell System (listed on Attachment A).

We support HR 6806 because it would achieve two important objectives—first it would clarify for the future the eligibility requirements for claiming liberalized tax depreciation and the investment tax credit by public utilities, and second it would eliminate for the past massive tax deficiencies for three California utilities, including Pacific Telephone & Telegraph Company (an AT&T subsidiary), resulting from rate orders issued by the California Public Utilities Commission (CPUC).

The need for HR 6806 arises from the following facts—

(1) A public utility is eligible to claim the investment tax credit and liberalized tax depreciation, subject however to the normalization requirements set forth in sections 46(*f*) and 167(*l*) of the Internal Revenue Code. If these normalization requirements are not met, the public utility loses its eligibility for the investment tax credit and its right to use liberalized tax depreciation.

(2) Rate orders issued by the CPUC prior to February 13, 1980 established methodology for the treatment of the investment tax credit and liberalized tax depreciation which the CPUC has asserted complies with the terms of sections 46(f) and 167(*l*).

(3) The Internal Revenue Service has ruled that the CPUC methodology does not comply with the terms of sections 46(f) and 167(*l*).

(4) As a result of these rate orders by the CPUC, Pacific Telephone and Telegraph Company and General Telephone of California face tax liabilities, for periods prior to February 13, 1980, which amount to over $1.6 billion.

(5) The IRS assessed a tax deficiency against Pacific Telephone of $89 million, plus $27 million interest, for the year 1974. Years subsequent to 1974 are still subject to audit. Pacific Telephone paid the 1974 deficiency in February 1980, and intends to file a claim for refund and contest the deficiency in court. Final judicial determination can be expected to require many years.

(6) An order issued by the CPUC on February 13, 1980 has adopted methodology for the future based on full normalization. This February 13, 1980 order applies only to the future, and has no effect on the tax liabilities of the past.

From the outset there have been substantial doubts as to whether the CPUC's methodology complies with the requirements of the tax law. The current situation has come about despite every possible effort by the telephone companies to avoid implementation of the CPUC orders which have caused this potential tax liability. The Companies have been caught in the middle of a conflict between the CPUC and the IRS, and they have been unable to obtain a judicial determination of eligibility in a state or Federal court, including the United States Supreme Court, prior to implementation of the CPUC orders. As matters now stand, absent legislation, there is no way to resolve the controversy short of litigation between the telephone companies and the IRS, and this can take many years before the issue is resolved. This is an unsatisfactory solution because the length of time involved subjects both investors and telephone customers to a cloud of uncertainty as to the effects on the financial position of the company and its ability to properly serve its customers.

Collection of these huge amounts does not make sense where, as here, the taxpayers involved had no control over the events which triggered the liability. The problem is further exacerbated by the fact that the companies' customers in California have already received, and will continue to receive, much of the benefits derived from the investment tax credit and the use of accelerated tax depreciation for periods prior to February 13, 1980. Loss of eligibility would require the companies to repay these same benefits to the IRS.

The companies will have enormous difficulty financing the tax payments. Pacific Telephone already has the lowest bond rating[1] in the Bell System, and it is doubtful, and in fact may be impossible for it to finance both the tax liability and the facilities required to provide communications services so essential to the economy of California. It would be ironic if the investment tax credit and accelerated tax depreciation provisions, which are intended to stimulate investment in productive assets should, through a misinterpretation of the tax requirements, cripple the ability of Pacific Telephone and General Telephone to finance the facilities required to furnish communications services.

HR 6806 provides a comprehensive and appropriate resolution to this problem. It eliminates tax deficiencies created by the CPUC methodology for prior years, while making it clear that such methodology will not be allowable in the future. It also reaffirms the intent of Congress that Federal tax incentives be used to encourage investment rather than subsidize utility rates, and that there must be no tampering with the full normalization rules.

Thus, we support HR 6806 not only as a means of protecting the utility companies and the public from the possible effects of a massive and undesired tax liability, but also as affirmation that the important Congressional objectives underlying the normalization provisions embodied in sections 46(f) and 167(*l*) will be retained.

Very truly yours,

ROBERT N. FLINT.

BELL SYSTEM COMPANIES

American Telephone and Telegraph Company.
The Bell Telephone Company of Pennsylvania.
The Diamond State Telephone Company.
Bell Telephone Laboratories, Incorporated.
The Chesapeake and Potomac Telephone Company.

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[1] Recently that rating went even lower as Standard and Poor's downgraded Pacific Telephone's preferred stock, notes and debentures citing continued uncertainty over Pacific's financial outlook, which has been exacerbated by the uncertainties created by this tax dispute.

