MISCELLANEOUS TAX BILLS IX

HEARINGS

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-SIXTH CONGRESS

SECOND SESSION

ON

S. 2512, S. 2900, S. 2915, S. 2916, S. 3070, S. 3076, S. 3080, H.R. 6883

SEPTEMBER 10, 1980

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MISCELLANEOUS TAX BILLS IX

WEDNESDAY, SEPTEMBER 10, 1980

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

The subcommittee met, pursuant to call, at 9 a.m., in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the subcommittee) presiding.

Present: Senators Byrd and Dole.

[The press releases announcing this hearing and the bills S. 2512, S. 2900, S. 2915, S. 2916, S. 3070, S. 3076, S. 3080 and H.R. 6883 and the description of H.R. 6883 follow:]

Press Release #H-45

P R E S S R E L E A S E

FOR IMMEDIATE RELEASE
August 6, 1980

COMMITTEE ON FINANCE
UNITED STATES SENATE
Subcommittee on Taxation and Debt Management
2227 Dirksen Senate Office Bldg.

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARING ON H.R. 6883, THE INSTALLMENT SALES REVISION ACT OF 1980

Senator Harry F. Byrd, Jr., 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 Wednesday, September 10, 1980, on H.R. 6883, the Installment Sales Revision Act of 1980.

The hearing will begin at 9:00 A.M. in Room 2221 of the Dirksen Senate Office Building.

Senator Byrd noted that on June 22, 1979, the Subcommittee held a hearing on proposals to simplify the tax laws. One of the proposals, simplifying certain aspects of tax procedure and administration, was enacted in December 1979 as part of P.L. 96-167.

Another bill considered in June 1979 was S. 1063, introduced by Senators Long and Dole, dealing with the simplification and improvement of the rules for installment sales of property. Although the testimony at the June 1979 hearing was generally favorable to the concept of the bill, there was also substantial criticism of a provision on sales to related parties and recommendations that additional topics should be covered.

On March 19, 1980, Senators Long and Dole introduced a revised bill, S. 2451, reflecting the criticisms and suggestions made at the Subcommittee hearing. A companion bill, H.R. 6883, was introduced at the same time in the House of Representatives by Messrs. Ullman, Conable, Rostenkowski, and Duncan. The latter bill has passed the House and has been referred to the Committee on Finance.

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 September 2, 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 September 12, 1980.

P.R. #H-45

Press Release #H-47

PRESS RELEASE

FOR IMMEDIATE RELEASE
August 26, 1980

COMMITTEE ON FINANCE
UNITED STATES SENATE
Subcommittee on Taxation and Debt Management
2227 Dirksen Senate Office Bldg.

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARING FOR S. 2512, S. 2900, S. 2915 AND S. 2916

Senator Harry F. Byrd, Jr., Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance announced today that the hearing scheduled for Wednesday, September 10, 1980, on H.R. 6883, the Installment Sales Revision Act of 1980 (Press Release #H-45, August 6, 1980), has been expanded to include S. 2512, S. 2900, S. 2915 and S. 2916.

The hearing will begin at 9:00 a.m. in Room 2221 of the Dirksen Senate Office Building as previously announced.

The following pieces of legislation of general application will be considered. Revenue estimates will be available at the time of the hearing.

S. 2512 -- Introduced by Senator Mathias. Would allow architects, engineers and other design professionals to deduct from gross income money paid into a self-insurance fund set up to cover service liability losses and expenses.

S. 2900 -- Introduced by Senator Mathias. Would extend the exemption from the Federal Unemployment Tax Act to officers and crew of vessels between 10 and 15 tons when such vessels are subject to the same restrictions as vessels under 10 tons.

S. 2915 -- Introduced by Senator Roth. Would provide that for purposes of Sec. 904 (relating to the limitations on the foreign tax credit), gain from the disposition of a patent, copyright or other similar property right which would otherwise qualify as a Sec. 1231 asset, shall be treated as ordinary income rather than as capital gain.

S. 2916 -- Introduced by Senators Dole and Talmadge. Would allow the investment tax credit, to the extent it is attributable to the active conduct of a trade or business, to be claimed against alternative minimum tax liability on a current basis.

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 September 2, 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.

<u>Legislative Reorganization Act</u> -- 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 September 12, 1980.

96TH CONGRESS
2D SESSION

S. 2512

To amend the Internal Revenue Code of 1954 to provide for a deduction for certain amounts paid into a reserve for service liability losses and expenses of design professionals, to provide a deduction for certain amounts paid to captive insurers, and for other purposes.

IN THE SENATE OF THE UNITED STATES

APRIL 1 (legislative day, JANUARY 3), 1980

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

---

A BILL

To amend the Internal Revenue Code of 1954 to provide for a deduction for certain amounts paid into a reserve for service liability losses and expenses of design professionals, to provide a deduction for certain amounts paid to captive insurers, and for other purposes.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. SHORT TITLE.**
4 This Act may be cited as the "Service Liability Partial
5 Self-Insurance Act of 1980".

1 SEC. 2. SELF-INSURANCE FOR SERVICE LIABILITY LOSSES.

2 (a) LOSS DEDUCTION ALLOWED FOR CONTRIBUTIONS
3 TO TRUST.—Section 165 of the Internal Revenue Code of
4 1954 (relating to losses) is amended by redesignating subsec-
5 tion (i) as subsection (j) and by inserting immediately after
6 subsection (h) the following new subsection:

7 "(i) SELF-INSURANCE FOR SERVICE LOSSES AND EX-
8 PENSES.—

9 "(1) GENERAL RULE.—In the case of an eligible
10 taxpayer who elects the benefits of this subsection for
11 the taxable year (in accordance with regulations pre-
12 scribed by the Secretary), there shall be allowed as a
13 deduction under subsection (a) the sum of any amounts
14 (other than rollover amounts described in paragraph
15 (5)(C))—

16 "(A) transferred by the taxpayer for such
17 taxable year to his service liability trust, and

18 "(B) paid by the taxpayer for such taxable
19 year to a captive insurer with respect to the serv-
20 ice liability of the taxpayer.

21 "(2) ELIGIBLE TAXPAYER.—For purposes of this
22 subsection, the term 'eligible taxpayer' means any
23 person who is engaged in a trade or business which in-
24 volves the furnishing of services (within the meaning of
25 paragraph (10)(A)).

1 "(3) LIMITATION.—The amount of the deduction
2 allowable because of paragraph (1) shall not exceed the
3 amounts specified in subparagraph (A) or (B) of this
4 paragraph, whichever is applicable.
5 "(A) TAXPAYER WITH SEVERE SERVICE LI-
6 ABILITY INSURANCE PROBLEM.—In the case of a
7 taxpayer who has a severe service liability insur-
8 ance problem (as defined in paragraph (10)(E)) for
9 the taxable year, the amount for such taxpayer
10 determined under paragraph (1) shall not exceed
11 the least of—
12 "(i) 5 percent of the gross receipts of
13 the taxpayer for such taxable year from the
14 furnishing of services with respect to which
15 the taxpayer may incur any service liability,
16 "(ii) the amount which when added to
17 the sum of—
18 "(I) the balance of the taxpayer's
19 service liability trust, and
20 "(II) the net contributions of the
21 taxpayer to a captive insurer, if any,
22 equals 15 percent of the taxpayer's average
23 yearly gross receipts from the furnishing of
24 services during the base period, or
25 "(iii) $100,000.

1 "(B) OTHER TAXPAYERS.—In the case of a
2 taxpayer who does not have a severe service lia-
3 bility insurance problem for the taxable year, the
4 amount determined under paragraph (1) shall not
5 exceed the least of—
6 "(i) 2 percent of the gross receipts of
7 the taxpayer for such taxable year from the
8 furnishing of services with respect to which
9 the taxpayer may incur any service liability,
10 "(ii) the amount which, when added to
11 the sum of—
12 "(I) the balance of the taxpayer's
13 service liability trust, and
14 "(II) the net contributions of the
15 taxpayer to a captive insurer, if any,
16 equals 10 percent of the taxpayer's average
17 yearly gross receipts from the furnishing of
18 services during the base period, or
19 "(iii) $25,000.
20 "(C) BASE PERIOD.—For the purpose of this
21 paragraph, the term 'base period' means the
22 shorter of—
23 "(i) the period beginning with the earli-
24 est preceding taxable year for which the tax-

1 payer elected to have this subsection apply
2 and ending with the current taxable year, or
3 "(ii) the 5-year period which includes
4 the current taxable year and the 4 taxable
5 years immediately preceding the current tax-
6 able year.
7 "(4) TREATMENT OF DISTRIBUTIONS FROM A
8 SERVICE LIABILITY ACCOUNT.—
9 "(A) IN GENERAL.—If any amount in a
10 service liability account is distributed during a
11 taxable year—
12 "(i) the amount of the distribution (other
13 than amounts described in paragraph (5)(A)
14 and rollover amounts described in paragraph
15 (5)(C)) shall be included in the gross income
16 of the taxpayer from whose account the dis-
17 tribution is made, and
18 "(ii) the distribution shall not be
19 treated, for the purpose of determining the
20 amount of the deduction allowable for the
21 taxable year under subsection (a) (determined
22 without reference to this subsection), as com-
23 pensation by insurance or otherwise.
24 "(B) PENALTY FOR UNAUTHORIZED DISTRI-
25 BUTION.—Except as provided in paragraph (5),

1 the liability of the taxpayer for the tax imposed
2 by this chapter for the taxable year shall be in-
3 creased by an amount equal to 10 percent of the
4 excess (if any) of—
5 "(i) the amount distributed to the tax-
6 payer for the taxable year from a service lia-
7 bility account, over
8 "(ii) the amount of the deductions al-
9 lowable for the taxable year which are at-
10 tributable to service liability losses (within
11 the meaning of paragraph (10)(C)).
12 "(5) EXCEPTIONS.—
13 "(A) CORRECTIVE WITHDRAWAL OF
14 EXCESS CONTRIBUTIONS.—Subparagraph (B) of
15 paragraph (4) shall not apply to amounts dis-
16 tributed from any service liability account no later
17 than the last day prescribed by law for filing the
18 taxpayer's return with respect to the tax imposed
19 by this chapter for the taxable year (including ex-
20 tensions thereof) to the extent that the amount of
21 such distribution is not more than the excess of—
22 "(i) the aggregate amount of payments
23 by the taxpayer to such account for the tax-
24 able year, over

1 "(ii) the maximum amount of such pay-
2 ments which may be deducted under para-
3 graph (3).
4 "(B) CHANGE IN CIRCUMSTANCES.—Sub-
5 paragraph (B) of paragraph (4) shall not apply to
6 a distribution from a service liability account if
7 the taxpayer establishes, in accordance with regu-
8 lations prescribed by the Secretary, that—
9 "(i) there was reasonable cause for the
10 creation of the service liability account, and
11 "(ii) there has been a change in circum-
12 stances concerning the taxpayer so that the
13 continued maintenance of such an account no
14 longer serves a trade or business purpose.
15 No exception shall be granted under this subpara-
16 graph while any amounts are accumulated by the
17 taxpayer pursuant to the second sentence of sec-
18 tion 537(b)(4).
19 "(C) ROLLOVER AMOUNTS.—Subparagraph
20 (B) of paragraph (4) shall not apply to a distribu-
21 tion from a service liability account to the extent
22 that all or any portion of the distribution is trans-
23 ferred by the taxpayer to another service liability
24 account of the taxpayer not later than the 90th
25 day after the day on which he receives such dis-

1 tribution. This subparagraph shall not apply to
2 any amount distributed from a service liability ac-
3 count if at any time during the 1-year period
4 ending on the day of such distribution any other
5 distribution to the taxpayer was not subject to
6 paragraph (4)(B) on account of this subparagraph.
7 "(D) COMPLETE LIQUIDATION.—Subpara-
8 graph (B) of paragraph (4) shall not apply to a
9 distribution from a service liability account made
10 on account of the liquidation of the trade or busi-
11 ness of the taxpayer which may result in service
12 liability. The Secretary may prescribe regulations
13 providing the extent to which this subparagraph
14 shall not apply to amounts distributed to a tax-
15 payer who remains subject to outstanding service
16 liability claims.
17 "(E) DEEMED DISTRIBUTIONS.—Subpara-
18 graph (B) of paragraph (4) shall not apply to
19 amounts treated as a distribution under paragraph
20 (6).
21 "(6) SALE MAY BE TREATED AS A DISTRIBU-
22 TION.—The Secretary may prescribe regulations speci-
23 fying facts and circumstances under which the service
24 liability account of an eligible taxpayer shall be deemed
25 to be distributed. Such regulations shall apply only

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1 where there is a transfer (in one transaction, or in a
2 series of related transactions) of more than 50 percent
3 of the control of the trade or business which is the
4 beneficiary of the service liability account. For pur-
5 poses of this paragraph, 'control' means—
6 "(A) voting stock, in the case of a corpora-
7 tion, or
8 "(B) capital or profits interest in the case of
9 a partnership or sole proprietorship.
10 "(7) TIME WHEN PAYMENTS DEEMED MADE.—
11 For purposes of this subsection, a taxpayer shall be
12 deemed to have made a payment to his service liability
13 account on the last day of the preceding taxable year if
14 the payment is made on account of such taxable year
15 and is made not later than the time prescribed by law
16 for filing the return for such taxable year (including ex-
17 tensions thereof).
18 "(8) PAYMENTS TO ACCOUNT TO BE IN CASH.—
19 No deduction shall be allowed under paragraph (1)
20 with respect to any payment to a taxpayer's service li-
21 ability account other than a payment in cash.
22 "(9) SPECIAL RULE FOR CONTROLLED
23 GROUPS.—
24 "(A) IN GENERAL.—For purposes of para-
25 graph (3)—

1 "(i) in the case of any taxpayer who,
2 during a taxable year, is a member of a con-
3 trolled group of corporations, only gross re-
4 ceipts properly attributable under section
5 482 to such taxpayer for such year shall be
6 taken into account; and
7 "(ii) the aggregate deductions under this
8 subsection taken by all of the members of a
9 controlled group of corporations for each tax-
10 able year shall be limited to the amount that
11 would be permitted under paragraph (3) if all
12 the component members of such group were
13 considered to be a single taxpayer.
14 "(B) DEFINITION OF CONTROLLED
15 GROUP.—For the purpose of subparagraph (A),
16 the term 'controlled group of corporations' has the
17 meaning given such term by paragraphs (1), (2),
18 and (3) of subsection (a) of section 1563.
19 "(C) DETERMINATION OF CONTROLLED
20 STATUS.—The determination of whether a tax-
21 payer is a member of a controlled group of corpo-
22 rations for a taxable year shall be made on the
23 December 31 which is included in such year.
24 "(D) CONTROLLED GROUPS CONTAINING
25 PERSONS OTHER THAN CORPORATIONS.—Under

1 regulations prescribed by the Secretary, principles
2 similar to the principles of subparagraphs (A), (B),
3 and (C) shall be applied to groups of taxpayers
4 under common control where one or more of such
5 taxpayers is not a corporation.
6 "(10) DEFINITIONS.—For purposes of this sub-
7 section—
8 "(A) SERVICE.—The term 'service' means
9 any service furnished by the taxpayer in the pro-
10 fessional design, surveying, planning, evaluation,
11 preparation of studies or specifications, or admin-
12 istration of a contract, for the construction or
13 modification of any building or structure on real
14 property.
15 "(B) SERVICE LIABILITY.—The term 'serv-
16 ice liability' means liability for damages arising
17 out of physical injury or emotional harm to indi-
18 viduals or damage to or loss of the use of prop-
19 erty attributable to negligence in, breach of war-
20 ranty regarding, or defects in the professional
21 design, planning, evaluation, preparation of speci-
22 fications, or administration of a contract, by the
23 taxpayer (whether in whole or in part) for the
24 construction or modification of buildings or struc-
25 tures on real property.

1 "(C) SERVICE LIABILITY LOSS.—The term
2 'service liability loss' means any loss attributable
3 to the service liability of the taxpayer, includ-
4 ing—
5 "(i) payment on any claim against the
6 taxpayer for service liability,
7 "(ii) expenses incurred in the investiga-
8 tion, settlement, and defense of any claims
9 against the taxpayer for service liability, and
10 "(iii) administrative and other incidental
11 expenses of a service liability account in con-
12 nection with the operation of the account and
13 the processing of claims against the
14 taxpayer.
15 "(D) SERVICE LIABILITY TRUST.—The term
16 'service liability trust' means any trust—
17 "(i) established in writing which is cre-
18 ated or organized under the laws of the
19 United States or of any State (including the
20 District of Columbia) by the taxpayer;
21 "(ii) the trustee of which is a bank (as
22 defined in section 581) or another person
23 (other than the taxpayer or any component
24 member of a controlled group of corpora-
25 tions, within the meaning of paragraph (9),

1 of which the taxpayer is a member) who
2 demonstrates to the satisfaction of the Secre-
3 tary that the manner in which that other
4 person will administer the trust will be con-
5 sistent with the purposes for which the trust
6 is established;
7 "(iii) the exclusive purpose of which is
8 to satisfy, in whole or in part, the service li-
9 ability losses sustained by the taxpayer;
10 "(iv) the assets of which will not be
11 commingled with any other property other
12 than in a common trust fund (as defined in
13 section 584) and will only be invested as
14 permitted in paragraph (11); and
15 "(v) the assets of which may not be
16 borrowed, used as security for a loan, or oth-
17 erwise used by the taxpayer for any purpose
18 other than that described in clause (iii).
19 "(E) SEVERE SERVICE LIABILITY INSUR-
20 ANCE PROBLEM.—A taxpayer has a severe serv-
21 ice liability insurance problem for a taxable year
22 if, for such taxable year—
23 "(i) the taxpayer is unable to obtain a
24 premium quotation for service liability insur-
25 ance, with coverage of up to $1,000,000,

1 with a reasonable deductible amount (but in
2 no case with a deductible amount greater
3 than the premium), from any insurer other
4 than a captive insurer, or
5 "(ii) the lowest insurance premium quo-
6 tation for service liability insurance, with
7 coverage of up to $1,000,000, with a rea-
8 sonable deductible amount (but in no case
9 with a deductible amount greater than the
10 premium), obtained by the taxpayer was
11 equal to more than 2 percent of the gross re-
12 ceipts of the taxpayer for such taxable year.
13 "(F) CAPTIVE INSURER.—The term 'captive
14 insurer' means any insurer—
15 "(i) which is directly or indirectly—
16 "(I) wholly owned by the taxpay-
17 er, or by members of a controlled
18 group, within the meaning of paragraph
19 (9), of which the taxpayer is a member,
20 or
21 "(II) wholly owned by an associ-
22 ation described in section 501(c)(6) of
23 which the taxpayer is a member,
24 "(ii) which is licensed to provide service
25 liability insurance to the taxpayer under the

1 laws of a State of the United States, or of
2 the District of Columbia,
3 "(iii) the exclusive purpose of which is
4 to provide insurance for service liability
5 losses, and
6 "(iv) the assets of which may not be
7 borrowed, used as security for a loan, or oth-
8 erwise used by any taxpayer who has paid
9 amounts into the captive insurer for any pur-
10 pose other than that described in clause (iii).
11 "(G) NET CONTRIBUTIONS OF A TAXPAYER
12 TO CAPTIVE INSURER.—The term 'net contribu-
13 tions of a taxpayer to a captive insurer' means
14 the sum of all premiums paid by the taxpayer to a
15 captive insurer, less all amounts paid by the cap-
16 tive insurer for service liability losses of the tax-
17 payer.
18 "(H) SERVICE LIABILITY ACCOUNT.—The
19 term 'service liability account' includes a 'service
20 liability trust' and a 'captive insurer'.
21 "(11) RESTRICTIONS ON INVESTMENTS OF
22 ASSETS.—The assets of a service liability account may
23 not be invested in anything other than—
24 "(A) public debt securities of the United
25 States,

1 "(B) obligations of a State or local govern-
2 ment which are not in default as to principal or
3 interest,
4 "(C) time or demand deposits in a bank (as
5 defined in section 581) insured by the Federal De-
6 posit Insurance Corporation, a savings and loan
7 association insured by the Federal Savings and
8 Loan Insurance Corporation, or an insured credit
9 union (as defined in section 101(6) of the Federal
10 Credit Union Act) located in the United States, or
11 "(D) any other asset which, under the laws
12 of the State where the service liability trust or
13 captive insurer is organized, is a permissible sub-
14 ject for investment by trustees or fiduciaries ad-
15 ministering a trust within such jurisdiction, other
16 than the stock or securities of, or a capital inter-
17 est in, any eligible taxpayer contributing to that
18 account.".
19 (b) TAX-EXEMPT STATUS FOR SERVICE LIABILITY
20 TRUST AND CAPTIVE INSURER.—Subsection (c) of section
21 501 of the Internal Revenue Code of 1954 (relating to orga-
22 nizations exempt from tax) is amended by adding at the end
23 thereof the following new paragraphs:
24 "(22) A service liability trust (within the meaning
25 of section 165(i)(10)(D)).

1 "(23) A captive insurer (within the meaning of
2 section 165(i)(10)(F)).".

3 (c) ACCUMULATED EARNINGS TAX.—Paragraph (4) of
4 section 537(b) of the Internal Revenue Code of 1954 (relat-
5 ing to the accumulated earnings tax) is amended to read as
6 follows:

7 "(4) SERVICE LIABILITY LOSS RESERVES OR IN-
8 SURANCE.—Amounts accumulated in a taxpayer's
9 service liability trust and amounts paid by a taxpayer
10 to a captive insurer for liability insurance shall be
11 treated as amounts accumulated for the reasonably an-
12 ticipated needs of the business of the taxpayer to the
13 extent those amounts are deductible under the rules of
14 section 165(i). The accumulation of reasonable
15 amounts, in addition to amounts deductible under sec-
16 tion 165(i), for the payment of reasonably anticipated
17 service liability losses (as defined in section
18 165(i)(10)(C)), as determined under regulations pre-
19 scribed by the Secretary, shall be treated as accumu-
20 lated for the reasonably anticipated needs of the busi-
21 ness.".

22 **SEC. 3. EFFECTIVE DATE.**

23 The amendments made by section 2 of this Act shall
24 apply with respect to taxable years beginning after the date
25 of enactment of this Act.

96TH CONGRESS
2D SESSION

S. 2900

To amend the Internal Revenue Code of 1954 to exempt officers and crewmembers of fishing vessels up to fifteen tons from the provisions of the Federal Unemployment Tax Act.

IN THE SENATE OF THE UNITED STATES

JUNE 28 (legislative day, JUNE 12), 1980

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

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A BILL

To amend the Internal Revenue Code of 1954 to exempt officers and crewmembers of fishing vessels up to fifteen tons from the provisions of the Federal Unemployment Tax Act.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That (a) section 3306(c)(17)(B) of the Internal Revenue Code
4 of 1954 (relating to definition of employment under the Fed-
5 eral Unemployment Tax Act) is amended by inserting after
6 "10 net tons", the following: ", or more than 15 net tons if
7 the area in which such vessel operates has fishing manage-
8 ment regulations and catch limitations for vessels from 10 to

1 15 net tons which are the same as those regulations and
2 limitations for fishing vessels under 10 net tons,".
3 (b) The amendment made by this Act shall be effective
4 with respect to service performed after the date of the enact-
5 ment of this Act.

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II

96TH CONGRESS
2D SESSION

S. 2915

To amend the Internal Revenue Code of 1954 to provide that gains from the sales of patents to unrelated persons should be treated in the same manner as ordinary income from the sale or licensing of patents.

IN THE SENATE OF THE UNITED STATES

JULY 1 (legislative day, JUNE 12), 1980

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

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A BILL

To amend the Internal Revenue Code of 1954 to provide that gains from the sales of patents to unrelated persons should be treated in the same manner as ordinary income from the sale or licensing of patents.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That (a) section 904(b)(3)(E) (relating to capital gains from
4 section 1231 assets for purposes of computing limitation on
5 credit) is amended by striking out "under section 1231." and
6 inserting in lieu thereof "under section 1231 (other than gain
7 from the sale, exchange, or other disposition of a patent, an

1 invention, model, or design (whether or not patented), a
2 copyright, a secret formula or process, or any other similar
3 property right)."
4 (b) The amendment made by this section shall apply to
5 taxable years beginning after December 31, 1977.

II

96TH CONGRESS
2D SESSION

S. 2916

To amend the Internal Revenue Code of 1954 to provide that the investment tax credit may be claimed against the alternative minimum tax to the extent that it is attributable to the active conduct of a trade or business.

IN THE SENATE OF THE UNITED STATES

JULY 1 (legislative day, JUNE 12), 1980

Mr. DOLE (for himself and Mr. TALMADGE) introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to provide that the investment tax credit may be claimed against the alternative minimum tax to the extent that it is attributable to the active conduct of a trade or business.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. CREDIT ALLOWED.**
4 Subparagraph (C) of section 55(c)(3) of the Internal
5 Revenue Code of 1954 (relating to investment credit) is
6 amended to read as follows:

1 "(C) INVESTMENT CREDIT.—

2 "(i) IN GENERAL.—For the purpose of deter-
3 mining under section 46(b) the amount of any in-
4 vestment credit carryback or carryover to any
5 other taxable year, the amount of the limitation
6 under section 46(a)(3) for the current taxable year
7 shall be determined under this subparagraph.

8 "(ii) CREDIT ATTRIBUTABLE TO ACTIVE
9 CONDUCT OF A TRADE OR BUSINESS.—To the
10 extent that the amount of the credit allowable
11 under section 38 for the current taxable year is
12 attributable to the active conduct of a trade or
13 business by the taxpayer, the limitation under sec-
14 tion 46(a)(3) for the current taxable year shall be
15 determined by treating the net tax imposed by
16 this section as part of the tax imposed by this
17 chapter for the taxable year (within the meaning
18 of section 46(a)(4)).

19 "(iii) CREDIT ATTRIBUTABLE TO PASSIVE
20 INVESTMENT.—To the extent that the amount of
21 the credit allowable under section 38 for the cur-
22 rent taxable year is not attributable to the active
23 conduct of a trade or business by the taxpayer,
24 the limitation under section 46(a)(3) for the cur-
25 rent taxable year shall be deemed to be—

1 "(I) the amount of the credit allowable
2 under section 38 for the current taxable year
3 without regard to this clause, reduced by
4 "(II) an amount equal to the lesser of—
5 "(A) the amount of the credit al-
6 lowable under section 38 for the current
7 taxable year without regard to this
8 clause, or
9 "(B) the net tax imposed by this
10 section for the current taxable year re-
11 duced by the sum of the amounts of re-
12 duction described in clause (ii) of sub-
13 paragraphs (A) and (B).".

14 **SEC. 2. EFFECTIVE DATE.**

15 The amendment made by section 1 shall apply with re-
16 spect to taxable years beginning after December 31, 1978.

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II

96TH CONGRESS
2D SESSION

S. 3070

To amend the Revenue Act of 1978 with respect to foreign tax credit adjustments for capital gains.

IN THE SENATE OF THE UNITED STATES

AUGUST 26 (legislative day, JUNE 12), 1980

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

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A BILL

To amend the Revenue Act of 1978 with respect to foreign tax credit adjustments for capital gains.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That (a) section 701(u)(2)(C) (relating to foreign tax credit
4 adjustments for capital gains) of the Revenue Act of 1978 is
5 amended—
6 (i) by inserting "AND GAIN FROM SALE OF STOCK
7 OF CERTAIN FOREIGN SUBSIDIARIES" after "GAIN
8 FROM LIQUIDATION OF CERTAIN FOREIGN CORPORA-
9 TIONS";

1 (ii) by inserting "either" after "shall not apply
2 with respect to";
3 (iii) by inserting "or a sale of at least 80 percent
4 of the total number of shares of all classes of stock of a
5 foreign corporation," after "to which part II of sub-
6 chapter C applies"; and
7 (iv) by inserting "or sale" after "during which the
8 distribution".
9 (b) EFFECTIVE DATE.—The amendments made by sec-
10 tion (a) shall apply to taxable years beginning after December
11 31, 1975.

96TH CONGRESS
2D SESSION

S. 3076

To provide an exemption from the tax on failure to distribute income by, and on excess business holdings of, a private foundation under the Internal Revenue Code of 1954.

IN THE SENATE OF THE UNITED STATES

AUGUST 26 (legislative day, JUNE 12), 1980

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

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A BILL

To provide an exemption from the tax on failure to distribute income by, and on excess business holdings of, a private foundation under the Internal Revenue Code of 1954.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 That (a) sections 4942 (relating to taxes on failure to distrib-
4 ute income) and 4943 (relating to taxes on excess business
5 holdings) of the Internal Revenue Code of 1954 shall not
6 apply to a private foundation described in subsection (b).
7 (b) A private foundation is described in this subsection
8 if—

1 (1) the foundation was organized before Janu-
2 ary 1, 1950,
3 (2) the foundation received by bequest before Jan-
4 uary 1, 1958, all of the outstanding stock of a manu-
5 facturing corporation (subject to intervening life estates
6 which terminated before January 1, 1972),
7 (3) the foundation is located in a community
8 which, as of the 1980 decennial census, had a popula-
9 tion of fewer than 10,000 persons,
10 (4) the foundation employed, as of January 1,
11 1980, fewer than 200 employees, and
12 (5) the corporation described in paragraph (2)
13 pays dividends for the calendar year with or within
14 which the taxable year of the formulation ends in an
15 amount equal to at least 30 percent of the average
16 annual earnings of that corporation for the 3-year
17 period ending with the calendar year.
18 SEC. 2. The first section of this Act shall apply with
19 respect to taxable years beginning after December 31, 1979.

96TH CONGRESS
2D SESSION

S. 3080

To amend the Internal Revenue Code of 1954 to provide for the annual imposition and payment of the gift tax.

IN THE SENATE OF THE UNITED STATES

SEPTEMBER 3 (legislative day JUNE 12), 1980

Mr. HARRY F. BYRD, JR. introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1954 to provide for the annual imposition and payment of the gift tax.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. IMPOSITION OF TAX ON ANNUAL BASIS.**
4 (a) IN GENERAL.—Subchapter A of chapter 12 of the
5 Internal Revenue Code of 1954 (relating to determination of
6 tax liability) is amended by adding at the end thereof the
7 following new section:

1 "SEC. 2506. ANNUAL DETERMINATION OF GIFT TAX LIABILITY.

2 "Notwithstanding any other provision of this chapter,
3 the tax imposed by section 2501(a)(1) shall be imposed on a
4 calendar year, rather than quarterly, basis. All references in
5 this chapter to calendar quarter shall, in accordance with
6 regulations prescribed by the Secretary, be disregarded to the
7 extent that they are inconsistent with the preceding
8 sentence.".

9 (b) CLERICAL AMENDMENT.—The table of sections for
10 such subchapter is amended by adding at the end thereof the
11 following new item:

"Sec. 2506. Annual determination of gift tax liability.".

12 SEC. 2. FILING REQUIREMENT.

13 Section 6019 of the Internal Revenue Code of 1954
14 (relating to gift tax returns) is amended by adding at the end
15 thereof the following new subsection:

16 "(d) ANNUAL RETURNS.—Notwithstanding any other
17 provision of this section, the return requirement imposed by
18 subsection (a) shall be applied, under regulations prescribed
19 by the Secretary, on a calendar year, rather than quarterly,
20 basis.".

21 SEC. 3. TECHNICAL AND CONFORMING CHANGES.

22 The Secretary of the Treasury shall, within 90 days
23 after the date of enactment of this Act, submit to the Com-
24 mittee on Ways and Means of the House of Representatives,
25 and to the Committee on Finance of the Senate, a draft of

1 any technical and conforming changes in the Internal Reve-
2 nue Code of 1954 which are necessary to reflect throughout
3 such Code the changes in the substantive provisions of law
4 made by this Act.

5 **SEC. 4. EFFECTIVE DATE.**

6 The amendments made by this Act shall apply with re-
7 spect to gifts made after the date of enactment of this Act.

96TH CONGRESS
2D SESSION

H. R. 6883

IN THE SENATE OF THE UNITED STATES

JUNE 20 (legislative day, JUNE 12), 1980

Read twice and referred to the Committee on Finance

AN ACT

To amend the Internal Revenue Code of 1954 to revise the rules relating to certain installment sales.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*
3 **SECTION 1. SHORT TITLE; AMENDMENT OF 1954 CODE.**
4 (a) SHORT TITLE.—This Act may be cited as the "In-
5 stallment Sales Revision Act of 1980".
6 (b) AMENDMENT OF 1954 CODE.—Except as otherwise
7 expressly provided, whenever in this Act an amendment or
8 repeal is expressed in terms of an amendment to, or repeal of,
9 a section or other provision, the reference shall be considered

1 to be made to a section or other provision of the Internal
2 Revenue Code of 1954.

3 **SEC. 2. INSTALLMENT SALES RULES.**

4 (a) GENERAL RULE.—Subpart B of part II of sub-
5 chapter E of chapter 1 is amended by striking out section
6 453 and inserting in lieu thereof the following new sections:

7 **"SEC. 453. INSTALLMENT METHOD.**

8 "(a) GENERAL RULE.—Except as otherwise provided
9 in this section, income from an installment sale shall be taken
10 into account for purposes of this title under the installment
11 method.

12 "(b) INSTALLMENT SALE DEFINED.—For purposes of
13 this section—

14 "(1) IN GENERAL.—The term 'installment sale'
15 means a disposition of property where at least 1 pay-
16 ment is to be received after the close of the taxable
17 year in which the disposition occurs.

18 "(2) EXCEPTIONS.—The term 'installment sale'
19 does not include—

20 "(A) DEALER DISPOSITION OF PERSONAL
21 PROPERTY.—A disposition of personal property
22 on the installment plan by a person who regularly
23 sells or otherwise disposes of personal property on
24 the installment plan.

1 "(B) INVENTORIES OF PERSONAL PROP-
2 ERTY.—A disposition of personal property of a
3 kind which would properly be included in the in-
4 ventory of the taxpayer if on hand at the close of
5 the taxable year.

6 "(c) INSTALLMENT METHOD DEFINED.—For purposes
7 of this section, the term 'installment method' means a method
8 under which the income recognized for any taxable year from
9 a disposition is that proportion of the payments received in
10 that year which the gross profit (realized or to be realized
11 when payment is completed) bears to the total contract price.

12 "(d) ELECTION OUT.—

13 "(1) IN GENERAL.—Subsection (a) shall not apply
14 to any disposition if the taxpayer elects to have subsec-
15 tion (a) not apply to such disposition.

16 "(2) TIME AND MANNER FOR MAKING ELEC-
17 TION.—Except as otherwise provided by regulations,
18 an election under paragraph (1) with respect to a dis-
19 position may be made only on or before the due date
20 prescribed by law (including extensions) for filing the
21 taxpayer's return of the tax imposed by this chapter
22 for the taxable year in which the disposition occurs.
23 Such an election shall be made in the manner pre-
24 scribed by regulations.

1 "(3) ELECTION REVOCABLE ONLY WITH CON-
2 SENT.—An election under paragraph (1) with respect
3 to any disposition may be revoked only with the con-
4 sent of the Secretary.
5 "(e) SECOND DISPOSITIONS BY RELATED PERSONS.—
6 "(1) IN GENERAL.—If—
7 "(A) any person disposes of property to a re-
8 lated person (hereinafter in this subsection re-
9 ferred to as the 'first disposition'), and
10 "(B) before the person making the first dis-
11 position receives all payments with respect to
12 such disposition, the related person disposes of the
13 property (hereinafter in this subsection referred to
14 as the 'second disposition'),
15 then, for purposes of this section, the amount realized
16 with respect to such second disposition shall be treated
17 as received at the time of the second disposition by the
18 person making the first disposition.
19 "(2) 2-YEAR CUTOFF FOR PROPERTY OTHER
20 THAN MARKETABLE SECURITIES.—
21 "(A) IN GENERAL.—Except in the case of
22 marketable securities, paragraph (1) shall apply
23 only if the date of the second disposition is not
24 more than 2 years after the date of the first
25 disposition.

1 "(B) SUBSTANTIAL DIMINISHING OF RISK
2 OF OWNERSHIP.—The running of the 2-year
3 period set forth in subparagraph (A) shall be sus-
4 pended with respect to any property for any
5 period during which the related person's risk of
6 loss with respect to the property is substantially
7 diminished by—
8 "(i) the holding of a put with respect to
9 such property (or similar property),
10 "(ii) the holding by another person of a
11 right to acquire the property, or
12 "(iii) a short sale or any other transac-
13 tion.
14 "(3) LIMITATION ON AMOUNT TREATED AS RE-
15 CEIVED.—The amount treated for any taxable year as
16 received by the person making the first disposition by
17 reason of paragraph (1) shall not exceed the excess
18 of—
19 "(A) the lesser of—
20 "(i) the total amount realized with re-
21 spect to any second disposition of the
22 property occurring before the close of the
23 taxable year, or
24 "(ii) the total contract price for the first
25 disposition, over

1 "(B) the sum of—
2 "(i) the aggregate amount of payments
3 received with respect to the first disposition
4 before the close of such year, plus
5 "(ii) the aggregate amount treated as
6 received with respect to the first disposition
7 for prior taxable years by reason of this sub-
8 section.
9 "(4) FAIR MARKET VALUE WHERE DISPOSITION
10 IS NOT SALE OR EXCHANGE.—For purposes of this
11 subsection, if the second disposition is not a sale or ex-
12 change, an amount equal to the fair market value of
13 the property disposed of shall be substituted for the
14 amount realized.
15 "(5) LATER PAYMENTS TREATED AS RECEIPT OF
16 TAX PAID AMOUNTS.—If paragraph (1) applies for any
17 taxable year, payments received in subsequent taxable
18 years by the person making the first disposition shall
19 not be treated as the receipt of payments with respect
20 to the first disposition to the extent that the aggregate
21 of such payments does not exceed the amount treated
22 as received by reason of paragraph (1).
23 "(6) EXCEPTION FOR CERTAIN DISPOSITIONS.—
24 For purposes of this subsection—

1 "(A) REACQUISITIONS OF STOCK BY ISSU-
2 ING CORPORATION NOT TREATED AS FIRST DIS-
3 POSITIONS.—Any sale or exchange of stock to
4 the issuing corporation shall not be treated as a
5 first disposition.
6 "(B) INVOLUNTARY CONVERSIONS NOT
7 TREATED AS SECOND DISPOSITIONS.—A compul-
8 sory or involuntary conversion (within the mean-
9 ing of section 1033) and any transfer thereafter
10 shall not be treated as a second disposition if the
11 first disposition occurred before the threat or im-
12 minence of the conversion.
13 "(C) DISPOSITIONS AFTER DEATH.—Any
14 transfer after the earlier of—
15 "(i) the death of the person making the
16 first disposition, or
17 "(ii) the death of the person acquiring
18 the property in the first disposition,
19 and any transfer thereafter shall not be treated as
20 a second disposition.
21 "(7) EXCEPTION WHERE TAX AVOIDANCE NOT A
22 PRINCIPAL PURPOSE.—This subsection shall not apply
23 to a second disposition (and any transfer thereafter) if
24 it is established to the satisfaction of the Secretary that
25 neither the first disposition nor the second disposition

1 had as one of its principal purposes the avoidance of
2 Federal income tax.
3 "(8) EXTENSION OF STATUTE OF LIMITA-
4 TIONS.—The period for assessing a deficiency with re-
5 spect to a first disposition (to the extent such defi-
6 ciency is attributable to the application of this subsec-
7 tion) shall not expire before the day which is 2 years
8 after the date on which the person making the first dis-
9 position furnishes (in such manner as the Secretary
10 may by regulations prescribe) a notice that there was a
11 second disposition of the property to which this subsec-
12 tion may have applied. Such deficiency may be as-
13 sessed notwithstanding the provisions of any law or
14 rule of law which would otherwise prevent such as-
15 sessment.
16 "(f) DEFINITIONS AND SPECIAL RULES.—For pur-
17 poses of this section—
18 "(1) RELATED PERSON.—The term 'related
19 person' means a person whose stock would be at-
20 tributed under section 318(a) (other than paragraph (4)
21 thereof) to the person first disposing of the property.
22 "(2) MARKETABLE SECURITIES.—The term
23 'marketable securities' means any security for which,
24 as of the date of the disposition, there was a market on
25 an established securities market or otherwise.

1 "(3) PAYMENT.—Except as provided in para-
2 graph (4), the term 'payment' does not include the re-
3 ceipt of evidences of indebtedness of the person acquir-
4 ing the property.
5 "(4) PURCHASER EVIDENCES OF INDEBTEDNESS
6 PAYABLE ON DEMAND OR READILY TRADABLE.—Re-
7 ceipt of a bond or other evidence of indebtedness
8 which—
9 "(A) is payable on demand, or
10 "(B) is issued by a corporation or a govern-
11 ment or political subdivision thereof and is readily
12 tradable,
13 shall be treated as receipt of payment.
14 "(5) READILY TRADABLE DEFINED.—For pur-
15 poses of paragraph (4), the term 'readily tradable'
16 means a bond or other evidence of indebtedness which
17 is issued—
18 "(A) with interest coupons attached or in
19 registered form (other than one in registered form
20 which the taxpayer establishes will not be readily
21 tradable in an established securities market), or
22 "(B) in any other form designed to render
23 such bond or other evidence of indebtedness read-
24 ily tradable in an established securities market.