The Chesapeake and Potomac Telephone Company of Maryland.
The Chesapeake and Potomac Telephone Company of Virginia.
The Chesapeake and Potomac Telephone Company of West Virginia.
Cincinnati Bell, Inc.
Illinois Bell Telephone Company.
Indiana Bell Telephone Company, Incorporated.
Michigan Bell Telephone Company.
The Mountain States Telephone and Telegraph Company.
New England Telephone and Telegraph Company.
New Jersey Bell Telephone Company.
New York Telephone Company.
Northwestern Bell Telephone Company.
The Ohio Bell Telephone Company.
Pacific Northwest Bell Telephone Company.
The Pacific Telephone and Telegraph Company and Bell Telephone Company of Nevada.
South Central Bell Telephone Company.
Southern Bell Telephone and Telegraph Company.
The Southern New England Telephone Company.
Southwestern Bell Telephone Company.
Western Electric Company, Incorporated.
Wisconsin Telephone Company.

Statement by the American Bankers Association

The American Bankers Association is a trade association composed of 13,200 banks, over 92 percent of the full service banks in the country. Because "investment annuities" could provide an important incentive to save and because they may provide an important part of the retirement security of many bank customers, the Association supports legislation that would restore the tax treatment afforded these annuities prior to Revenue Rulings 77-85 and 80-274.

In September of this year, the Internal Revenue Service reversed its ruling position on tax treatment of the income earned by a separate asset account that is invested at the direction of an annuity contract in a deposit account in a financial institution. Prior to the September ruling, the Service had held that the income was taxable to the insurer. Then in Revenue Ruling 80-274, the Service held that the policyholder is the owner of the deposit account and thus its income is taxable to the policyholder. This holding is contrary to the law and to the facts. An annuity contract requiring the investment of the separate asset account in a deposit at a bank or thrift institution is virtually identical to the more traditional variable annuity contract except that it directs the investment as opposed to giving the insurance company investment discretion over the separate account. The mortality risk assumed by the insurer is similar to that assumed under other forms of annuities, and the policyholder's right to withdraw a part or all of the cash value of the policy prior to the annuity date is the same as in most annuities.

The insurer in the deposit related annuity receives a fee out of the first premium and any subsequent premium and receives an annual fee from the separate asset account. Should there be a withdrawal of the cash value prior to the annuity date, there may be an additional fee. There is no contractual relationship between the policyholder and the financial institution. The policyholder's rights are derived solely from the annuity contract and the insurer may satisfy its obligation to the policyholder using funds derived from sources other than the deposit account. Despite all this the Service held the policyholder to be the owner of the deposit and liable to pay tax currently on its income.

The Service based its holding on Revenue Ruling 77-85, a thoroughly discredited ruling that the Service refuses to abandon. The subject of this ruling, which also was a reversal of many prior rulings, was "investment annuities." These annuities also are virtually identical to the traditional variable annuity except for the investment provisions. The contract involved in this earlier ruling gave the policyholder investment discretion over the assets in the separate account. Again the insurer under the investment annuity contract assumed the mortality risk and the policyholder had no direct ownership interest over the separate account assets. Nevertheless, the Service held that the income of the account was currently taxable to the policyholder.

Revenue Ruling 77-85 was challenged in the federal courts. The U.S. District Court for the District of Columbia in a well reasoned and persuasive opinion in *Investment Annuity, Inc.* v. *Blumenthal,* 442 F. Supp. 681 (1977), held the Revenue Ruling "erroneous and unreasonable and, therefore, unlawful and beyond the statu-

tory authority of the IRS." Judge Charles R. Richey initially decided not to grant injunctive relief against the IRS on the assumption that it would proceed appropriately, in good faith, and in a manner fully consistent with the declaratory relief granted without the coercion of a court order. Subsequently, the Court felt compelled to enjoin the Service and the Service appealed the case. On appeal, the U.S. Court of Appeals for the District of Columbia reversed the District Court for lack of jurisdiction without reaching the merits of the case, *Investment Annuity, Inc.* v. *Blumenthal*, 609 F. 2d 1 (1979).

The Congress, by enacting the Anti-Injunction Act and the tax exceptions to the Declaratory Judgment Act prevented the courts in this case from requiring the IRS to comply with the law. Because of actions of other federal and state agencies, the plaintiffs have been unable to relitigate the issue in the tax court or in a refund suit. Therefore, we urge the Congress to take steps to require the Service to comply with the law. The enactment of either S. 3082 or S. 3094 would have this effect, particularly if it were amended to include a specific reference to Revenue Ruling 80-274.

Enactment of this legislation is needed not only to achieve compliance with the law by the IRS but to revitalize the investment annuity, whether related to a separate account invested in bank or savings and loan deposits or a separate account over which the policyholder exercises the investment discretion. These annuities before IRS interference attracted many savers and provided needed capital for housing and other economic growth. We urge the Subcommittee to take action on this legislation at the earliest possible time.