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1 "(6) LIKE-KIND EXCHANGES.—In the case of any
2 exchange described in section 1031(b)—
3 "(A) the total contract price shall be reduced
4 to take into account the amount of any property
5 permitted to be received in such exchange without
6 recognition of gain,
7 "(B) the gross profit from such exchange
8 shall be reduced to take into account any amount
9 not recognized by reason of section 1031(b), and
10 "(C) the term 'payment' shall not include
11 any property permitted to be received in such ex-
12 change without recognition of gain.
13 Similar rules shall apply in the case of an exchange
14 which is described in section 356(a) and is not treated
15 as a dividend.
16 "(g) SALE OF DEPRECIABLE PROPERTY TO SPOUSE
17 OR 80-PERCENT OWNED ENTITY—
18 "(1) IN GENERAL.—In the case of an installment
19 sale of depreciable property between—
20 "(A) the taxpayer and the taxpayer's spouse,
21 "(B) the taxpayer and an 80-percent owned
22 entity, or
23 "(C) two 80-percent owned entities,

1 subsection (a) shall not apply, and, for purposes of this
2 title, all payments to be received shall be deemed re-
3 ceived in the year of the disposition.
4 "(2) 80-PERCENT OWNED ENTITY.—For purposes
5 of this subsection, the term '80-percent owned entity'
6 means—
7 "(A) a corporation 80 percent or more in
8 value of the outstanding stock of which is owned
9 (directly or indirectly) by or for the taxpayer,
10 "(B) a partnership 80 percent or more of the
11 capital interest or profits interest in which is
12 owned (directly or indirectly) by or for the tax-
13 payer, and
14 "(C) a portion of a trust of which the tax-
15 payer or the taxpayer's spouse (or a corporation
16 or partnership described in subparagraph (A) or
17 (B)) is treated as the owner under subpart E of
18 part I of subchapter J (relating to grantors and
19 others treated as substantial owners).
20 "(3) CONSTRUCTIVE OWNERSHIP.—For purposes
21 of subparagraphs (A) and (B) of paragraph (2), the
22 principles of section 318 shall apply, except that—
23 "(A) the member of an individual's family
24 shall consist only of such individual and such indi-
25 vidual's spouse, and

1 "(B) paragraphs (2)(C) and (3)(C) of section
2 318(a) shall be applied without regard to the 50-
3 percent limitation contained therein.
4 "(4) SUBSECTION INAPPLICABLE IN CASE OF DI-
5 VORCE, ETC.—For purposes of this subsection, individ-
6 uals shall be treated as not married if—
7 "(A) at the time of the disposition, they are
8 legally separated under a decree of divorce or
9 separate maintenance, or
10 "(B) the disposition occurs pursuant to a set-
11 tlement in a proceeding which culminates in a
12 decree of divorce or separate maintenance.
13 "(5) DEPRECIABLE PROPERTY.—For purposes of
14 this subsection, the term 'depreciable property' means
15 property of a character which (in the hands of the
16 transferee) is subject to the allowance for depreciation
17 provided in section 167."
18 "(h) USE OF INSTALLMENT METHOD BY SHAREHOLD-
19 ERS IN SECTION 337 LIQUIDATIONS.—
20 "(1) RECEIPT OF OBLIGATIONS NOT TREATED
21 AS RECEIPT OF PAYMENT.—
22 "(A) IN GENERAL.—If, in connection with a
23 liquidation to which section 337 applies, in a
24 transaction to which section 331 applies the
25 shareholder receives (in exchange for the share-

holder's stock) an installment obligation acquired in respect of a sale or exchange by the corporation during the 12-month period set forth in section 337(a), then, for purposes of this section, the receipt of payments under such obligation (but not the receipt of such obligation) by the shareholder shall be treated as the receipt of payment for the stock.

"(B) OBLIGATIONS ATTRIBUTABLE TO SALE OF INVENTORY MUST RESULT FROM BULK SALE.—Subparagraph (A) shall not apply to an installment obligation described in section 337(b)(1)(B) unless such obligation is also described in section 337(b)(2)(B).

"(C) OBLIGATIONS OF SHAREHOLDER'S SPOUSE OR 80-PERCENT OWNED ENTITY.—Subparagraph (A) shall not apply to any installment obligation received by the shareholder if the obligor and the shareholder bear a relationship described in subsection (g).

"(D) COORDINATION WITH SUBSECTION (e)(1)(A).—For purposes of subsection (e)(1)(A), disposition of property by the corporation shall be treated also as disposition of such property by the shareholder.

1 "(E) SALES BY LIQUIDATING SUBSIDI-
2 ARY.—For purposes of subparagraph (A), in any
3 case to which section 337(c)(3) applies, an obliga-
4 tion acquired in respect of a sale or exchange by
5 the selling corporation shall be treated as so ac-
6 quired by the corporation distributing the obliga-
7 tion to the shareholder.
8 "(2) DISTRIBUTIONS RECEIVED IN MORE THAN 1
9 TAXABLE YEAR OF SHAREHOLDER.—If—
10 "(A) paragraph (1) applies with respect to
11 any installment obligation received by a share-
12 holder from a corporation, and
13 "(B) by reason of the liquidation such share-
14 holder receives property in more than 1 taxable
15 year,
16 then, on completion of the liquidation, basis previously
17 allocated to property so received shall be reallocated
18 for all such taxable years so that the shareholder's
19 basis in the stock of the corporation is properly allo-
20 cated among all property received by such share-
21 holder in such liquidation.
22 "(i) REGULATIONS.—
23 "(1) IN GENERAL.—The Secretary shall prescribe
24 such regulations as may be necessary or appropriate to
25 carry out the provisions of this section.

1 "(2) SELLING PRICE NOT READILY ASCERTAIN-
2 ABLE.—The regulations prescribed under paragraph
3 (1) shall include regulations providing for ratable basis
4 recovery in transactions where the gross profit or the
5 total contract price (or both) cannot be readily ascer-
6 tained.

7 "SEC. 453A. INSTALLMENT METHOD FOR DEALERS IN PER-
8 SONAL PROPERTY.

9 "(a) GENERAL RULE.—
10 "(1) IN GENERAL.—Under regulations prescribed
11 by the Secretary, a person who regularly sells or
12 otherwise disposes of personal property on the install-
13 ment plan may return as income therefrom in any tax-
14 able year that proportion of the installment payments
15 actually received in that year which the gross profit,
16 realized or to be realized when payment is completed,
17 bears to the total contract price.
18 "(2) TOTAL CONTRACT PRICE.—For purposes of
19 paragraph (1), the total contract price of all sales of
20 personal property on the installment plan includes the
21 amount of carrying charges or interest which is deter-
22 mined with respect to such sales and is added on the
23 books of account of the seller to the established cash
24 selling price of such property. This paragraph shall not

1 apply with respect to sales of personal property under
2 a revolving credit type plan.
3 "(b) CHANGE FROM ACCRUAL TO INSTALLMENT
4 BASIS.—
5 "(1) GENERAL RULE.—If a taxpayer entitled to
6 the benefits of subsection (a) elects for any taxable
7 year to report his taxable income on the installment
8 basis, then in computing his taxable income for such
9 year (referred to in this subsection as 'year of change')
10 or for any subsequent year—
11 "(A) installment payments actually received
12 during any such year on account of sales or other
13 dispositions of property made in any taxable year
14 before the year of change shall not be excluded;
15 but
16 "(B) the tax imposed by this chapter for any
17 taxable year (referred to in this subsection as 'ad-
18 justment year') beginning after December 31,
19 1953, shall be reduced by the adjustment com-
20 puted under paragraph (2).
21 "(2) ADJUSTMENT IN TAX FOR AMOUNTS PREVI-
22 OUSLY TAXED.—In determining the adjustment re-
23 ferred to in paragraph (1)(B), first determine, for each
24 taxable year before the year of change, the amount
25 which equals the lesser of—

1 "(A) the portion of the tax for such prior
2 taxable year which is attributable to the gross
3 profit which was included in gross income for
4 such prior taxable year, and which by reason of
5 paragraph (1)(A) is includible in gross income for
6 the taxable year, or
7 "(B) the portion of the tax for the adjustment
8 year which is attributable to the gross profit de-
9 scribed in subparagraph (A).
10 The adjustment referred to in paragraph (1)(B) for the
11 adjustment year is the sum of the amounts determined
12 under the preceding sentence.
13 "(3) RULE FOR APPLYING PARAGRAPH (2).—For
14 purposes of paragraph (2), the portion of the tax for a
15 prior taxable year, or for the adjustment year, which is
16 attributable to the gross profit described in such para-
17 graph is that amount which bears the same ratio to the
18 tax imposed by this chapter, other than by sections 55
19 and 56, for such taxable year (computed without
20 regard to paragraph (2)) as the gross profit described in
21 such paragraph bears to the gross income for such tax-
22 able year.
23 "(4) REVOCATION OF ELECTION.—An election
24 under paragraph (1) to report taxable income on the in-
25 stallment basis may be revoked by filing a notice of

1 revocation, in such manner as the Secretary prescribes
2 by regulations, at any time before the expiration of 3
3 years following the date of the filing of the tax return
4 for the year of change. If such notice of revocation is
5 timely filed—
6 "(A) the provisions of paragraph (1) and sub-
7 section (a) shall not apply to the year of change
8 or for any subsequent year;
9 "(B) the statutory period for the assessment
10 of any deficiency for any taxable year ending
11 before the filing of such notice, which is attributa-
12 ble to the revocation of the election to use the in-
13 stallment basis, shall not expire before the expira-
14 tion of 2 years from the date of the filing of such
15 notice, and such deficiency may be assessed
16 before the expiration of such 2-year period not-
17 withstanding the provisions of any law or rule of
18 law which would otherwise prevent such assess-
19 ment; and
20 "(C) if refund or credit of any overpayment,
21 resulting from the revocation of the election to
22 use the installment basis, for any taxable year
23 ending before the date of the filing of the notice of
24 revocation is prevented on the date of such filing,
25 or within one year from such date, by the oper-

1 ation of any law or rule of law (other than section
2 7121 or 7122), refund or credit of such overpay-
3 ment may nevertheless be made or allowed if
4 claim therefor is filed within one year from such
5 date. No interest shall be allowed on the refund
6 or credit of such overpayment for any period prior
7 to the date of the filing of the notice of revoca-
8 tion.

9 "(5) ELECTION AFTER REVOCATION.—If the tax-
10 payer revokes under paragraph (4) an election under
11 paragraph (1) to report taxable income on the install-
12 ment basis, no election under paragraph (1) may be
13 made, except with the consent of the Secretary, for
14 any subsequent taxable year before the fifth taxable
15 year following the year of change with respect to
16 which such revocation is made.

17 "(c) CARRYING CHARGES NOT INCLUDED IN TOTAL
18 CONTRACT PRICE.—If the carrying charges or interest with
19 respect to sales of personal property, the income from which
20 is returned under subsection (a)(1), is not included in the total
21 contract price, payments received with respect to such sales
22 shall be treated as applying first against such carrying
23 charges or interest.

1 "SEC. 453B. GAIN OR LOSS ON DISPOSITION OF INSTALLMENT
2 OBLIGATIONS.

3 "(a) GENERAL RULE.—If an installment obligation is
4 satisfied at other than its face value or distributed, transmit-
5 ted, sold, or otherwise disposed of, gain or loss shall result to
6 the extent of the difference between the basis of the obliga-
7 tion and—

8 "(1) the amount realized, in the case of satisfac-
9 tion at other than face value or a sale or exchange, or
10 "(2) the fair market value of the obligation at the
11 time of distribution, transmission, or disposition, in the
12 case of the distribution, transmission, or disposition
13 otherwise than by sale or exchange.

14 Any gain or loss so resulting shall be considered as resulting
15 from the sale or exchange of the property in respect of which
16 the installment obligation was received.

17 "(b) BASIS OF OBLIGATION.—The basis of an install-
18 ment obligation shall be the excess of the face value of the
19 obligation over an amount equal to the income which would
20 be returnable were the obligation satisfied in full.

21 "(c) SPECIAL RULE FOR TRANSMISSION AT DEATH.—
22 Except as provided in section 691 (relating to recipients of
23 income in respect of decedents), this section shall not apply
24 to the transmission of installment obligations at death.

25 "(d) EFFECT OF DISTRIBUTION IN CERTAIN LIQUIDA-
26 TIONS.—

1 "(1) LIQUIDATIONS TO WHICH SECTION 332 AP-
2 PLIES.—If—
3 "(A) an installment obligation is distributed
4 in a liquidation to which section 332 (relating to
5 complete liquidations of subsidiaries) applies, and
6 "(B) the basis of such obligation in the hands
7 of the distributee is determined under section
8 334(b)(1),
9 then no gain or loss with respect to the distribution of
10 such obligation shall be recognized by the distributing
11 corporation.
12 "(2) LIQUIDATIONS TO WHICH SECTION 337
13 APPLIES.—If—
14 "(A) an installment obligation is distributed
15 by a corporation in the course of a liquidation,
16 and
17 "(B) under section 337 (relating to gain or
18 loss on sales or exchanges in connection with cer-
19 tain liquidations) no gain or loss would have been
20 recognized to the corporation if the corporation
21 had sold or exchanged such installment obligation
22 on the day of such distribution,
23 then no gain or loss shall be recognized to such corpo-
24 ration by reason of such distribution. The preceding
25 sentence shall not apply to the extent that under para-

1 graph (1) gain to the distributing corporation would be
2 considered as gain to which section 341(f), 617(d)(1),
3 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a) applies.
4 "(e) LIFE INSURANCE COMPANIES.—In the case of a
5 disposition of an installment obligation by any person other
6 than a life insurance company (as defined in section 801(a)) to
7 such an insurance company or to a partnership of which such
8 an insurance company is a partner, no provision of this subti-
9 tle providing for the nonrecognition of gain shall apply with
10 respect to any gain resulting under subsection (a). If a corpo-
11 ration which is a life insurance company for the taxable year
12 was (for the preceding taxable year) a corporation which was
13 not a life insurance company, such corporation shall, for pur-
14 poses of this subsection and subsection (a), be treated as
15 having transferred to a life insurance company, on the last
16 day of the preceding taxable year, all installment obligations
17 which it held on such last day. A partnership of which a life
18 insurance company becomes a partner shall, for purposes of
19 this subsection and subsection (a), be treated as having trans-
20 ferred to a life insurance company, on the last day of the
21 preceding taxable year of such partnership, all installment
22 obligations which it holds at the time such insurance com-
23 pany becomes a partner.

1 "(f) OBLIGATION BECOMES UNENFORCEABLE.—For
2 purposes of this section, if any installment obligation is can-
3 celled or otherwise becomes unenforceable—
4 "(1) the obligation shall be treated as if it were
5 disposed of in a transaction other than a sale or ex-
6 change, and
7 "(2) if the obligor and obligee are related persons
8 (within the meaning of section 453(f)(1)), the fair
9 market value of the obligation shall be treated as not
10 less than its face amount."
11 (b) TECHNICAL AMENDMENTS.—
12 (1) Section 311(a) and section 336 (as in effect on
13 the day before the date of the enactment of the Crude
14 Oil Windfall Profit Tax Act of 1980) are each amend-
15 ed by striking out "section 453(d)" and inserting in
16 lieu thereof "section 453B".
17 (2) Subsection (d) of section 481 is amended by
18 striking out "section 453" and inserting in lieu thereof
19 "section 453A".
20 (3) Subsection (f) of section 644 is amended by
21 striking out "elects to report income under section
22 453" and inserting in lieu thereof "reports income
23 under section 453".
24 (4) Paragraph (4) of section 691(a) is amended—

1 (A) by striking out "received by a decedent
2 on the sale or other disposition of property, the
3 income from which was properly reportable by the
4 decedent on the installment basis under section
5 453" and inserting in lieu thereof "reportable by
6 the decedent on the installment method under sec-
7 tion 453 or 453A", and
8 (B) by striking out "section 453(d)" each
9 place it appears and inserting in lieu thereof "sec-
10 tion 453B".
11 (5) Paragraph (2) of section 1255(b) is amended
12 by striking out "453(d)(4)(B)" and inserting in lieu
13 thereof "453B(d)(2)".
14 (c) CONFORMING AMENDMENTS.—
15 (1) Subsection (a) of section 336 (as amended by
16 the Crude Oil Windfall Profit Tax Act of 1980) is
17 amended by striking out "section 453(d)" and inserting
18 in lieu thereof "section 453B".
19 (2) Paragraph (3) of section 337(f) is amended by
20 striking out "section 453(d)(1)" and inserting in lieu
21 thereof "section 453B(a)".
22 (3) Paragraph (2) of section 453B(d) is amended
23 by adding at the end thereof the following new sen-
24 tence: "In the case of any installment obligation which
25 would have met the requirements of subparagraphs (A)

1 and (B) of the first sentence of this paragraph but for
2 section 337(f), gain shall be recognized to such corpo-
3 ration by reason of such distribution only to the extent
4 gain would have been recognized under section 337(f)
5 if such corporation had sold or exchanged such install-
6 ment obligation on the date of such distribution."
7 (4) Subparagraph (B) of section 403(b)(2) of the
8 Crude Oil Windfall Profit Tax Act of 1980 is hereby
9 repealed.
10 (d) CLERICAL AMENDMENT.—The table of sections for
11 such subpart B is amended by striking out the item relating
12 to section 453 and inserting in lieu thereof the following:

"Sec. 453. Installment method.
"Sec. 453A. Installment method for dealers in personal property.
"Sec. 453B. Gain or loss on disposition of installment obligations."

13 **SEC. 3. COORDINATION WITH SECTION 691.**

14 Subsection (a) of section 691 (relating to income in re-
15 spect of a decedent) is amended by adding at the end thereof
16 the following new paragraph:
17 "(5) OTHER RULES RELATING TO INSTALLMENT
18 OBLIGATIONS.—
19 "(A) IN GENERAL.—In the case of an in-
20 stallment obligation reportable by the decedent on
21 the installment method under section 453 or
22 453A, for purposes of paragraph (2)—

1 "(i) the second sentence of paragraph
2 (2) shall be applied by inserting '(other than
3 the obligor)' after 'or a transfer to a person',
4 "(ii) any cancellation of such an obliga-
5 tion shall be treated as a transfer, and
6 "(iii) any cancellation of such an obliga-
7 tion occurring at the death of the decedent
8 shall be treated as a transfer by the estate of
9 the decedent (or, if held by a person other
10 than the decedent before the death of the de-
11 cedent, by such person).
12 "(B) FACE AMOUNT TREATED AS FAIR
13 MARKET VALUE IN CERTAIN CASES.—In any
14 case to which the first sentence of paragraph (2)
15 applies by reason of subparagraph (A), if the dece-
16 dent and the obligor were related persons (within
17 the meaning of section 453(f)(1)), the fair market
18 value of the installment obligation shall be treated
19 as not less than its face amount.
20 "(C) CANCELLATION INCLUDES BECOMING
21 UNENFORCEABLE.—For purposes of subpara-
22 graph (A), an installment obligation which be-
23 comes unenforceable shall be treated as if it were
24 cancelled."

1 SEC. 4. AMENDMENT OF SECTION 1038.

2 Section 1038 (relating to certain reacquisitions of real
3 property) is amended by adding at the end thereof the follow-
4 ing new subsection:

5 "(g) ACQUISITION BY ESTATE, ETC., OF SELLER.—
6 Under regulations prescribed by the Secretary, if an install-
7 ment obligation is indebtedness to the seller which is de-
8 scribed in subsection (a), and if such obligation is, in the
9 hands of the taxpayer, an obligation with respect to which
10 section 691(a)(4)(B) applies, then—

11 "(1) for purposes of subsection (a), acquisition of
12 real property by the taxpayer shall be treated as reac-
13 quisition by the seller, and

14 "(2) the basis of the real property acquired by the
15 taxpayer shall be increased by an amount equal to the
16 deduction under section 691(c) which would (but for
17 this subsection) have been allowable to the taxpayer
18 with respect to the gain on the exchange of the obliga-
19 tion for the real property."

20 SEC. 5. EFFECTIVE DATES.

21 (a) FOR SECTION 2.—

22 (1) IN GENERAL.—Except as otherwise provided
23 in this subsection, the amendments made by section 2
24 shall apply to dispositions made after the date of the
25 enactment of this Act in taxable years ending after
26 such date.

1 (2) FOR SECTION 453(e).—Section 453(e) of the
2 Internal Revenue Code of 1954 (as amended by sec-
3 tion 2) shall apply to dispositions made after May 14,
4 1980.
5 (3) FOR SECTION 453(h).—Paragraphs (1) and (2)
6 of section 453(h) of such Code (as amended by section
7 2) shall apply in the case of distributions of installment
8 obligations after March 31, 1980.
9 (4) FOR SECTION 453B(f).—Section 453B(f) of the
10 Internal Revenue Code of 1954 (as amended by sec-
11 tion 2) shall apply to installment obligations becoming
12 unenforceable after the date of the enactment of this
13 Act.
14 (5) FOR SECTION 2(c).—The amendments made
15 by section 2(c) shall take effect as if included in the
16 amendments made by section 403(b) of the Crude Oil
17 Windfall Profit Tax Act of 1980.
18 (b) FOR SECTION 3.—The amendment made by section
19 3 shall apply in the case of decedents dying after the date of
20 the enactment of this Act.

1 (c) FOR SECTION 4.—The amendment made by section
2 4 shall apply to acquisitions of real property by the taxpayer
3 after the date of the enactment of this Act.

Passed the House of Representatives June 17, 1980.

Attest: EDMUND L. HENSHAW, JR.,

Clerk.

By W. RAYMOND COLLEY,

Deputy Clerk.

INTRODUCTION

The bill described in this pamphlet (H.R. 6883) has been scheduled for a hearing on September 10, 1980, by the Subcommittee on Taxation and Debt Management Generally of the Senate Committee on Finance. The bill relates to the tax rules for reporting gain under the installment method for sales of real property and personal property other than inventory. This bill was developed as a result of the suggestions and comments received in connection with other bills, H.R. 3899 and S. 1063, which were introduced last year.

A hearing was held by the Subcommittee on Select Revenue Measures of the Ways and Means Committee on the provisions of H.R. 3899 in July 1979. Senate hearings were also held on an identical bill, S. 1063, which had been introduced by Senators Long and Dole. At the hearings, most of the provisions of the bill were supported by the witnesses.

However, a number of modifications were suggested and a number of additional problems were raised for consideration. After the hearings, the staff was directed to develop a revised bill to simplify and improve this area of the tax law by taking into account the comments and testimony received. In developing the revised bill, the staff worked closely with the Treasury Department, the Tax Section of the American Bar Association, and the Federal Tax Division of the American Institute of Certified Public Accountants. In addition, comments and suggestions were received from a number of other professional organizations, including the New York City and State Bar Associations, and the Illinois and California Bar Associations. Also, representatives of small business, real estate, banking and farm groups made comments and suggestions.

The bill, H.R. 6883, was the subject of a hearing by the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means on April 17, 1980. With amendments, that subcommittee approved the bill on April 24, 1980, and the Ways and Means Committee approved the bill on May 15, 1980. The House of Representatives passed the bill on June 17, 1980.

In connection with the hearing scheduled for H.R. 6883, the staff of the Joint Committee on Taxation has prepared for each provision a description of present law and the bill provision. The pamphlet also includes the estimated revenue effect of the bill.

I. SUMMARY

INSTALLMENT SALES REVISION ACT OF 1980

The bill (H.R. 6883) amends the rules for reporting gain under the installment method for sales of real property and casual sales of personal property.

The bill makes the following changes:

(1) ***Structural improvements.***—Under present law, a single provision (Code sec. 453) prescribes rules for installment method reporting for dealers in personal property, for sales of real property and nondealer personal property, and special disposition rules. Under the bill, the basic rules for nondealer transactions will be contained in one Code section (sec. 453), the rules for dealer transactions will be contained in another section (sec. 453A), and generally applicable installment obligation disposition rules will be contained in a third section (sec. 453B).

(2) ***Initial payment limitation.***—The bill eliminates the requirement that no more than 30 percent of the selling price be received in the taxable year of sale to qualify for installment sale reporting for gains from sales of realty and nondealer personal property.

(3) ***Two-payment rule.***—The bill eliminates the requirement that a deferred payment sale be for two or more payments. Thus, a sale will be eligible for installment reporting even if the purchase price is to be paid in a single lump sum amount in a year subsequent to the taxable year in which the sale is made.

(4) ***Selling price requirements.***—The bill eliminates the requirement that the selling price for casual sales of personal property must exceed $1,000 to qualify for installment sale reporting.

(5) ***Election.***—The bill eliminates the present law requirement that the installment method must be elected for reporting gains from sales of realty and nondealer personal property. Instead, the provision will automatically apply to a qualified sale unless the taxpayer elects not to have the provision apply with respect to a deferred payment sale.

(6) ***Related Party sales.***—The bill prescribes special rules for situations involving installment sales to certain related parties who also dispose of the property and for situations involving installment sales of depreciable property between a taxpayer and his spouse or certain 80-percent owned corporations or partnerships.

Sales other than sales of depreciable property between certain closely-related parties.—Under the bill, the amount realized upon a resale by the related party installment purchaser will trigger recognition of gain by the initial seller, based on his gross profit ratio, only to the extent the amount realized from the second disposition exceeds actual payments made under the installment sale. Thus, acceleration of recognition of the installment gain from the first sale will generally result only to the extent additional cash and other property flows into the related group as a result of a second disposition of the property.

The excess of any amount realized from resales over payments received on the first sale as of the end of a taxable year will be taken into account. If, under these rules, a resale results in the recognition of gain to the initial seller, subsequent payments actually received by that seller will be recovered tax-free until they equal the amount realized from the resale which resulted in the acceleration of recognition of gain.

In the case of property other than marketable stock and securities, the resale rule will apply only with respect to second dispositions occurring within 2 years of the initial installment sale. In the case of marketable stock and securities, the resale rule will apply without a time limit for resales occurring before the installment obligation is satisfied.

The bill also contains several exceptions to the application of these rules. Since gain from the sale of a corporation's treasury stock is nontaxable and therefore its basis in the stock is irrelevant, the related party rule will not apply to any sale or exchange of stock to the issuing corporation. In addition, there generally will be no acceleration of recognition of gain as a result of a second disposition which is an involuntary conversion of the property or which occurs after the death of the installment seller or purchaser. Finally, the resale rules will not apply in any case where it is established to the satisfaction of the Internal Revenue Service that none of the dispositions had as one of its principal purposes the avoidance of Federal income taxes.

For purposes of the related party rules, the bill adopts a definition of related parties which will include spouses, children, grandchildren, and parents but will exclude brothers and sisters. However, it is to be understood that the omission of a specific family relationship is not intended to preclude the Internal Revenue Service from asserting the proper tax treatment to transactions that are shams. A corporation will be considered to be related to another taxpayer if stock of another corporation which is or might be owned by it would be treated as owned by the taxpayer under the general corporate attribution rules. Generally, a related corporation will be one in which a person directly or indirectly owned 50 percent or more in value of the stock in the corporation. Also for this purpose, the principles of the general corporate stock ownership attribution rules will apply in determining the related party status of partnerships, trusts, and estates.

Sales of depreciable property between certain closely-related parties.—Under the bill, the accrual method of accounting in effect is required for deferred payment sales of depreciable property between certain closely-related parties. In general, this special rule applies to transactions which are fairly analogous to "self-dealing" and involve transfers of depreciable property to obtain income tax deferral benefits. For these transactions the deferred payments will be deemed to be received in the taxable year in which the sale occurs.

This special rule will apply only to deferred payment sales between a taxpayer and the taxpayer's spouse, the taxpayer and a trust treated as owned by the taxpayer or the taxpayer's spouse under present law, the taxpayer and a partnership or corporation which is 80-percent owned by the taxpayer and/or the taxpayer's spouse, and between partnerships and corporations which are 80-percent owned by the taxpayer and/or the taxpayer's spouse. To avoid possible application to transactions which may be undertaken other than for tax avoid-

ance purposes, an exception is provided with respect to a deferred payment sale between a taxpayer and his spouse if the sale is incident to a divorce or a separation.

(7) ***Like-kind exchanges.***—The bill provides that the receipt of like-kind property in connection with a disposition will not be taken into account in determining gain recognized for installment sale reporting purposes. Under the present Internal Revenue Service position, the receipt of like-kind property results in the recognition of installment gain before cash is received by the taxpayer because the value of such property is treated as a payment received. The bill reverses this rule.

(8) ***Installment obligations distributed in a corporate liquidation.***—In general, the bill provides nonrecognition of gain treatment for a shareholder who receives installment obligations as liquidating distributions from a corporation liquidating within 12 months of adoption of a plan of complete liquidation. In general, this rule will apply to obligations arising from sales by a corporation during the 12-month period. Obligations from the sale of inventory will qualify only if the inventory of that trade or business is sold in bulk. The gain realized by the shareholder on his stock will be recognized as payments are received on the installment obligation. Thus, in most significant aspects, the tax consequences to a shareholder will be essentially the same whether the corporation sells its assets and then distributes installment obligations in complete liquidation or the shareholder makes an installment sale of the stock.

Under the bill, nonrecognition treatment will not be available if the installment purchaser is either the shareholder-distributee's spouse, a trust treated as owned by the shareholder-distributee or his spouse, or a corporation or a partnership which is 80-percent owned by the shareholder-distributee and/or his spouse.

(9) ***Sales subject to a contingency.***—The bill permits installment method reporting for sales for a contingent selling price. Under present law, these sales are not eligible for installment reporting. In extending eligibility, the bill does not prescribe specific rules which would apply to every conceivable transaction. Rather, the bill provides that the specific rules will be prescribed under regulations.

However, it is intended that, for sales under which there is a stated maximum selling price, the regulations will permit basis recovery on the basis of a gross profit ratio determined by reference to the stated maximum selling price. In cases where the sales price is indefinite but payable over a fixed period of time, it is generally intended that the basis of the property sold would be recovered ratably over that fixed period. In cases where the selling price and payment period are both indefinite, it is intended that the regulations would permit ratable basis recovery over some reasonable period of time. Also, in appropriate cases, it is intended that basis recovery would be permitted under an income forecast type method.

(10) ***Cancellation of installment obligation.***—The bill makes it clear that the cancellation of an installment obligation is treated as a disposition of the obligation by the holder of the obligation.

(11) ***Bequest of obligation to obligor.***—The bill provides that the installment obligation disposition rules cannot be avoided by the bequest of an obligation to the obliger.

(*12*) ***Foreclosure of real property sold on installment method by deceased taxpayer.***—The bill provides that an executor or beneficiary who receives a secured installment obligation from a decedent will succeed the decedent for purposes of qualifying for nonrecognition treatment if the real property sold by the decedent is reacquired in cancellation of the obligation.

(*13*) ***Effective dates.***—In general, the bill is effective for sales, cancellations, bequests, and reacquisitions of real property, as the case may be, occurring after the date of enactment. However, the related party installment sale rules apply to installment sales after May 14, 1980. The provision relating to the distribution of installment obligations in connection with a 12-month corporate liquidation apply with respect to installment obligations distributed after March 31, 1980.

(*14*) ***Revenue effects.***—Due to the interaction between the provisions of this bill, revenue effects for each specific provision cannot be determined independently. It is estimated that on balance the provisions of this bill (except related party sales) will not have a significant revenue effect on budget receipts.

Due to the extensive litigation and controversy concerning the treatment of related party sales under present law, the revenue gain for the related party provision of the bill is indeterminant.

II. EXPLANATION OF THE BILL*

A. Installment Sales Generally (sec. 2 of the bill and sec. 453 of the Code)

Present law

Generally, under present law (Code sec. 453), income from a sale of property on the installment basis may be reported as the payments are received. If the installment method is elected for qualifying sales, the gain reported for any taxable year is the proportion of the installment payment received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price. In general, the contract price is the amount which will be paid to the seller.

The function of the installment method of reporting income is to permit the spreading of the income tax over the period during which payments of the sales price are received. Thus, the installment method alleviates possible liquidity problems which might arise from the bunching of gain in the year of sale when a portion of the selling price has not been actually received.

Explanation of provision

In general

Although the bill makes structural revisions of existing law and makes the specific changes described below, most of the basic concepts of existing law are continued. As under present law, the provisions relate to installment reporting of gains and do not affect the time for recognizing losses from the sale or exchange of property for deferred payments.

Except as otherwise provided for sales subject to a contingency or for sales to certain related persons, gain from an installment sale would continue to be recognized for any taxable year with respect to the payments received in that year in the same proportion as the gross profit from the sale bears to the total contract price. The payments taken into account as being received in a taxable year would not include the purchaser's obligation of future payment, whether dischargeable in money or other property (including foreign currency), unless that obligation is a bond or other evidence or indebtedness which is either payable on demand or has been issued by a corporation or government and is readily tradable.

Structural improvements

Under present law, a single provision (Code sec. 453) prescribes rules for installment method reporting for dealers in personal property, for sales of real property and nondealer personal property, and special disposition rules. Under the bill, the rules for nondealer transactions are contained in one Code section (sec. 453), the rules for

*This explanation is from the Ways and Means Committee report on the bill, House Rept. No. 96–1042.

personal property dealer transactions are contained in another section (sec. 453A), and generally applicable installment obligation disposition rules are contained in a third section (sec. 453B).

In making these structural changes and certain language changes, no substantive changes are intended to be made by the bill with respect to the provisions relating to installment sales by dealers in personal property. The substantive changes under the bill relate only to sales of realty and casual sales of personal property.

For purposes of the bill, it is intended that gain from the sale of property which is not required to be inventoried by a farmer under his method of accounting will be eligible for installment method reporting as gain from a casual sale of personal property.

B. Initial Payment Limitation (sec. 2 of the bill and sec. 453(b)(2) of the Code)

Present law

Under present law, gain from the sale of realty or nondealer personal property may not be reported under the installment method if the payments received in the taxable year of sale exceed 30 percent of the selling price.

A number of problems have arisen in connection with the 30-percent initial payment requirement which was designed to limit installment sale reporting to transactions where hardships might result from current imposition of tax on uncollected amounts. Some have argued that it is an arbitrary limitation which has unduly complicated and interfered with normal business transactions. In addition, it has been argued that the limitation has operated as a trap for the unwary. If a taxpayer fails to secure competent advice and inadvertently exceeds the 30-percent limitation, however slightly, the entire gain must be recognized in the year of sale. The limitation has produced an inordinate amount of litigation and confusion.

In applying the 30-percent limitation, the problem areas generally involve interpretations of the terms "selling price" and "payment." Where the imputed interest provision applies (Code sec. 483), the limitation may not be satisfied if the selling price is reduced by the amount required to be treated as unstated interest (Treas. reg. § 1.453(b)(2)). Thus, after reduction of the selling price for unstated interest, the payments received in the year of sale may exceed 30 percent of the selling price although the limitation appeared to be satisfied on the basis of the written sales agreement. A similar disqualification can arise when the installment obligation is a corporate obligation issued at a discount because the amount treated as original issue discount is not included as part of the selling price (Treas. reg. § 1.453-1(b)(3)).

Another problem arises under present law in connection with the sale of property which is subject to an existing mortgage which is assumed by the installment buyer. Generally, the amount of the mortgage is taken into account as part of the selling price but is not taken into account for purposes of determining the contract price or the amount of payments received by the seller. However, to the extent the mortgage exceeds the seller's basis in the property, the excess is considered as a payment received and correspondingly is included in the contract amount. (Treas. reg. § 1.453-4(c)). The problem arising from

this treatment does not involve its correctness but rather the inadvertent disqualification of the sale for installment method reporting for failing to take the amount of the mortgage in excess of basis into account for the 30-percent initial payment requirement. Where the taxpayers are cognizant of problems of this type, the 30-percent requirement has fostered ingenious "wraparound" mortgage arrangements to qualify for installment method reporting.[1]

Under the wraparound arrangement, the buyer does not assume the mortgage and agrees not to make direct payments to the mortgagee but agrees to make the payments to the seller who will continue to pay the mortgage debt. In one case, the wraparound technique was used by having the seller retain title to the property for a period of years so there would be no transfer of property "subject to" the existing mortgage.[2] If title passes in the year of sale, the Internal Revenue Service will treat the mortgage debt in excess of basis as a payment received in the year of the sale.[3] This issue is said to be another instance of the 30-percent initial payment rule fostering uncertainty and litigation.

Another problem area relates to the treatment of selling expenses when determining whether the mortgage assumed by the buyer exceeds the adjusted basis of the property sold. Under the regulations, commissions and selling expenses are taken into account as an offset to selling price for purposes of determining the gross profit from a sale by a nondealer (Treas. reg. § 1.453-1(b)), but do not reduce the amount of the payments, the total contract price, or the selling price (Treas. reg. § 1.453-4(c)). However, the Ninth Circuit has held that selling expenses are to be added to basis for this purpose.[4] The Internal Revenue Service has announced that it will not follow the Ninth Circuit's decision on the treatment of selling expenses.[5] Thus, this is anouther area where the 30-percent initial payment requirement may foster litigation and confusion.

Another problem area involves the case where the buyer pays some of the seller's obligations in the year of sale. The Service has ruled that, in the case of a casual sale of personal property, the assumption and payment of secured and general unsecured liabilities by the purchaser will not be considered as a payment to the seller for installment sale reporting qualification purposes if the seller establishes that the liabilities were incurred in the ordinary course of business and not for purposes of avoiding the 30-percent initial payment limitation.[6] The avoidance test under the ruling would involve a subjective determination of motive. Thus, this is another area where the initial payment rule may foster litigation and confusion.

Explanation of provision

The bill eliminates the 30-percent initial payment limitation for reporting gain on the installment method from the disposition of real property or nondealer personal property.

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[1] Wyndelts and Campbell "Installment Reporting Need Not Be Lost When Year-Of-Sale Payments Are More Than 30%," 20 *Taxation for Accountants* 328 (1978); Ginsburg, "Taxing the Sale for Future Payment," 30 *Tax Law Review* 469, 488 (1975).

[2] *Stonecrest*, 24 TC 659 (1955) *nonacq*. 1956-1 C.B. 6.

[3] Letter rulings 7814010 and 7814011.

[4] *Kirschenmann* v. *United States*, 488 F.2d 270 (9th Cir. 1973).

[5] Rev. Rul. 74-384, 1974-2 C.B. 152.

[6] Rev. Rul. 73-555, 1973-2 C.B. 159.

C. Two-Payment Rule (sec. 2 of the bill and sec. 453 of the Code)

Present law

Under present law, it is the position of the Internal Revenue Service that a taxpayer may not elect to report income from the sale of real property on the installment method if the total purchase price is payable in a lump sum in a taxable year subsequent to the year of sale.[7] The same issue may arise with respect to casual sales of personal property. The rationale for the ruling is that the installment concept generally calls for two or more payments of the purchase price in two or more taxable years and that a single payment sale cannot be considered to to be payable in installments. The courts have agreed with the Service's interpretation.[8]

It is argued that the two-payment rule is a trap for the unwary and results in different tax results for transactions that are substantially similar. For example, installment method reporting would be available for a taxpayer who sells for a modest down payment with the balance due in 5 years but would not be available for a taxpayer who receives no down payment with the entire balance due in 5 years. In these situations, the ability to pay income taxes from the sales proceeds is essentially the same. Thus, to the extent the rationale for installment method reporting is based on ability to pay concepts, both sales should qualify for installment reporting.

Explanation of provision

The bill eliminates the requirement that a sale must be for two or more payments to qualify for installment method reporting. Thus, under the bill, income from the sale of qualifying property for a purchase price payable in a lump sum in a taxable year subsequent to the year of sale may be reported in the year in which payment is received.

D. Selling Price Limitation for Casual Sales of Personal Property (sec. 2 of the bill and sec. 453(b)(1)(B) of the Code)

Present law

Under present law, a casual sale of personal property must be for a selling price in excess of $1,000 to qualify for installment reporting.

In certain situations, the selling price requirement may be difficult to apply because questions may arise as to whether there is a single sale of several items for more than $1,000, which satisfies the requirement, or a number of sales of individual items for $1,000 or less for each item.

Explanation of provision

The bill eliminates the selling price requirement to qualify for installment reporting.[9]

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[7] Rev. Rul. 69-462, 1969-2 C.B. 107, amplified by Rev. Rul. 71-595, 1971-2 C.B. 223.

[8] *Baltimore Baseball Co. Inc.*, v. *U.S.*, 481 F.2d 1283 (Ct. Cl. 1973); *10-42 Corp.*, 55 TC 593 (1971).