AMERICAN GUARANTY FINANCIAL CORP.,
Portland, Oreg., November 13, 1980.

Mr. MICHAEL STERN,
Staff Director, Senate Committee on Finance, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: We understand there is to be a subcommittee taxation meeting on Senate Bills 3082 and 3094. We are extremely interested in the passage of these bills, as for several years we wrote the investment annuity; basically with savings and loan associations throughout the nation. In California alone we had 151 savings and loans doing business with us, nine of the ten largest being our customers.

This is an excellent way of stopping disintermediation from the savings and loans and it will certainly improve the granting of loans for the housing industry by the savings and loan institutions.

I would be most happy to give you any additional information on this and will appreciate it if these thoughts can be brought before the committee in their consideration of passage of these bills.

Very truly yours,

JAMES R. ANDERSON,
President and Chairman of the Board.

PREPARED STATEMENT OF JOHN E. BRYSON, PRESIDENT, CALIFORNIA PUBLIC UTILITIES COMMISSION

On Behalf of the California Public Utilities Commission (CPUC), I wish to express our opposition to HR 6806.

This bill revises the accounting procedures required for public utilities to avail themselves of certain accelerated depreciation and investment tax credit (ITC) benefits. As you know, in California a case has arisen in which the continued eligibility of the Pacific Telephone Company and the General Telephone Company for those benefits has come into question, creating a potential billion dollar tax liability for these companies. This situation does continued harm, not only to these companies, but also to the people of California. We are eager to join in seeking a legislative solution to this problem which will resolve issues of uncertainty for both the past and the future, but it is critically important that the issues really be resolved.

While we believe—and find considerable support for our belief—that the normalization method required by the CPUC is fully consistent with continued eligibility of the companies for the tax benefits, we agree with the companies that the time has come to end this controversy once and for all. Unfortunately, the bill before you, HR 6860, will not resolve the problem, and indeed will only create new complications and uncertainties. The present situation is the result of years of litigation. A legislative solution, such as HR 6806, which lacks adequate sensitivity to more than a decade of court battles can only cause additional problems. The interests and

principles at stake are too important to be overlooked in the rush to enact a bill at this late stage of the Congressional session.

After illustrating the nature of the problems likely to be caused by HR 6806, I will propose a solution which is in the spirit of HR 6806, but which more readily deals with the particular issues relating to the present situation. The Public Utilities Commission has long stood in the middle of this problem, torn between conflicting demands of companies and intervenors, and potentially conflicting orders of state courts and federal agencies. The solution I propose is not perfect, but it attempts to deal comprehensively and fairly with a problem that has existed for better than a decade, and which existed prior to Congress' first legislative efforts in this area in the Tax Reform Act of 1969. If HR 6806 is enacted, it will be seen as special legislation for the companies, and will open the door for additional years of dispute. Adoption of an alternative, such as the one I will propose, will quell the problem in California permanently, while firmly protecting the Congressional interest in assuring that these tax benefits be used to further capital formation by the companies.

In order to appreciate the need for such a solution, it is worthwhile first to examine the historical circumstances which produced the present situation, and take a close look at just what it is that has been done; second, to examine the implications of HR 6806 in light of these circumstances; and third, to develop the argument for a legislative approach which effectively resolves the present impasse.

The current situation arose out of a series of orders of the California Supreme Court, which mandated the Public Utilities Commission to attempt to adopt a method of normalization for these companies which would provide for a greater sharing of tax benefits with customers than is accomplished through use of the normalization method traditionally advocated by the companies. These California Supreme Court orders were handed down as a result of intervenors' suits challenging the Public Utilities Commission's granting to the companies the particular method of normalization which they advocate.

In light of this mandate from the California Supreme Court, which was renewed by the court on two subsequent occasions, the Commission undertook the laborious process of seeking to ensure eligibility for the companies, while providing for an equitable sharing of tax benefits with customers. As is suggested by Mr. Halperin's testimony presented during hearings before the House Judiciary Committee last summer, a variety of normalization techniques exist which preserve eligibility, but which differ from the method advocated by the companies. The method ultimately adopted by the Commission, known as Average Annual Adjustment (AAA) and Annual Adjustment (AA) Normalization, was recommended to the Commission by the federal government, which appeared through the Secretary of Defense in our proceedings, as well as by the state Supreme Court itself. The method has received support from independent commentators as well.

What the normalization method adopted by the CPUC basically does is to assure that Congress' intent that tax benefits be treated as cost-free capital for the companies is carried out. Congress indicated its intention in this respect by stating specifically in 1969 that the normalization statute "in no way diminishes whatever power the (regulatory) agency may have to require that the deferred tax reserve be excluded from the base upon which the utility's permitted rate of return is calculated." Although the rules for investment credit normalization differ from those for accelerated depreciation in some respects, the differences do not bear significantly on the AAA and AA normalization method. The AAA and AA method differs from the method adopted in other states only in that it takes account of the growth that is likely to occur in the value of the companies' tax benefits over the several years that a set of rates is in effect, and adjusts the rate base accordingly. Under AAA and AA normalization the companies receive approximately two-thirds of what they would under their preferred method of normalization. The AAA and AA method is not a "flow-through" of tax benefits to consumers, which assertedly would result in ineligibility for the benefits; rather it represents a normalization method appropriate for an inflationary era. At this moment, of course, eligibility under this method is in doubt; that is the source of the uncertainty we face today.

HR 6806 is proposed as a legislative solution to this uncertainty. It would recognize the uncertainty of the existing statute as to the AAA and AA normalization method. This is accomplished by indicating that use of that method in the past would not constitute an impermissible method of normalization. For the future, however, such a normalization method would explicitly be ruled out, even where it was already in place.

Rather than eliminating uncertainty for the future, HR 6806 would create uncertainty. First, some have claimed that the CPUC since it acted under a remand order of the California Supreme Court, cannot cease implementing the AAA and AA

normalization method, since use of that method has been upheld by the California Supreme Court. In the event such claims, which are likely to be litigated soon, are upheld, the effect of HR 6806 would be to provide eligibility through 1980, but to certainly deny eligibility for the future. Second, even if the CPUC is free to change to another method of normalization, under the terms of the California Supreme Court's orders to us we may still be compelled to seek a method other than that traditionally advocated by the companies. Such a course will only produce another round of uncertainty much like we face today. Third, even if the CPUC were to grant the companies the method of normalization they prefer, intervenors surely would again sue and take the matter to the California Supreme Court. This very issue has been before that court on three occasions during the last decade, and on each occasion the court has ruled either unanimously or by 6–1 vote that CPUC adoption of the company-preferred normalization method is inappropriate if alternatives exist. Those decisions were all issued during the years when many of the court's members had been appointed by President-elect Reagan. Personnel shifts on the court since that time do not make it likely that the court would overturn those earlier rulings. I am sure that this Committee does not wish merely to produce new uncertainty. That, however, is the likely result of HR 6806.

In considering alternatives to HR 6806 it is important to keep in mind both that the circumstances which produced the situation in California predate passage of the 1969 normalization statute, and that it is desirable to fashion a legislative solution to the present problem which will resolve it prospectively as well as retrospectively.

Throughout the 1960's California's Public Utilities Commission attempted to flow-through to customers the companies' tax benefits. The companies resisted by refusing to elect tax benefits. In response, the Commission in 1968, following a similar action by the Federal Power Commission which had been upheld in federal court, imputed flow-through accounting to the companies. The federal normalization laws, passed in 1969 and 1971, included a "grandfather" clause which permitted continued use of flow-through where that method was actually in use, but not where its use was merely imputed. The Congress justified this provision on the grounds that "there are a limited number of cases . . . where a regulated company particularly needs to maintain a low rate for consumers, and has under prior law flowed the benefits of fast depreciation through currently to customers." Because they had refused to elect tax benefits, General Telephone and Pacific Telephone, unique among California utilities, did not qualify under the terms of the "grandfather" clause. It was the companies' action in this regard, prior to the 1969 statute, that engendered the three Supreme Court rulings, and the finding by the court of "imprudence" and "mismanagement." The result is the present situation, including adoption by California of a normalization method providing a substantial part of the benefits the companies would receive under their preferred method, but which raises eligibility questions.

There is an alternative to HR 6806 which would provide a fair, equitable and final resolution of the uncertainties referred to above, prospectively as well as retrospectively. We believe that the appropriate solution is to freeze the status quo, thereby recognizing the uniqueness of the situation which has arisen. This would permit continuing use of AAA and AA normalization by companies already employing that method, while allowing Congress to clearly state its position regarding the appropriateness of use of that method by additional taxpayers.

Such a solution would be limited in effect to the unique circumstances of the instant situation, and certainly would not open the door for other states to follow such a line. In fact no on-going desire on the part of other states to adopt AAA and AA normalization is evident; the situation you are addressing is a unique one. The only difference such a solution would have from HR 6806 is that it would provide certainty for the future as well as for the past. Like HR 6806, such legislation could clearly spell out whether such a method would be appropriate or inappropriate for use elsewhere.

This approach would permanently solve the problem that has arisen in California in a manner which preserves for the companies the greater share of the benefits they would have received through use of their preferred normalizaiton method, while maintaining the integrity of Congress' commitment to normalization accounting in an era of capital shortage. At the same time, it would allow in California the continued use of the only normalization method which has been upheld by the California Supreme Court.

We respectfully urge the Committee to adopt such a solution as soon as possible.

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