[9] If, for practical reasons, it is not feasible to report gain from sales for relatively small amounts, a taxpayer could elect not to report gain under the installment method and thereby eliminate compliance burdens. See the following discussion relating to installment sale elections under the bill.

E. Election of Installment Reporting (sec. 2 of the bill and new sec. 453(d) of the Code)

Present law

Under present law, an election may be made to report gain from an installment sale on a timely filed return, a delinquent return, or on an amended return for the year of sale not barred by the statute of limitations, if the facts indicate no position inconsistent with the installment election had been taken with respect to the sale (Rev. Rul. 65-297, 1965-2 C.B. 152). If a return is filed which includes in gross income the entire gain from an installment sale, an amended return or claim for refund cannot be used to elect installment sale reporting for the sale because the election to report the gain in full is treated as a binding election not to report on the installment method.[10]

Explanation of provision

The bill eliminates the present law requirement that the installment method must be elected for reporting gains from sales of realty and nondealer personal property. Instead, installment reporting would automatically apply to a qualified sale unless the taxpayer elects not to have the provision apply with respect to a deferred payment sale. Generally, the election not to have installment method reporting apply to a deferred payment sale must be made in the manner prescribed by regulations on or before the due date (including extensions of time for filing) for filing the income tax return for the year in which the sale occurs. It is anticipated that reporting the entire gain in gross income for the taxable year in which the sale occurs will operate as an election not to have installment sale reporting apply. It is anticipated that, under regulations, late elections will be permitted in rare circumstances when the Internal Revenue Service finds that reasonable cause for failing to make a timely election exists under the particular circumstances of each case.

Generally, an election made under this provision is to be irrevocable. However, an election may be revoked with the consent of the Internal Revenue Service. Generally, it is anticipated that consent would be given by the Internal Revenue Service in circumstances when a revocation does not have as one of its purposes the avoidance of income taxes. Also, it is anticipated that consent to revocation will generally be granted in cases involving a contingent selling price if the election is made prior to adoption of final regulations under the provisions of the bill relating to contingent selling price sales and the request for revocation is filed within a reasonable time after the regulations are adopted.

It is anticipated that the regulations will prescribe election rules relating to the treatment of gains from deferred payment sales of property by a nonresident alien. Under the installment method rules of present law, these gains do not become taxable as payments are received after the seller becomes a resident or citizen subject to U.S. income tax for a taxable year subsequent to the year in which the sale was made. It is intended that the election regulations will continue this treatment in appropriate cases.

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[10] *Robert F. Kock*, T.C. Memo 1978-271; *Pacific National Co.* v. *Welch*, 304 U.S. 191 (1938).

F. Related Party Sales (sec. 2 of the bill and new sec. 453(e), (f), and (g) of the Code)

Present law

Under present law, the installment sale statutory provision does not preclude installment sale reporting for sales between related parties. Further, the statutory provision does not preclude installment sale reporting for sales of marketable securities although the seller might readily obtain full cash proceeds by market sales.[11]

Under the existing statutory framework, taxpayers have used the installment sale provision as a tax planning device for intra-family transfers of appreciated property, including marketable securities.[12] There are several tax advantages in making intra-family installment sales of appreciated property. The seller would achieve deferral of recognition of gain until the related buyer actually pays the installments to the seller, even if cash proceeds from the property are received within the related party group from a subsequent resale by the installment buyer shortly after making the initial purchase. In addition to spreading out the gain recognized by the seller over the term of the installment sale, the seller may achieve some estate planning benefits since the value of the installment obligation generally will be frozen for estate tax purposes. Any subsequent appreciation in value of the property sold, or in property acquired by reinvestment of the proceeds from the property sold on the installment basis, would not affect the seller's gross estate since the value of the property is no longer included in his gross estate.

With respect to the related buyer, there is usually no tax to be paid if the appreciated property is resold shortly after the installment purchase. Since the buyer's adjusted basis is a cost basis which includes the portion of the purchase price payable in the future, the gain or loss from the buyer's resale would represent only the fluctuation in value occurring after the installment purchase. Thus, after the related party's resale, all appreciation has been realized within the related group but the recognition of the gain for tax purposes may be deferred for a long period of time.

In the leading case, *Rushing* v. *Commissioner*,[13] the test was held to be that, in order to receive the installment benefits, the "seller may not directly or indirectly have control over the proceeds or possess the economic benefit therefrom." In this case, a sale of corporate stock was made to the trustee of trusts for the benefit of the seller's children. Since the sales were made to trusts created after the corporations had adopted plans of liquidation, the Government made an assignment of income argument. The Court upheld installment sale treatment for the stock sold to the trustee under the "control or enjoyment" test because the trustee was independent of the taxpayer and owed a fidu-

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[11] The receipt of the buyer's obligation payable on demand or a readily tradable evidence of indebtedness is treated as the receipt of payment by the seller. For this purpose, readily tradable items include bonds and notes issued by a corporation or governmental unit with interest coupons attached or in registered form or in any other form designed to make the bond or note readily tradable in an established securities market.

[12] Another technique used for intra-family transfers involves the so-called "private annuity" arrangement. The bill does not deal directly with this type of arrangement.

[13] 441 F. 2d 593 (5th Cir. 1971), *aff'g* 52 T.C. 888 (1969).

ciary duty to the children. The Court rejected the assignment of income argument because it found that no income was being assigned.

The *Rushing* case has been followed in another case where the stock sold to a family trust was that of a corporation which was to be liquidated after the sale.[14] The liquidation was formally authorized after the sale to the trust. In other cases, the Tax Court has rejected the Service's substance over form and constructive receipt arguments and held that the sales to a family trust qualified for installment method reporting.[15] In the *Pityo* case, the taxpayer's wife was the beneficiary of one of the trusts to which the installment sale was made. In the *Roberts* case, the trustees were the seller's brother and personal accountant. In both cases, installment sale reporting was allowed because the Tax Court held that the trustees were independent of the seller and satisfied the *Rushing* control or enjoyment test.

In another case, installment method reporting was allowed for a sale of marketable stock by a wife to her husband although a resale by the husband was contemplated.[16] In this case, the Court held that the husband could not be considered a mere conduit for the wife's sale of the stock since both were "very healthy economic entities" and the husband had an independent purpose for obtaining needed funds for an investment at a low rate of interest.

In the few cases in which the Service has prevailed, installment method reporting has been denied with respect to transactions involving a controlled corporation,[17] a sale to a son where the son was forced to resell the stock and invest the proceeds in other securities held in escrow,[18] and, in the case of a sale by a husband to his wife, where the Court found there was no bona fide purpose for the transaction other than tax avoidance.[19]

Explanation of provision

The bill prescribes special rules for situations involving installment sales to certain related parties who also dispose of the property and for situations involving installment sales of depreciable property between a taxpayer and his spouse or certain trusts, and 80-percent owned corporations or partnerships.

Sales other than sales of depreciable property between certain closely-related parties

Under the bill, the amount realized upon certain resales by the related party installment purchaser will trigger recognition of gain by

[14] *Carl E. Weaver*, 71 T.C. 443 (1978).

[15] *William D. Pityo*, 70 T.C. 225 (1978); *Claire E. Roberts*, 71 T.C. 311 (1978). Also, in *William J. Goodman*, 74 T.C. No. 53 (July 16, 1980), a prearranged resale was made by the trustees of a family trust one day after the installment sales were made to the trusts of which the installment sellers were the trustees. The two-step installment sales were used because the taxpayers believed that "a cash sale was not attractive because of the income tax liability on such a sale."

[16] *Nye* v. *U.S.*, 407 F. Supp. 1345, 75–1 USTC ¶9150 (M.D.N.C. 1975).

[17] *Griffiths* v. *Helvering*, 308 U.S. 355 (1939). This case involved the creation of a corporation to receive the assignment of a settlement owed to the taxpayer with the corporation agreeing to pay the money received from the settlement to the taxpayer over a 40-year term. The Court held that there had been an anticipatory assignment of income and therefore the income was taxable to the shareholder rather than the corporation.

[18] *Paul G. Lustgarten*, 71 T.C. 303 (1978). The Court held that the taxpayer had constructively received the proceeds from the "resale."

[19] *Phillip W. Wrenn*, 67 T.C. 576 (1976).

the initial seller, based on his gross profit ratio, only to the extent the amount realized from the second disposition exceeds actual payments made under the installment sale. Thus, acceleration of recognition of the installment gain from the first sale will generally result only to the extent additional cash and other property flows into the related group as a result of a second disposition of the property. In the case of a second disposition which is not a sale or exchange, the fair market value of the property disposed of is treated as the amount realized for this purpose.

The excess of any amount realized from resales over payments received on the first sale as of the end of a taxable year will be taken into account. Thus, the tax treatment would not turn on the strict chronological order in which resales or payments are made. If, under these rules, a resale results in the recognition of gain to the initial seller, subsequent payments actually received by that seller would be recovered tax-free until they have equaled the amount realized from the resale which resulted in the acceleration of recognition of gain.

In the case of property other than marketable securities, the resale rule will apply only with respect to second dispositions occurring within 2 years of the initial installment sale. For this purpose, the running of the 2-year period would be suspended for any period during which the related purchaser's risk of loss with respect to the property is substantially diminished. This rule will apply with respect to the holding of a put, the holding of an option by another person, a short sale, or any other transaction which has the effect of substantially diminishing the risk of loss. However, for this purpose, a typical close corporation shareholders' agreement is not intended to be taken into account. Further, the holding of an option is not to be considered to have the effect of substantially diminishing risk of loss if the option purchase price is to be determined by reference to the fair market value of the property at the time the option is exercised.

In the case of marketable securities, the resale rule would apply without a time limit for resales occurring before the installment obligation is satisfied. For this purpose, the term "marketable security" means any security for which, as of the date of disposition, there was a market on an established securities market, or otherwise.[20]

The bill also contains several exceptions to the application of these rules. Since gain from the sale of a corporation's treasury stock is nontaxable and therefore its basis in the stock is irrelevant, this related party rule will not apply to any nonliquidating installment sale of stock to the issuing corporation. In addition, there would be no acceleration of recognition of gain as a result of a second disposition which is an involuntary conversion of the property if the first sale occurred before the threat or imminence of the conversion. Further there would be no acceleration of recognition of gain from a second disposition which occurs after the death of the installment seller or

[20] The term "marketable securities" includes securities which are listed on the New York Stock Exchange, the American Stock Exchange, or any city or regional exchange in which quotations appear on a daily basis, including foreign securities listed on a recognized foreign national or regional exchange; securities regularly traded in the national or regional over-the-counter market, for which published quotations are available; securities locally traded for which quotations can readily be obtained from established brokerage firms; and units in a common trust fund. Mutual fund shares for which redemption prices are published would also be considered marketable securities.

purchaser. Finally the resale rules will not apply in any case where it is established to the satisfaction of the Internal Revenue Service that none of the dispositions had as one of its principal purposes the avoidance of Federal income taxes.

Generally, the bill limits the specific exceptions to situations where the second disposition is of an involuntary nature. In cases of voluntary transfers, the nontax avoidance exception may apply. However, for these exceptional cases, it is anticipated that regulations would provide definitive rules rather than having complicated legislation prescribe substituted property or taxpayer rules which would not be of general application. In appropriate cases, it is anticipated that the regulations and rulings under the nontax avoidance exception will deal with certain tax-free transfers which normally would not be treated as a second disposition of the property, e.g., charitable transfers, gift transfers, and transfers to a controlled corporation or a partnership. Generally, it is intended that a second disposition will qualify under the nontax avoidance exception when it is of an involuntary nature other than by reason of an involuntary conversion such as casualty or condemnation, e.g., foreclosure upon the property by a judgment lien creditor of the related purchaser or bankruptcy of the related purchaser. In addition, it is intended that the exception will apply in the case of a second disposition which is also an installment sale if the terms of payment under the installment resale are substantially equivalent to, or longer than, those for the first installment sale. However, the exception would not apply if the resale terms would permit significant deferral of recognition of gain from the initial sale when proceeds from the resale are being collected sooner.

Under the bill, the period for assessing a deficiency in tax attributable to a second disposition by the related purchaser will not expire before the day which is 2 years after the date the initial installment seller furnishes a notice that there was a second disposition of the property. The notice is to be furnished in the manner prescribed by regulations. Under the bill, a protective notification may be filed to prevent the tolling of the period of limitations for assessing a deficiency in cases where there are questions as to whether a second disposition has occurred (e.g., a lease which might be characterized as a sale or exchange for tax purposes) or whether there is a principal purpose of Federal income tax avoidance.

For purposes of the related party rules, the bill adopts a definition of related parties which will include spouses, children, grandchildren, and parents but will exclude brothers and sisters. However, it is to be understood that the provisions governing the use of the installment method to report sales between related parties, and the definition of such relationships, are not intended to preclude the Internal Revenue Service from asserting the proper tax treatment of transactions that are shams. In the case of a corporation, it will be considered to be related to another taxpayer if stock which is or might be owned by it is or would be treated as owned by the other taxpayer under the general corporate attribution rules (Code sec. 318). Generally, a related corporation will be one in which a person directly or indirectly owns 50 percent or more in value of the stock in the corporation. Also for this purpose, the principles of the general corporate stock ownership attribution rules (Code sec. 318) will apply in determining the related party status of partnerships, trusts, and estates.

Sales of depreciable property between certain closely-related parties

Under the bill, the accrual method of accounting in effect is required for deferred payment sales of depreciable property between certain closely-related parties.[21] In general, this special rule applies to transactions which are fairly analogous to "self-dealing" transactions involving transfers of depreciable property to obtain income tax deferral benefits. For transactions to which the special rule will apply, the deferred payments will be deemed to be received in the taxable year in which the sale occurs. In the case of sales for contingent future payments, it is intended that, in general, the amount realized in the year of sale will be equal to the value of the property sold.

This special rule will apply only to deferred payment sales between a taxpayer and the taxpayer's spouse; the taxpayer and a trust treated as owned by the taxpayer or the taxpayer's spouse under present law; the taxpayer and a partnership or corporation which is 80-percent owned by the taxpayer and/or the taxpayer's spouse; and between partnerships and corporations which are 80-percent owned by the taxpayer and/or the taxpayer's spouse.[22] To avoid possible application to transactions which may be undertaken other than for tax avoidance purposes, an exception is provided with respect to a deferred payment sale between a taxpayer and his spouse if the sale is incident to a divorce or a separation. Thus, the special rules will not apply, if, at the time of the installment sale, the husband and wife are legally separated under a decree of divorce or separate maintenance. Also, they will not apply if the installment sale occurs pursuant to a settlement in a proceeding which culminates in a decree of divorce or separate maintenance.

The Ways and Means Committee intended that no inference be drawn from these provisions as to the proper treatment of any related party installment sale occurring prior to the effective date provided under the bill.

G. Receipt of Like Kind Property (sec. 2 of the bill and new sec. 453(f)(6) of the Code)

Present law

Under present law, the transfer of property for cash payments and like kind property may qualify both for installment method reporting and, with respect to the gain attributable to the like kind exchange, nonrecognition treatment (Code sec. 1031 and Rev. Rul.

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[21] In the case of transfers which are treated as tax-free transfers to a controlled corporation or to a partnership (Code secs. 351, 362, 721, and 723), the provisions of present law would continue to apply and would not be affected by the provisions. Also, in the case of transactions which are governed by the doctrine of liquidation-reincorporation under present law, the tax treatment for those transactions would continue to be governed by present law and would not be affected by the provision.

[22] In general, the relationships covered by the special rule will be similar to the relationships covered under the provisions of existing law which prescribe special income characterization rules for certain transactions between closely-related taxpayers (Code secs. 1239 and 707(b)(2)). However, ownership by family members other than husband and wife will not be attributed.

65–155, 1965–1 C.B. 356). In this case, the gain to be recognized under installment method reporting is the total gain realized on the transaction less the gain eligible for nonrecognition under the like kind exchange provision. However, the value of the like kind property received by the seller is taken into account in determining the amount of the selling price, the contract price, and payments received for purposes of the installment sale provision.[23] The value of the like kind property received is treated as a payment received in the taxable year in which the sale or exchange is made.

Explanation of provision

Under the bill, property permitted to be received without recognition of gain in an exchange described in Code section 1031(b) [24] will not be treated as payment for purposes of reporting income under the installment method.

Thus, in reporting the gain on the exchange under the installment method where an installment obligation is received in addition to the like kind property, the gross profit will be the amount of gain which will be recognized on the exchange if the installment obligation were satisfied in full at its face amount. Also, the total contract price will not include the value of the like kind property but instead will consist solely of the sum of the money and fair market value of other property received plus the face amount of the installment obligation.

The basis of the like kind property received (determined under section 1031(d)) will be determined as if the obligation had been satisfied at its face amount.[25] Thus, the taxpayer's basis in the property transferred will first be allocated to the like kind property received (but not in excess of its fair market value) and any remaining basis will be allocated ratably among the installment obligation and any cash or nonqualifying property.

The bill also provides that similar treatment applies in the case of an exchange under a plan of corporate reorganization described in section 356(a) which is not treated as a dividend.

These provisions may be illustrated by the following example. Assume that the taxpayer exchanges property with a basis of $400,000 for like kind property worth $200,000, and an installment obligation for $800,000 with $100,000 payable in the taxable year of the sale and the balance payable in the succeeding taxable year. The example compares present law, which takes like kind property into account as payment, with the bill which reverses this rule.

[23] Rev. Rul. 65–155, 1965–1 C.B. 356; *Clinton H. Mitchell*, 42 T.C. 953, 965 (1964); *Albert W. Turner*, TC Memo 1977–437. A similar case under present law involves the treatment of an installment obligation received as "boot" in exchange by a shareholder under a plan of corporate reorganization (sec. 356(a)(1)). Present law is unclear whether the exchange qualifies for installment sale reporting.

[24] This provision includes like kind exchanges (sec. 1031), exchanges of certain insurance policies (sec. 1035), certain exchanges of stock of the same corporation (sec. 1036), and certain exchanges of United States obligations (sec. 1037).

[25] This is the same rule as presently set forth in Rev. Rul. 65–155, *supra*.

	Rev. Rul. 65-155—Like kind property taken into account	*Like kind property not taken into account*
Contract price	$1,000,000	$800,000
Gross profit	600,000	600,000
Gross profit ratio (percent)	(60)	(75)
Gain to be reported for:		
1. Taxable year of sale:		
(a) 60% of $300,000 (payments "received" of $100,000 cash and $200,000 value of like property)	180,000	
(b) 75% of $100,000 (cash payments)		75,000
2. Succeeding taxable year:		
(a) 60% of $700,000 (cash received)	420,000	
(b) 75% of $700,000 (cash received)		525,000
Total gain recognized	600,000	600,000
3. Basis of like kind property received	200,000	200,000

H. Installment Obligations Distributed in a 12-Month Corporate Liquidation (sec. 2 of the bill and new sec. 453(h) of the Code)

Present law

Under present law, gain or loss is not generally recognized at the corporate level for sales and exchanges occurring during the 12-month period after the corporation has elected a plan of complete liquidation (Code sec. 337). A special rule provides that in this situation gain or loss generally is not recognized to the liquidating corporation for distributions of installment obligations (Code sec. 453(d)(4)(B)). Gain or loss is recognized by the shareholders with respect to the liquidating distributions. No special exception applies for the distribution of installment obligations to shareholders so that the shareholders may defer reporting gain from the obligations.

Explanation of provision

Under the bill, in the case of a corporate liquidation the receipt by a shareholder (under Code sec. 331) of an installment obligation which was received by the corporation during its 12-month liquidation period (under Code sec. 337) generally will not be treated as the receipt of payment by the shareholder. Instead, the shareholder may report gain from the exchange of stock on the installment method, taking gain into account as payments are received on the installment obligation received as a liquidating distribution. Where a parent liquidating corporation had a subsidiary which received an obligation during the

subsidiary's liquidation (to which sec. 337(c)(3) applied) that obligation also will qualify for installment reporting by the shareholders of the parent corporation. However, in no event will obligations received by the liquidating corporation from the sale of inventory, other than from the bulk sale, qualify for installment treatment by the shareholder.

Where liquidating distributions are received by a shareholder in more than one taxable year, the shareholder will be required to recompute the gain reported from the liquidation by allocating basis in the stock pro rata over all payments received (or to be received). This may require amended returns if the liquidating distributions are not all received during the same taxable year of the shareholder.

The following example will illustrate the operation of this rule. Assume that the taxpayer is the sole shareholder of a corporation with an adjusted basis of $200,000 in the stock (all of the stock having been acquired in the same transaction at the same cost), and is a calendar year taxpayer. Also, assume that the corporation adopts a plan of liquidation in July 1982, that the corporation sells all of its assets in August 1982 to an unrelated purchaser for $1 million, consisting of $250,000 in cash and an installment note for $750,000, that the entire gain qualifies for nonrecognition under section 337, that there is no imputed interest income or original issue discount, that the corporation distributes the cash in November 1982 and that the note is distributed in complete liquidation in June 1983. The taxpayer would initially report a gain of $50,000 in 1982 ($250,000 cash received less $200,000 basis in the stock).

After the distribution of the note in 1983, under the installment method, the taxpayer would recompute the gain reported in 1982 by allocating basis according to the installment sales rules. Thus, 75 percent ($750,000 (face amount of installment obligation) divided by $1 million (total distribution)) of the taxpayer's basis in the stock, or $150,000 (75 percent times $200,000) would be allocated to the installment obligation. Further, 25 percent ($250,000 divided by $1 million) of the taxpayer's basis in the stock or $50,000 (25 percent times $200,000) is allocated to the distribution of the cash. The taxpayer thus is required to file an amended return for 1982 to reflect an additional $150,000 of gain (cash received of $250,000 less the sum of $50,000 basis and $50,000 gain initially reported). Eighty percent of each payment on the note (other than interest) must be reported as gain by the taxpayer (gain of $600,000 ($750,000 face amount of obligation less basis of $150,000) divided by $750,000 (contract price)).

Under the bill, nonrecognition treatment will not be available if the installment purchaser is either the shareholder-distributee's spouse, a trust treated as owned by the shareholder-distributee or his spouse, or a corporation or a partnership which is 80-percent owned by the shareholder-distributee and/or his spouse.[26]

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[26] In general, the relationships covered by the exception to nonrecognition treatment are similar to the relationships covered under the provisions of existing laws which prescribe special income characterization rules for certain transactions between closely related taxpayers (Code secs. 1239 and 707(b)(2). However, ownership by family members other than husband and wife will not be attributed.

In the case of transactions which are governed by the doctrine of liquidation-reincorporation under present law, the tax treatment for those transactions would continue to be governed by present law and would not be affected by this provision.

Finally, if another related party (a person who is not covered by the preceding special recognition rule but who is related within the meaning of new sec. 453(f)(1)) purchases the corporate assets and then disposes of them, the related party disposition rules (as previously described under part F of this report) will apply to the shareholder who received the related party's installment obligations as a liquidating distribution. In other words, in these cases, the shareholder-distributee will be substituted for the liquidated corporation for purposes of applying the related party resale rules provided under the bill.

I. Sales Subject to a Contingency (sec. 2 of the bill and new sec. 453(i) of the Code)

Present law

As a general rule, installment reporting of gain from deferred payments is not available where all or a portion of the selling price is subject to a contingency. The case law holds that the selling price must be fixed and determinable for section 453(b) to apply.[27] An agreement, however, to indemnify the purchaser for breach of certain warranties and representations by offset against the purchase price will not disqualify an installment sale under section 453(b).[28] Exactly how broad such contingencies can be is unclear.

Where an installment sale is subject to a contingency with respect to the price and the installment method is not available, the taxpayer is required to recognize all of the gain in the year of the sale with respect to all of the payments to be made, even though such payments are payable in future taxable years. In the case of a cash-method taxpayer whiere the future payments have no readily ascertainable fair market value, the taxpayer may treat the transaction with respect to those payments as "open" and use the cost-recovery method under *Burnet* v. *Logan*, 2830 U.S. 404 (1931).

Explanation of provision

The bill permits installment sale reporting for sales for a contingent selling price. In extending eligibility, the bill does not prescribe specific rules for every conceivable transaction. Rather, the bill provides that specific rules will be prescribed under regulations.

However, it is intended that, for sales under which there is a stated maximum selling price, the regulations will permit basis recovery on the basis of a gross profit ratio determined by reference to the stated maximum selling price. For purposes of this provision, incidental or remote contingencies are not to be taken into account in determining if there is a stated maximum selling price. In general, the maximum selling price would be determined from the "four corners" of the contract agreement as the largest price which could be paid to the taxpayer assuming all contingencies, formulas, etc., operate in the taxpayer's favor. Income from the sale would be reported on a pro rata basis with respect to each installment payment using the maximum selling price to determine the total contract price and gross profit

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[27] *Gralapp* v. *United States*, 458 F.2d 1158 (10th Cir. 1972); *In re Steen*, 509 F.2d 1398 (9th Cir. 1975).

[28] See Rev. Rul. 77-56, 1977-1 C.B. 135.

ratio. If, pursuant to standards prescribed by regulations, it is subsequently determined that the contingency will not be satisfied in whole or in part, thus reducing the maximum selling price, the taxpayer's income from the sale would be recomputed. The taxpayer would then report reduced income, as adjusted, with respect to each installment payment received in the taxable year of adjustment and subsequent taxable years. If the maximum price is reduced in more than one taxable year, *e.g.*, because of successive changes in the status of the contingency, each such year of reduction would constitute an adjustment year.

Where the taxpayer has reported more income from installment payments received in previous taxable years than the total recomputed income, the taxpayer would be permitted to deduct the excesses in the adjustment year as a loss.

In cases where the sales price is indefinite and no maximum selling price can be determined but the obligation is payable over a fixed period of time, it is generally intended that basis of the property sold would be recovered ratably over that fixed period. In a case where the selling price and payment period are both indefinite but a sale has in fact occurred, it is intended that the regulations would permit ratable basis recovery over some reasonable period of time. Also, in appropriate cases, it is intended that basis recovery would be permitted under an income forecast type method.[29]

The creation of a statutory deferred payment option for all forms of deferred payment sales significantly expands the availability of installment reporting to include situations where it has not previously been permitted. By providing an expanded statutory installment reporting option, the Ways and Means Committee believed that in the future there should be little incentive to devise convoluted forms of deferred payment obligations to attempt to obtain deferred reporting. In any event, the effect of the new rules is to reduce substantially the justification for treating transactions as "open" and permitting the use of the cost-recovery method sanctioned by *Burnet* v. *Logan*, 283 U.S. 404 (1931). Accordingly, it was the Ways and Means Committee's intent that the cost-recovery method not be available in the case of sales for a fixed price (whether the seller's obligation is evidenced by a note, contractual promise, or otherwise), and that its use be limited to those rare and extraordinary cases involving sales for a contingent price where the fair market value of the purchaser's obligation cannot reasonably be ascertained.

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[29] In general, the income forecast method for basis recovery is considered appropriate for a transaction with respect to which it may be demonstrated that receipts will be greater for the earlier years of the payment period and then decline for the later years of the payment period. It is intended that the regulations will deal with the application of this method with respect to sales of property qualifying for depreciation under the income forecast method (e.g., movies), mineral rights when the selling price is based on production, a sale under which the amount payable to the seller is based on a declining percentage of the purchaser's revenues, and similar sales. In developing these regulations, the committee intends that the Treasury Department will prescribe rules for this method to avoid, whenever possible, leaving a seller with an unrecovered basis in the obligation, and thereby creating a capital loss, after the final payment is received. For qualifying transactions, a more rapid basis recovery under this method is to be allowed even if there is a fixed period over which payments are to be received.

J. Cancellation of Installment Obligation (sec. 2 of the bill and new sec. 453B(f) of the Code)

Present law

Under present law, some have argued that the installation obligation disposition rules can be avoided by making gift cancellations of the obligation or the installments as they come due. In other words, by making an installment sale and then cancelling the obligation or a number of installment payments, it is argued that the seller will incur no income tax liability, but possibly some gift taxes, and the buyer will have a cost basis in the property sold although no income tax cost will have been incurred on the transaction. If a direct gift is made, the donee's basis is generally the same as the donor's basis rather than a "cost" basis which reflects future payments which will never be made.

This cancellation technique is based on a District Court's decision in *Miller* v. *Usry*.[30] In that case, the court held that the disposition rules for obligations disposed of other than by sale or exchange were directed at corporate transfers and should not be applied to a cancellation of the obligation where there has been no actual, real, or material gain to the taxpayer. The court did not consider the possible benefit to the donee from acquiring a cost basis through the installment sale. Next, the court held that the disposition rules for satisfaction at other than face value did apply to a cancellation but no tax was incurred because no amount was realized by the taxpayer.

Explanation of provision

The bill makes it clear that the cancellation of an installment obligation is treated as a disposition of the obligation. In the case where the obligor is a related party, the amount taken into account as a disposition triggering recognition of unreported gain attributable to the obligation is not to be less than the face amount of the installment obligation.

K. Bequest of Obligation to Obligor (sec. 3 of the bill and new sec. 691(a)(5) of the Code)

Present law

Under present law, the installment obligation disposition rules do not apply to the transmission of installment obligations at death (Code secs. 453(d)(3) and 691(a)(4)). However, unreported gains attributable to installment obligations are treated as items of gross income in respect of a decedent so that the recipient is taxed upon receipt of the installment payments in the same manner as the deceased seller would have been had he lived to receive the payments. A special rule allows a deduction for the estate taxes attributable to the unreported gain on the installment obligation (Code sec. 691(c)).

Another provision (Code sec. 691(a)(2)) provides that the transfer of an installment obligation to the estate of the deceased seller will not be treated as a transfer requiring the reporting of gain. In addition, this rule applies to a transfer to a person pursuant to the right of such person to receive the installment obligation by reason of the death of the seller or by bequest, devise, or inheritance from the seller.

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[30] 160 F. Supp. 368, 58-1 USTC ¶ 9393 (W.D. La. 1958).

Because of these rules, it has been argued that any unreported gain remaining at the death of the seller will never be taxed if the installment obligation is left to the obligor. In this case, it is argued that there will never be a disposition or collection of the unpaid balance because there has been a merger of interests of obligor and obligee. In other words, the obligor will have acquired a cost basis for depreciation and resale purposes prior to the seller's death, but no income tax cost will have been incurred with respect to the gain unreported by the seller at the time of his death.

Explanation of provision

The bill provides that any previously unreported gain from an installment sale will be recognized by a deceased seller's estate if the obligation is transferred or transmitted by bequest, devise, or inheritance to the obligor or is cancelled by the executor.

In the absence of some act of cancelling the obligation by distribution or notation which results in cancellation under the Uniform Commercial Code or other local law, the disposition will be considered to occur no later than the time the period of administration of the estate is concluded.

If the cancellation occurs at the death of the holder of the obligation, the cancellation is to be treated as a transfer by the estate of the decedent. However, if the obligation were held by a person other than the decedent, such as a trust, the cancellation will be treated as a transfer immediately after the decedent's death by that person.

If the decedent and the obligor were related persons (within the meaning of new Code section 453(f)(1)), the fair market value of the obligation for disposition purposes is not to be treated as less than its face amount.

For purposes of this provision, if an installment obligation becomes unenforceable, it will be treated as if it were cancelled.

L. Foreclosure of Real Property Sold on Installment Method by Deceased Taxpayer (sec. 4 of the bill and sec. 1038 of the Code)

Present law

Under present law, the recognition of gain upon a reconveyance of real property to the seller in partial or full satisfaction of purchase money debt is limited (Code sec. 1038). Losses, including bad debt losses, are also not recognized upon a reconveyance of real property. With respect to gains, the amount of gain required to be recognized upon reconveyance of the real property sold generally is limited to the lesser of the amount of any remaining unreported portion of the original gain or the amount by which the sum of the money and fair market value of property received prior to the reacquisition exceeds the amount of gain previously reported. The Internal Revenue Service has ruled that this provision does not apply to a reconveyance to the estate of a deceased taxpayer who made the original sale (Rev. Rul. 69–83, 1969–1, C.B. 202). In other words, a decedent's estate is not permitted to succeed to the tax treatment which would have been available to the decedent had he lived to receive the reconveyance because the estate is considered to be a separate taxable entity.

Explanation of provision

Under the bill, the estate or beneficiary of a deceased seller will be entitled to the same nonrecognition treatment upon the acquisition of real property in partial or full satisfaction of secured purchase money debt as the deceased seller would have been entitled.

The basis of the property acquired will be the same as if the property had been reacquired by the original seller, increased by an amount equal to the section 691(c) deduction for estate taxes which would have been allowable had the repossession been taxable.

M. Effective Dates (sec. 5 of the bill)

In general, the provisions of the bill are effective for dispositions of property, cancellations and reacquisitions of real property, as the case may be, occurring after the date of enactment. However, the related party installment sale rules would apply to installment sales (first dispositions) after May 14, 1980. The provision relating to the distribution of installment obligations in connection with a 12-month corporate liquidation would apply with respect to installment obligations distributed after March 31, 1980.

N. Revenue Effects

Due to the interaction between the provisions of this bill, revenue effects for each specific provision cannot be determined independently. It is estimated that on balance the provisions of this bill (except related party sales) will not have a significant revenue effect on budget receipts.

Due to the extensive litigation and controversy concerning the treatment of related party sales under present law, the revenue gain for this provision of the bill is indeterminant.

The Director of the Congressional Budget Office and the Treasury Department agree with this statement.

Senator BYRD. The hour of 9 o'clock having arrived, the subcommittee will come to order.

The subcommittee will today consider H.R. 6883, and seven miscellaneous tax bills, S. 2512, S. 2900, S. 2915, S. 2916, S. 3070, S. 3076, and S. 3080.

The installment sales bill, H.R. 6883, deserves careful attention. It represents a major effort on the part of the professional tax community, the Congress, and the Department of the Treasury to develop a simplified system of installment sales reporting. At the same time, many are concerned that while simplifying certain parts of the tax code, the bill will add additional complications as far as transactions between related parties are concerned. The subcommittee must assess carefully as to whether the changes in this area are worth the additional complications involved.

The subcommittee looks forward to the statements of each of the witnesses.

The first bill to be considered will be H.R. 6883, the installment sale proposal. Our first witness was to be the distinguished Senator from Maryland, Senator Mathias, but he has been momentarily delayed.

Mr. Halperin, would you want to begin your statement. We may need to interrupt you temporarily when Senator Mathias gets here. If it would be satisfactory to you, why don't you proceed until Senator Mathias arrives.

STATEMENT OF DANIEL I. HALPERIN, DEPUTY ASSISTANT SECRETARY (TAX LEGISLATION), DEPARTMENT OF THE TREASURY

Mr. HALPERIN. Thank you, Mr. Chairman.

Senator BYRD. Are you speaking in support or in opposition to this proposal.

Mr. HALPERIN. We are speaking in support of H.R. 6883. We do not object to S. 3080. We oppose the other six bills before you.

Senator BYRD. Wait just 1 minute, I would like to get these facts down.

You favor 6883, is that correct?

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

Senator BYRD. What about S. 2512?

Mr. HALPERIN. We oppose S. 2512.

Senator BYRD. You oppose that?

Mr. HALPERIN. Yes.

Senator BYRD. What about S. 2900?

Mr. HALPERIN. We oppose S. 2900.

Senator BYRD. What about S. 2915?

Mr. HALPERIN. We oppose S. 2915.

Senator BYRD. What about S. 2916?

Mr. HALPERIN. We oppose S. 2916.

Senator BYRD. S. 3070?

Mr. HALPERIN. We oppose S. 3070.

Senator BYRD. S. 3076?

Mr. HALPERIN. We oppose S. 3076.

Senator BYRD. S. 3080?

Mr. HALPERIN. We have no objections to S. 3080.

Senator BYRD. You may proceed.

Mr. HALPERIN. Thank you, Mr. Chairman.

I think that it is perhaps fitting that a hearing focused on simplification in the area of installment sales is somewhat encumbered by consideration of six miscellaneous matters. One thing that we have been pointing out to the committee over the last several years is that one detriment to the work that should go forward on cleaning up technical problems and uncertainties in the code is the time taken of the staff and of the committee to consider, often, special interest matters which have no justification, or which cannot justify the time that is required to be spent on them.

Senator BYRD. I don't understand what you mean by that. If a Senator or a Member of the House introduces a piece of legislation, you say you are going to judge whether it is frivolous or not, and whether it is worth the time of the staff and yourself to consider it. Is that what you are saying?

Mr. HALPERIN. Mr. Chairman, I am saying that there is limited time that this committee has and that the staff has.

Senator BYRD. No one knows that better than the members of the committee. We are the ones who have to sit here day after day.

Mr. HALPERIN. We have to choose what we can work on. We have to choose what we can spend our time on. Unless we are willing to limit the time that we spend on special interest matters, we will have less time available for matters of more general applicability.

Senator BYRD. I think that you had better clarify what you are saying. I don't understand what you are saying. If I do understand it, I don't think much of it.

Please clarify what you are saying.

Mr. HALPERIN. Mr. Chairman, I can see that you are not agreeing with the position that we have taken.

Senator BYRD. What is your position?

Mr. HALPERIN. Our position is that we have to select priorities. We cannot do everything.

Senator BYRD. Who has to select priorities?

Mr. HALPERIN. The committee has to select priorities.

Senator BYRD. That is what the committee is doing.

Mr. HALPERIN. Mr. Chairman, the committee is able, through the way it operates and through the approach that it takes to matters, to indicate what things it will spend its time on, and what matters it believes are important. The committee, therefore, can select an agenda which will deal with more generally important matters.

Obviously, it does not mean that it will not look at particular bills.

Senator BYRD. What does it mean, then? You feel you want to select what bills the committee will consider?

Mr. HALPERIN. Certainly not, Mr. Chairman.

Senator BYRD. Senator Mathias introduced S. 2512. Senator Mathias introduced S. 2900. Senator Roth introduced S. 2915. Senator Durenberger introduced S. 3770. Senator Dole and Senator Talmadge introduced S. 2916. Senator Durkin introduce S. 3076. Senator Byrd of Virginia introduced S. 3080, which bill, incidentally, you are not opposed to.

Are you saying that Senator Mathias ought not to have his day in court because you don't think that it is an important enough bill?

Are you saying that Senator Dole, or Senator Durenberger, or Senator Talmadge should not have an opportunity to present their views?

Mr. HALPERIN. No, Mr. Chairman, I am not trying to take that position, obviously.

Senator BYRD. It is the position you are taking.

Mr. HALPERIN. Obviously, they are entitled to have their bills considered by the committee.

Senator BYRD. The position you are taking is, apparently, that you want to tell this committee what bills it ought to consider and what bills it ought not to consider.

Mr. HALPERIN. That is not what I am trying to say, Mr. Chairman.

Senator BYRD. All right, so long as this Senator is chairman of this subcommittee, this committee will make the decisions as to what bills we feel we need to hear, and we will proceed accordingly.

Now, you may go ahead with your testimony.

Mr. HALPERIN. As we indicated, Mr. Chairman, we oppose six of the bills before you. Some of them are matters of special interest. For example, S. 3076 would allow a particular foundation to continue to own the stock of one business corporation, even though there is no current benefit to charity.

The 1969 act provided restrictions on the activities of private foundations. We believe that the policy adopted in 1969 was sound, and it has resulted over the last 10 years in strengthening the charitable sector. There is no reason to adopt special exemptions to those provisions at this point, and of course one single exemption will inevitably lead to another.

Some of the other bills before you, S. 2916, for example, which involves the investment credit and the minimum tax, and S. 2915 and S. 3070, which deal with the foreign tax credit limitations, involve matters of general applicability.

Mr. Chairman, maybe here I can make the point that I have been trying to make clear. These bills do involve matters of general interest, but I believe that they are illustrations of the wrong way to approach the problem.

The question of the foreign tax credit on capital gains was an issue that this Congress dealt with in 1976. It closed what was a obvious loophole in the law, and we believe that to the extent these bills reopen the 1976 loophole, they have no justification.

For example, people were able to use the creation of capital gains from foreign sources, sometimes artificially created, and by creating that additional foreign source income they were able to offset their U.S. tax on what was essentially income from U.S. sources. In other words, they were using the foreign tax credit not to avoid double taxation, but to avoid paying taxes on income from U.S. sources.

At the same time, we do recognize that the 1976 act did not fully deal with the problem in a comprehensive manner. Taxpayers with excessive foreign tax credits still have an incentive to export their

passive investments. A taxpayer who is sitting there with excess foreign tax credits realizes that he can create income from foreign sources, he does not have to pay any U.S. tax on that income.

So that taxpayer, rather than putting the money in a U.S. bank, for example, or buying stock in a U.S. corporation, might look to do the same thing abroad, often is able to do that with very low foreign taxes, and pays no U.S. tax because of the existing excess credits. That is not a healthy situation for the American economy, and it is something we ought to try to eliminate.

We have suggested a possible solution to that problem, and we would suggest that those parties interested in S. 2915 and S. 3070, rather than developing an ad hoc reaction to their particular situation, which they feel was unfairly treated by the 1976 change, that they join us in an overall solution, which may well alleviate their problem, as well as the one that I have indicated.

I think that if the committee would urge people, when they have particular problems, to try to look at it in the overall context, and try to consider the general problems of the Internal Revenue Code, and the administration of the tax law. Then we could have more fruitful tax legislation, than if we just respond to particular instances without looking at them in context.

Senator BYRD. I am sure the Members of the Senate will appreciate your lecture on what they should do.

I might say that this committee hasn't the slightest intention of telling each Member of the Senate what piece of legislation he should introduce, and what he should not introduce. If you want to do that, it is up to you.

Mr. HALPERIN. As we know, Mr. Chairman, the subject today is simplification. As we contemplate enactment, hopefully, of H.R. 6883 and S. 3080, we might look to some of the other matters before us.

In particular let me refer to S. 2512 to test whether there is a constituency for simplification, or certainty in the application of the tax law and for neutrality, for example, for tax transactions or business transactions which are alike, and should be treated alike, without regard to how they are planned by particular tax advisers.

As we all know, simplification is easy to use as an argument for the substantive results that we desire. Taxpayers do not often oppose complexity when the result is to their advantage, and the same is ordinarily true of the approach taken by the Treasury.

If we are to achieve simplification, we ought to all strive to overcome our parochial interests, and temper our version of equity with the recognition that sometimes equity is not worth the cost that it imposes on the administrability of the system.

We believe that we have gone far in that direction on the installment sales bill in an effort to get this process rolling. We have, as we have indicated, not opposed the annual filing of gift tax returns despite the revenue loss that it would entail because we believe that it will reduce the administrative burden on both the taxpayer and the Internal Revenue Service.

We urge all others to join us in trying to build a constituency for simplification. I might refer to S. 2512 as a good place to start.

That bill contemplates deductions for contributions to a tax exempt trust for setting aside funds to meet potential liabilities for performances of services by architects and engineers.

We indicate in our testimony why we oppose the bill on policy grounds. For example, we don't agree that it is sound policy to encourage self-funding for risk since it involves tying up more capital if each person has to anticipate the maximum possible exposure than would be the case if there were a sharing of risk through insurance or otherwise.

Second, we don't believe that deferral of tax on investment income, which is essentially what S. 2512 accomplishes, is the best way of giving a subsidy if such a subsidy were desired. Essentially, those particular taxpayers who set aside funds for the longest period, those who have the lowest product or service liability, for example, would get the biggest benefit out of the bill, which does not seem to be what it is trying to accomplish.

But even if there were disagreements on policy, and people felt that our arguments against the bill on equity grounds were not valid, I think that there are more important reasons why that proposal ought to be rejected, when one looks at the burden that it imposes on the tax system compared to the minimal benefit achieved by the businesses involved.

There is nothing in the bill, as it is now drafted, which limits set-asides based on potential liabilities of particular taxpayers. It does not try to figure out whether one architect or one engineer has a certain exposure to potential liability as compared to another one. It has rather arbitrary limits on the amount that can be set aside.

Any effort that would be required in order to limit the set-aside to the amount actually needed, or to eliminate the benefit that taxpayers would get from putting aside funds, which they never use to meet their potential liabilities, would involve the bill in enormous complexities.

So what we have is either a complex bill, or an opportunity for tax deferral without regard to the purposes of the legislation. So we think that S. 2512 is an example where very limited benefits are sought for certain particular individuals, and the benefits are not extraordinarily significant for them. On the other hand, the burden that it potentially imposes on the tax system and the potential abuses that it creates are far greater.

If there were constituency building for simplification, that constituency would oppose that bill, and would join us in opposing that bill.

We believe that the primary focus today should be the installment sales legislation. You will hear a number of witnesses who will describe the details, and I will not go into it at this point.

I do want to point out, however, that we don't believe that complex or detailed rules necessarily can be viewed as increasing the complexity. Complexity occurs in part because people cannot understand the rules. It also occurs because the rules are uncertain. It also occurs if transactions do not produce the normal results that people expect.

If we get tax results which do not seem natural to people, they will often fall into traps, or they often will have to engage in artificial planning in order to achieve the tax results that seem

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sensible. Simplicity means getting rid of that incentive for planning, and creating certain results, and creating neutral results. We believe that this bill goes a long way to accomplishing that, particularly in the way it handles transactions between related parties.

I think it is the most important thing to recognize that we have begun a process. A number of groups have worked together. We have identified the problems with the original proposals. We have worked together to correct them. We have developed consensus among disparate interests. We are being closely watched by the business and tax community.

If this process is to continue, if people are to believe that it is worth the effort, it is important to give tangible evidence that it can work. Therefore, we urge prompt enactment of H.R. 6883. I think that it can be a start in moving toward even further simplification of the rules.

Thank you, Mr. Chairman.

[Statement of Daniel I. Halperin follows:]

For Release Upon Delivery
Expected at 9:00 a.m., EDT

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

September 10, 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 the following bills: H.R. 6883, the Installment Sales Revision Act of 1980; S. 2512, providing for a reserve for service liability losses of architects and construction engineers; S. 2915 and S. 3070, relating to foreign tax credit limitations on capital gains; S. 2916, providing that the investment tax credit may be claimed against the alternative minimum tax to the extent that it is attributable to the active conduct of a trade or business; S. 2900, exempting officers and crewmembers of fishing vessels up to 15 tons from the provisions of the Federal Unemployment Tax Act; S. 3076, exempting certain private foundations from the excess business holdings and minimum distribution rules and S. 3080, providing for annual filing of gift tax returns.

After setting out a summary and the position of the Treasury Department with respect to each bill, I will discuss each proposal in detail.

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SUMMARY

H.R. 6883 substantially revises and simplifies the rules governing the sale of real estate and the casual sale of personal property for deferred payment. The Treasury strongly supports enactment of H.R. 6883.

S. 2512 would provide for the current deduction of contributions to exempt trusts or captive insurers organized to self-fund for contingent liabilities of design professionals, such as architects and engineers, for design or construction defects. The Treasury opposes S. 2512.

S. 2900 would exclude from coverage under the Federal Unemployment Tax Act (FUTA) services performed on a fishing vessel of 10-15 net tons, if such vessel operates in an area that has the same fishing management regulations and catch limitations for vessels in the 10-15 net ton class as for vessels under 10 net tons. The Treasury opposes S. 2900.

S. 2915 and S. 3070* restore, retroactively, unjustified advantages eliminated by the Tax Reform Act of 1976 in the application of the foreign tax credit limitation to capital gain income. The Treasury strongly opposes enactment of these bills. The Treasury recommends that consideration be given to comprehensive proposals to improve the operation of the foreign tax credit limitation.

S. 2916 would provide that the investment credit may be claimed against the alternative minimum tax to the extent the credit is attributable to the active conduct of a trade or business. The Treasury Department believes that the changes made by this bill are not appropriate at this time. However, Treasury believes that the issues raised could be considered by the Congress in its consideration of capital cost recovery.

S. 3076 would exempt from the private foundation excess business holdings and minimum distribution rules a foundation which received by bequest before 1958 all of the outstanding stock of a manufacturing corporation and which satisfies certain other conditions. S. 3076 is intended to benefit the Bell Peabody Brown Foundation. The Treasury Department opposes S. 3076.

S. 3080* would eliminate the quarterly filing of gift tax returns and restore annual filing. The Treasury does not oppose S. 3080.

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* Because S. 3070 and S. 3080 were added to the agenda too recently to permit review by the Office of Management and Budget, testimony on those bills does not necessarily represent the views of the Administration.

H.R. 6883

INTRODUCTION

The Installment Sales Revision Act of 1980 is the first major substantive tax simplification effort of this Congress. At hearings on this bill's predecessor, S. 1063, Treasury emphasized the high priority it places upon simplification as a tax policy goal. Moreover, we also agreed that the installment sale area was an excellent choice for beginning what we hope will become an ongoing process.

The history of the installment sale bill to date indicates that the tax simplification process is off to a promising start. At the hearings on S. 1063, Treasury urged this Subcommittee to go beyond the specific provisions of that bill and address the area of sales for deferred payment more generally. We submitted a number of specific proposals for simplification. Representatives of the Section of Taxation of the American Bar Association, the Tax Committee of the American Institute of Certified Public Accountants and the Tax Committees of the New York State and City Bar Associations testified in support of both the concept and the general framework of the Treasury proposals.

After the completion of those hearings and similar hearings before the Select Revenue Measures Subcommittee of the House Ways and Means Committee, the staff of the Joint Committee on Taxation and the Treasury met on numerous occasions with the various groups who had indicated an interest in this area. The objective was to produce a revised bill incorporating the proposals made and resolving adequately the issues raised in the testimony and comments received by the Subcommittee. Treasury, along with those groups whose representatives were willing to donate the requisite time and effort to engage in constructive dialogue were, thereafter, intimately involved with the staff in the development of the revised installment sale bill.

This consensual process of attacking a discrete area of the tax law has been both instructive and rewarding. The prevailing attitude of those who chose to participate in this process was one of concern for the dual goals of simplification and maintenance of the integrity of the income tax. These participants shed parochial interests in order to attain these objectives. The result is H.R. 6883, a bill which Treasury endorses.

Although the bill may appear to be a more complex provision than the present section 453, it nevertheless represents a significant clarification of this area of law. The present rule is simply stated but it has given rise to a morass of case law as confusing to the sophisticated tax advisor as to the uninitiated. In addition, under present law the form, as opposed to the substance, of the transaction often determines the tax result. This

bill simplifies the law by establishing clear rules in presently unsettled areas and by making it unnecessary to engage in artificial "planning" in order to obtain a desired result.

I do not intend to examine all the technical aspects of H.R. 6883. However, because H.R. 6883 is a more ambitious bill than its predecessor, I should like to mention the major areas in which it differs from S. 1063 and also, where appropriate, to highlight the resolution of problems identified in prior testimony.

GENERAL RULE

H.R. 6883 creates a general rule for the reporting of income from deferred payment sales. Under the bill, unless the seller otherwise elects, income generally is recognized as deferred payments are received. Thus, the bill reflects the decision that, in general, deferred reporting of gain is appropriate when payment is deferred. The bill does not, however, alter existing law as to what constitutes payment* in any particular year (except as specifically provided in connection with like-kind exchanges described in section 1031(b).

The general rule accomplishes a number of significant and welcome results. First, it eliminates the election requirement of present law and thereby removes a "trap" for taxpayers who, for the most part, desire the deferred reporting privilege. Second, it greatly expands the availability of the deferred reporting privilege to include, in particular, sales in which the seller receives more than 30 percent of the selling price in the year of sale and sales in which the total price is uncertain or subject to a contingency. Third, uncertainty surrounding calculation of the present law 30 percent threshhold limitation, which has proved a fertile ground for error and litigation, is eliminated. Fourth, the inducement to structure normal business transactions in a byzantine manner in order to achieve deferred reporting of gain is removed.

The key to allowing deferred payment reporting where the gross profit or total contract price (or both) is uncertain or subject to contingencies lies in the development of rules requiring basis to be allocated ratably to the deferred payments. This

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* We understand that an amendment may be offered which provides that a third-party guarantee or standby letter of credit do not constitute payment. We do not object to such an amendment, provided it is strictly limited. In addition, we believe that a suggested amendment permitting installment sale treatment for sales to cooperatives is unnecessary in light of Revenue Ruling 73-210, 1973-1 C.B. 211.

is recognized in the bill. However, rather than attempting to provide basis allocation rules for every conceivable transaction, the bill provides that specific rules will be prescribed by regulation. Thus, unusual cases can be resolved as they arise.

In general, the regulations to be promulgated pursuant to this authority will provide that, for sales under which there is a stated maximum selling price, basis will be recovered in accordance with a gross profit ratio determined by reference to the stated maximum selling price. In general, where the sales price is indefinite but payable over a fixed period of time, the basis of the property sold would be recovered ratably over that fixed period. In cases where the selling price and payment period are both indefinite, the regulations will permit ratable basis recovery over some reasonable period of time, such as 20 years. Also, in appropriate cases, basis recovery will be permitted under an income forecast-type method.

ELECTION TO ACCELERATE RECOGNITION

Mandatory deferred gain recognition could work hardships where taxpayers desire to accelerate recognition, for example, to use otherwise expiring carryovers. Some witnesses also expressed concern that in the rare case where it was not possible to calculate the value of the consideration to be received by the seller, it would likewise be impossible to provide an adequate ratable basis recovery rule.

These concerns are addressed by permitting taxpayers to elect not to report gain on the installment method. Election out of the installment method must generally be made on or before the due date (including extensions) of the taxpayer's return for the year of the sale. An election may be revoked with the consent of the Secretary. That consent will be granted where a tax avoidance purpose is not present.

Where a taxpayer elects out of the installment method, the gain in the year of sale will be equal to the difference between the value of the deferred payment obligation and the seller's basis. However, under the bill, the justification for treating transactions as "open" and permitting the use of the cost-recovery method of accounting is substantially reduced. Therefore, the cost-recovery method will not be available in the case of sales for a fixed price or stated maximum price (whether the seller's obligation is evidenced by a note, contractual promise or otherwise). Its use will be limited to those rare and extraordinary cases involving sales for a contingent price where the fair market value of the purchaser's obligation cannot reasonably be ascertained.

SALES TO RELATED PARTIES

The installment method is currently abused by taxpayers who sell appreciated property to related persons (for example, a trust set up for the benefit of the seller's children) who immediately resell the property to a third party as a part of a prearranged transaction. The original seller defers recognition of gain. The related person receives the full sale proceeds tax free because the tax basis of the property in the hands of the related person is its purchase price. Thus, the economic unit comprised of the two related persons has cash equal to the value of the property while deferring taxation of the gain which would have been immediately recognized had the initial sale been for cash.

The witnesses appearing before the Subcommittee at its hearings on S. 1063 generally recognized that this technique (known as the Rushing rule, after the case which upheld the tax treatment described above) constituted an abuse which should be eliminated. However, all also agreed that the S. 1063 flat prohibition of installment reporting for sales between certain related parties was too broad in its impact, particularly where the subject of the installment sale was a farm or closely held business interest.

Testimony at the prior hearing suggested that a related party sale rule should focus on the source of the abuse -- the disposition of the property by the related party buyer -- and this is the approach taken by H.R. 6883. Due to the attention this provision has attracted, it is appropriate to describe the related party rule of H.R. 6883 in some detail.

Under the bill, sales to family members, controlled corporations and partnerships, or to trusts and estates in which any related person has a specified interest will be subject to a special disposition rule. For purposes of this rule, persons will be treated as related if stock ownership in any amount would be attributed from one to the other under section 318(a). A subsequent disposition by the related purchaser will result in the acceleration of gain recognition on the installment obligations held by the seller based on the amount of the consideration received in the second sale.

This rule would not apply to dispositions of the property (other than marketable securities) by the related purchaser more than two years after the first sale. Thus, the bill provides a bright line test designed to separate prearranged transactions from those which occur in the normal course of business. The running of the two-year period would be suspended, however, if the related purchaser substantially diminishes his risk of loss through a short sale, the holding of a "put" or similar transaction.

The bill recognizes that even the above narrowly focused formulation may result in unwarranted acceleration of gain recognition to related sellers where dispositions by related purchasers are occasioned by unforseen events or economic necessity or otherwise do not result in the abuse in section is intended to cure. Thus, dispositions after the death of either the purchaser or seller, dispositions which occur by reason of an involuntary conversion where the initial sale occurred prior to the threat or imminence of the conversion, and sales by the issuing corporation of stock acquired from a related person are specifically excepted from the related party rules. In addition, if it can be established to the satisfaction of the Secretary that neither the first nor the second disposition has as one of its principal purposes the avoidance of Federal income tax, the disposition may be exempted from this rule.

Treasury believes strongly that the "satisfaction of the Secretary" standard should be retained. Unlike S. 1063, this provision is very narrowly focused to the abuse of the tax law it is intended to prevent. A two-year safe harbor and broad exceptions are provided. It is, therefore, appropriate to establish a strict standard for qualification for this final, catch-all exception because most legitimate transactions are already protected. This is especially true since Treasury will issue rulings and regulations describing additional categories of transactions which qualify for this exception, and it will not be necessary for taxpayers to obtain advance rulings in order to qualify.

The result is a rule Treasury believes to be fair. The parent who sells the family farm or closely held business interest to a child in a transaction structured to allow the child to pay for the interest over time is not affected by this rule so long as the child does not sell the acquired interest within two years. Thus, the rule will not cause problems for farms or businesses kept in the family. Moreover, even if the related purchaser does sell within two years, gain will not be accelerated if one of the specific exemptions applies or tax avoidance was not a principal purpose of the transaction. Thus, ample flexibility exists to deal with difficult cases as they arise.

INTERSPOUSAL SALES

H.R. 6883 includes a rule denying installment sale treatment to sales of depreciable property between spouses or controlled entities either directly or through liquidation of a corporation. We believe that this rule is appropriate. However, we suggest that technical changes be made which will make the provisions more uniform and consistent with the rules of section 1239 of the Code.* This will simplify its application.

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* In addition, a technical defect in the attribution rules under §1239 will be corrected.

The problem involving husband-wife sales, essentially a matter of self-dealing, came to our attention just before the Ways and Means Subcommittee on Select Revenue Measures was scheduled to mark up H.R. 6883. At the mark-up, the Subcommittee took a broad approach to eliminate the potential for abuse. The full Committee focused the provision more narrowly on the husband-wife situation.

After H.R. 6883 passed the House of Representatives, a new problem was discovered. Direct husband-wfe installment sales of depreciable property would be taxed on the accrual method, based on the face amount of the installment obligations. On the other hand, husband-wife installment sales of depreciable or nondepreciable property made indirectly through a liquidating corporation would be taxed, based on the fair market value of the installment obligations. This distinction between direct and indirect sales and depreciable and nondepreciable property is, of course, anamalous and should be eliminated.

In general, any sale of depreciable property between spouses or entities 80 percent controlled by the husband or wife (including partnerships as well as corporations) would be taxed on the accrual method based on the face amount of the obligation. This would apply whether the sale is direct or indirect through a liquidating corporation. Section 1239 would be amended so that its coverage would be consistent with this rule.

An exception would apply for transactions not motivated by tax avoidance such as those where the deferred gain is not recognized later than the time of enjoyment of the increased depreciation deduction created by the sale. We also intend that sales incident to a legal separation or divorce will be excepted, but expect to exempt other types of husband-wife sales only in rare or extraordinary circumstances.

SECTION 337 LIQUIDIATIONS

Under current law, a corporation generally recognizes no gain upon the distribution of installment obligations to its shareholders pursuant to a 12-month liquidation under section 337, except for recapture and other similar items. However, shareholders are taxed upon receipt as having received a distribution equal to the fair market value of the notes.

This structure leads to disparate results at the shareholder level depending upon whether a corporation sells its assets for installment obligations and then liquidates under section 337 or the shareholder sells stock in the corporation for installment obligations. In one case, gain attributable to the unpaid installment obligation is accelerated; in the other, it is not.

The transaction in which Mr. Rushing engaged was designed to avoid precisely this anamoly. The bill recognizes the anamoly and eliminates the motive for future Rushing type transactions in this area by providing that, in general, installment obligations received by corporations for assets sold after the date of adoption of a section 337 plan can be distributed without gain acceleration.

DOUBLE TAXATION OF DEALER SALES

Under present law, a technicality causes certain receipts to be taxed twice when a dealer in personal property who reports on the accrual method elects to report on the installment method. This result, of course, is unintended.

We do not object to an amendment to eliminate this problem. However, any such amendment should make clear that the taxpayer who fails to accrue the full amount of gain has elected to be treated on the installment method.

SUMMARY

I have highlighted certain portions of H.R. 6883 for the Subcommittee's attention. The bill also clarifies and rationalizes the application of the installment sale rules to like-kind exchanges, refines the definition of the disposition of an installment obligation and applies to executors and heirs the rules presently available for sellers who reacquire, in foreclosure, property sold for future payment.

It should be apparent from the foregoing that H.R. 6883 is an ambitious undertaking. Admittedly, it does not address every problem in the area of sales for future payment. However, as we have time for further study, Congressional and Treasury staffs and tax practitioners will analyze additional areas and make additional proposals when appropriate.

In the meantime, it is important that the simplification process show some tangible results. We all advocate technical simplification. We also recognize that dramatic improvements cannot be achieved overnight. But unless results are assured, we cannot expect the professional tax community or the staffs to expend the necessary resources. Prompt passage of H.R. 6833 will ensure that the enthusiasm and willingness to work hard toward this goal will be maintained.

S. 2900

S. 2900 would amend section 3306(c) of the Internal Revenue Code to exclude from the definition of covered employment under the Federal Unemployment Tax Act (FUTA) services performed by crew

members of certain fishing vessels. Under existing Code section 3306(c)(17)(B), services performed by a crew member on a fishing vessel are covered under the FUTA, if the services are performed on a vessel of more than 10 net tons. S. 2900 would amend this provision to exclude from coverage under the FUTA services performed on a vessel of from 10 to 15 net tons, if the area in which such vessel operates has fishing management regulations and catch limitations for vessels from 10 to 15 net tons which are the same as those regulations and limitations for fishing vessels under 10 net tons. These crew members would then not be considered to be employees of the fishing boat operators, and it is likely that they would be ineligible for unemployment benefits.

Historically, maritime workers have had unique employment relationships, but under maritime law, which is applied in determining their status for employment tax purposes, captains and crew members are nearly always considered to be employees of the owners of the vessels. Thus, the bill would relieve employers from paying the FUTA tax for the services of crew members, but would not alter their existing relationships which, in fact, do not reflect self-employment.

Further, such crew members, if excluded from FUTA coverage, could not obtain unemployment compensation coverage as self-employed persons, since all states provide that only employees may obtain coverage for services performed by them. Exclusion of these workers from FUTA coverage by their employers would therefore leave such workers without any protection, if, as experience has demonstrated, a Federal exclusion is quickly followed by state exclusions.

Although the revenue effects of this bill are not significant, we do not believe that an exclusion of these workers from FUTA coverage is desirable. Therefore, the Treasury Department opposes S. 2900.

S. 2915 and S. 3070

I will now comment on S. 2915 and S. 3070. These bills would amend provisions of Code section 904(b), the foreign tax credit lmitation for capital gains.

S. 2915 would amend Code section 904(b) to provide that in computing the foreign tax credit limitation, gains from the sales of patents to unrelated persons are treated in "the same manner" as ordinary income from the sale or licensing of patents. S. 3070 would amend Code section 904(b) to provide that in computing the foreign tax credit limitation, gains from the sale of certain foreign subsidiaries would be foreign source rather than U.S. source as provided under current law.

S. 2915 and S. 3070 are special interest bills designed to restore retroactively unjustified advantages eliminated by the Tax Reform Act of 1976. The Treasury strongly opposes these bills.

In the 1976 legislation Congress made badly needed changes in the application of the foreign tax credit limitation to capital gain income. First, Congress recognized that because U.S. tax is applied to capital gains at preferential rates, the foreign tax credit limitation of section 904 must be adjusted downward to avoid giving excessive foreign tax credits where there are foreign source capital gains.* Second, since U.S. law nets foreign and U.S. source capital gains and losses before applying the preferential rate, Congress in 1976 enacted the rules necessary to account for such netting in the foreign tax credit limitation.**

Third, under pre-1976 law there was considerable opportunity to assure that capital gain income would be foreign source and, therefore, avoid U.S. tax. By using the Code rule allowing the source of income to be determined by the place of sale of an asset (i.e., the place where title to the asset passes), taxpayers could plan sales of personal property to assure little or no additional foreign taxes while increasing the foreign tax credit limitation and consequently the amount of foreign taxes that could be used as a credit against U.S. tax liability. The 1976 legislation dealt with this problem by providing that for purposes of the foreign tax credit limitation for a corporation, unless the gain was subject to a foreign income tax of 10 percent or more, capital gain income attributable to the sale of personal property (other than stock in a corporation) could be foreign source only if the property was sold either in a country in which the property was used in a trade or business of the taxpayer or in which the taxpayer derived more than 50 percent of its gross income. Gain from the sale of stock in a subsidiary corporation could also be

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* For example, if a corporation had 100X of ordinary income from U.S. sources taxed at a 46 percent rate and 100X of foreign source capital gain taxed at 28 percent, pre-1976 law would have set the foreign tax credit limit equal to one-half the total U.S. tax liability. Obviously, however, the foreign source income produced significantly less than one-half of the tax burden.

** Thus, if there were a $100 capital gain from foreign sources and a $100 capital loss from U.S. sources, there would be no U.S. tax on foreign source income and the foreign tax credit limitation should be zero.

foreign source if the stock was sold in the foreign country in which the subsidiary derived more than 50 percent of its gross income.

The rules adopted by Congress in 1976 addressed serious defects in the foreign tax credit limitation. Under S. 2915 none of these 1976 rules would apply, however, to capital gains attributable to the sale, exchange or other disposition of patents, inventions, models, designs, copyrights, secret formulas and processes and any other similar property rights. Thus, if S. 2915 were enacted, a U.S. taxpayer could claim the U.S. tax benefits applicable to capital gains derived from the sale of a patent, which are greater today than they were in 1976, and inflate its foreign tax credit to avoid U.S. tax on income from U.S. sources. Although the bill states that the gain on the sale of patents should be treated in "the same manner" as ordinary income, the bill does not amend current law to tax the gain at the rates applicable to ordinary income.

A sale of patents and similar rights has all of the potential for abuse identified in 1976: (1) the possibility for over crediting by manipulating the source of the gain on the sale; (2) over crediting because of a failure to net U.S. and foreign source capital gains and losses; (3) over crediting because of a failure to account for the lower U.S. rate on capital gains. There is, therefore, no good reason to exempt patents and other intangibles from the corrective legislation enacted in 1976.

We also object to S. 3070. S. 3070 would change Code section 904 to provide that gain from the sale of stock in a foreign subsidiary could be foreign source even if the stock is sold in a country other than a country where the subsidiary derives more than 50 percent of its gross income and no foreign tax was imposed on the gain. The gain could be treated as foreign source as long as the subsidiary earned less than 50 percent of its gross income from within the United States. In effect, S. 3070 would reverse the provisions of the 1976 Act and restore to taxpayers the ability to choose the country where the income from the sale of stock is to be derived and thereby both avoid foreign taxes and increase the amount of foreign taxes they can use against their U.S. tax liability.

It should be noted that S. 3070 is not a "technical correction" even though the form of the legislation suggests that it is a minor modification to the Revenue Act of 1978. Section 701(u)(2)(C) of the Revenue Act of 1978 revised the 1976 Act rules on the foreign tax credit limitation to allow gain from a liquidation of a foreign subsidiary to be foreign source as long as less than 50 percent of the income of that subsidiary was from U.S. sources. The justification given for the exception enacted in 1978 was that a liquidation does not have the potential for manipulation and avoidance of foreign tax that does a sale of stock. Clearly, this justification does not apply to S. 3070 which would expand the

special exception for liquidations to encompass sales of stock. With this amendment, the "special exception" would subsume the 1976 rule.

S. 2915 and S. 3070 are offensive for another reason. Both bills would repeal the 1976 legislation retroactively. The effective date of S. 2915 is taxable years beginning after December 31, 1977. The effective date for S. 3070 is taxable years beginning after December 31, 1975. Such retroactive relief is not justified.

The 1976 reforms to the foreign tax credit limitation, with respect to the source of capital gains, were motivated by a concern that taxpayers could easily create "foreign source" income on certain transactions. As a consequence, both foreign and U.S. tax was being avoided. In other words, the foreign tax credit was being used to avoid all taxation, not double taxation.

Unfortunately, the 1976 legislation dealt solely with the manipulation problem in the context of transactions generating capital gains. That is, the legislation did not remove the incentive under current law for U.S. taxpayers to export capital to generate low foreign tax, foreign source passive income. This income is effectively shielded from U.S. tax to the extent that it absorbs excess credits attributable to foreign trade or business income. Since 1976 the U.S. corporate tax rate has droped. As the U.S. tax rate falls more U.S. companies find themselves with excess foreign tax credits and a growing incentive to export passive investment capital. This problem should be addressed. It could be solved by the creation of separate foreign tax credit limitations for different types of foreign source income. Income that is derived from the conduct of a trade or business in a foreign country is likely to be subject to tax in such country, and on a net basis. It is appropriate for such income to be grouped under one foreign tax credit limitation. This limitation could encompass certain types of royalty and capital gain income, such as income derived from the trade or business of developing and licensing patents for use abroad. The limitation could also encompass items such as dividends from foreign subsidiaries or gain from the sale of stock in such a subsidiary which in essence are the repatriation of trade business profits from a foreign country. A second limitation could encompass passive investment income which is likely to be subject to a different foreign tax regime than trade or business income. This second limitation could include two items that under current law are already subject to separate foreign tax credit limitations under Code section 904(d): DISC dividends and certain interest. As is the case today, separate treatment would be afforded foreign extraction income.

We believe that there is room for improvement in the foreign tax credit limitation as it applies to capital gains and other types of income. We are prepared to work with this Committee to address problems existing under current law. S. 2915 and S. 3070 do not, however, address any of those problems. Rather, the bills would simply reverse constructive steps taken in 1976.

S. 2512

S. 2512 would allow current deductions for contributions to tax-exempt trusts (or exempt captive insurers) organized to defray liability for damages arising out of services rendered in connection with the design of structures -- essentially architects' and structural engineers' product liability. The bill is similar to measures such as S. 3049 and H.R. 10272, considered during the 95th Congress, both of which would have authorized the establishment of similar trusts to defray the costs of product liability. The Treasury strongly opposes this bill, as we did the product liability bills introduced last Congress.

The Treasury testified before both the Senate and the House on the product liability bills. In our House testimony we dealt in detail with the considerations which led the Treasury (and the Administration) to object to those bills. Those observations are as pertinent to S. 2512 as they were to the product liability bills. I have, therefore, attached our testimony before the House Ways and Means Subcommittee on Miscellaneous Revenue Measures, dated September 29, 1978, to my statement.

Today I will confine myself to reiterating briefly our reasons for concluding these bills are unsound. They are that (1) self-funding, such as would be facilitated by these bills, is inherently less efficient than the pooling of risks (through commercial insurance or otherwise) as a means of providing insurance coverage for service liability; (2) with the exception of tax deferral on amounts contributed to a service liability trust or captive insurer, substantially all the benefits that would be derived from S. 2512 are available under current law; and (3) subsidizing self-funding of service liability losses through tax deferral, even assuming some subsidy is desirable, is less efficient than other forms of subsidy.

First, it should be recognized that self-funding for service liability losses is inherently less efficient than risk-pooling mechanisms. The former requires a self-insuring design professional to attempt as nearly as possible to set aside funds sufficient to cover his or her own possible loss. In contrast, risk-pooling mechanisms (including, but not limited to, commercial insurance) allow each participant to secure coverage at a cost equal to only a fraction of the amount for which they desire coverage. This is because each covered person, through the payment of premiums, makes some contribution to defraying the losses actually suffered by

other participants during the year. Through this mechanism, risk-pooling allows participants to secure coverage without tying up working capital in the entire amount of the coverage desired. Given this inherent efficiency of risk pooling arrangement by contrast with self-funding, we question the desirability of subsidizing self-funding.*

Second, under current law the combination of the deductibility of service liability losses when incurred, the availability of carrybacks and carryovers of net operating losses, and the ability to self-fund for service liability losses on a tax-paid basis provide virtually all the benefits that are available under S. 2512. Thus, as we noted in our testimony on product liability, the tax law does not discriminate in favor of commercial insurance and against self-funding. The reasons why this is so are set out in detail in our September 28, 1978 testimony. The only additional benefit to be derived from S. 2512 is the tax deferral stemming from the exemption of the service liability trusts proposed by S. 2512.

Finally, we do not believe that tax deferral is the most appropriate way in which to subsidize service liability coverage, even if some subsidy is believed to be appropriate. For one thing, the benefits of tax deferral tend to rise with the marginal tax bracket of the taxpayer. Moreover, deferral tends to offer proportionately greater benefits the longer money is tied up in an exempt service liability trust, and will therefore provide more benefit for those whose money remains in such trusts for a longer period of time. As a result, the greatest benefits from S. 2512 will flow to those who suffer service liability losses least frequently, a result that we do not think would be in keeping with the desires of its sponsors.

In any event, the deferral benefits available to a taxpayer through a measure such as S. 2512 do not, in our judgment, offset the burden such measures impose on the tax system. As we noted with respect to product liability there is no assurance that amounts set aside in a self-insurance trust will ever be expended to pay service liability claims. Even if subsequent withdrawals were fully taxed the settlor of the trust would be better off than if the money had never been set aside in trust. S. 2512 attempts to deal with this problem by providing for a 10 percent addition to tax in the case of certain withdrawals but a 10 percent penalty will only reduce, not eliminate, the benefit of deferral.

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* Thus, the Administration has supported legislation to facilitate the organization of small risk pooling arrangements (referred to as "risk retention groups") that would operate as a pooled alternative to the risk spreading that is available through commercial insurance.

Moreover, S. 2512 makes very little effort to limit the set aside according to the needs of the taxpayer. Since any rules designed to do so would create severe administrative problems, S. 2512 essentially opens the door to deferral of tax on investment income without regard to the magnitude of potential liability.

S. 2916

S. 2916 would amend existing law to provide that an individual may claim the investment tax credit against alternative minimum tax liability to the extent the credit is attributable to the active conduct of a trade or business. This bill reopens basic decisions made by the Congress when it enacted the alternataive minimum tax in 1978. The Treasury Department believes that it is too soon to reconsider that recent legislation. However, these issues could be appropriately faced by the next Congress when it considers the matter of capital cost recovery.

To put the issues raised by S. 2916 in perspective, I believe some background would be helpful to the Committee.

Investment Credit

Under existing law, a taxpayer is entitled to a tax credit for a portion of the investment made in qualified property. The purpose of this credit is to stimulate capital formation by reducing the cost of certain capital equipment. Generally, the amount of the credit is a function of the cost of the property and the property's useful life. Additionally, since the credit applies to offset tax liability, and is not refundable, the credit allowable in any one year is limited by the amount of tax. Presently, the credit may offset $25,000 of tax plus 70 percent of liability in excess of $25,000. In 1981 and 1982 the percentages are scheduled to increase to 80 and 90 percent respectively. Where the taxpayer's tax liability limits full use of the credit, the law allows the unused credits to be carried back for three years and forward for seven years.

Minimum Tax

By the late 1960s it became apparent that, through the use of various forms of tax-favored income and deductions, some persons with large economic incomes were paying little, or no, federal income tax. The result was an unequal distribution of the tax burden depending on the type of income received. Thus, to ensure that those receiving these "tax preferences" paid their fair share of tax, the Congress in 1969 enacted a separate, minimum tax on those preferences. The minimum tax as amended in 1976 was equal to 15 percent of the preference items reduced by the greater of $10,000 or one-half of regular tax liability.

Alternative Minimum Tax

From the enactment of the minimum tax, the deduction for long-term capital gains was taxed as a preference item. In 1978, Congress determined that taxpayers who paid a substantial tax on the taxable portion of long-term capital gain should not also be subject to a minimum tax. At the same time, the Congress sought to ensure that all individuals would have some tax liability. Thus, the Congress replaced the add-on minimum tax with an alternative minimum tax based on taxable income increase by the capital gains deduction and excess itemized deductions. This alternative tax is payable to the extent that it exceeds regular tax liability. Thus, individuals with a large regular tax liability will generally have little or no exposure to the alternative minimum tax, while for individuals with large capital gains and low regular tax liability the opposite will be true.

In structuring the alternative minimum tax, the Congress expressly provided that the tax would apply to the extent it exceeds regular taxes as reduced by nonrefundable credits. Thus, the Congress decided that use of these credits, such as the investment credit, should increase exposure to the alternative tax. Further, the Congress specifically provided that, aside from the foreign tax credit, nonrefundable credits would not be permitted as an offset. These results were based on the decision that the alternative minimum tax should operate so that all individuals pay some federal income tax. Other methods of insuring that the includible portion of capital gain income would in fact be subject to some tax, rather than totally offset by losses, for example, was rejected. Thus, while this treatment of credits was designed principally to prevent taxpayers with large capital gains from eliminating all tax liability, it was also intended to ensure that even taxpayers with little or no capital gains would be subject to the alternative tax if their credits nearly, or completely, wiped out their regular tax liability.

To compensate, the Congress provided a special rule to preserve the value of the investment and certain other credits. Under the rule, if the application of the alternative tax causes the taxpayer not to receive the full use of the credit, the amount of the unused credit is available as a carryover under the usually applicable principles.

S. 2916

S. 2916 would reverse these decisions. This bill would permit the investment credit to offset the tax generated under the alternative minimum tax to the extent the credit is attributable to the active conduct of a trade or business. Under this bill, an individual with large capital gains and a substantial investment credit might be able to escape tax liability entirely. S. 2916 thus conflicts with the premise of the alternative minimum tax

enacted less than two years ago by the Congress after careful consideration. The Treasury Department believes the Congress should not change its course so quickly.

Additionally, S. 2916 raises a number of other issues. First, the bill makes a distinction between the alternative tax on the one hand and other special taxes -- including the add-on minimum tax on the other tax preferences -- on the other. As I stated earlier, the amount of investment credit allowable is limited by tax liability for the year. The Code provides that, for this purpose, tax liability does not include special taxes such as, among others, the add-on minimum tax, the accumulated earnings and personal holding company taxes, and the tax on certain capital gains of subchapter S corporations. It is not readily apparent to us why, in the case of a taxpayer with substantial tax preferences from capital gains or excess itemized deductions, the alternative minimum tax applicable generally to these preferences should be treated differently for investment credit purposes.

Further, the investment credit is not the only credit limited by tax liability. Other nonrefundable credits include the energy credits, targeted jobs credit and the work incentive program credit. Present law and S. 2916 do not permit these other credits to offset the alternative tax.

Finally, S. 2916 permits the offset only for credits attributable to the active conduct of a trade or business. Presumably, this limitation is designed to prevent credits derived from tax shelters from reducing the alternative tax. While the Treasury agrees that credits flowing from shelters should not be accorded special favorable treatment, the distinction made by S. 2916 may prove difficult to administer. In other areas of the tax laws, in which a given result depends upon whether the taxpayer is engaged in the active conduct of a trade or business, substantial uncertainty and attendant litigation have arisen over the issues of whether an activity constitutes a trade or business and, if so, whether that trade or business is actively conducted. Perhaps for that reason, the Code does not generally distinguish between tax shelters and other activities on this basis.

As you know, Congress will be considering the question of capital cost recovery in an effort to stimulate business investment and improve productivity. Included in those discussions will be the issues of the refundability of the investment credit and the appropriate recovery allowance for investment in capital equipment. This would be the appropriate vehicle for consideration of the interaction of the alternative minimum tax with these investment incentives.

S. 3076

Under present law, a private foundation's ability to own a business enterprise is limited by the Internal Revenue Code (section 4943). In general, the maximum permitted holdings are 20 percent of the voting stock of the business enterprise reduced by the percentage of voting stock owned by certain related parties referred to as disqualified persons. The amount of permitted holdings is increased to 35 percent if effective control of the enterprise is in persons who are not disqualified persons with respect to the foundation. Special rules provide extended disposition periods for private foundations which had excess business holdings on May 26, 1969.

Also under present law, a private foundation is, in effect, required to distribute certain amounts annually for charitable purposes (section 4942). The amount required to be distributed is, in general, equal to the greater of (i) the foundation's net income, computed with certain adjustments, and (ii) 5 percent of the fair market value of the foundation's assets not used directly in carrying out the foundation's exempt functions (the minimum investment return). Section 4942(a) imposes a tax on the excess of the amount required to be distributed under section 4942 over the amount actually distributed by the foundation.

S. 3076 would make section 4943 and section 4942(a) inapplicable to a private foundation which met the following conditions:

(i) The foundation must be organized before January 1, 1950;

(ii) The foundation must have received by bequest before January 1, 1958 all of the oustanding stock of a manufacturing corporation (subject to intervening life estates terminating before January 1, 1972);

(iii) The foundation must be located in a community with a population of less than 10,000 persons under the 1980 census;

(iv) The foundation must have employed fewer than 200 employees as of January 1, 1980;

(v) The corporation described in (ii) must pay annual dividends of at least 30 percent of its average annual earnings over the three-year period ending with the year in question.

The effect of S. 3076 would be to enable a foundation meeting these requirements to own 100 percent of the stock of an above-described corporation indefinitely, notwithstanding the generally applicable excess business holdings rules, and to enable such a foundation to maintain such stock ownership notwithstanding that

the stock investment might not produce any income for charitable uses. (Taken literally, the bill would not require the foundation to distribute any income for charitable purposes, even income actually received from the corporation, although this result may not have been intended).

We understand that the bill is intended to benefit the Belle Peabody Brown Foundation, which owns all of the stock of the Arthur S. Brown Manufacturing Company. It would appear that the bill is drafted to benefit only this foundation, although it is conceivable that other foundations may fall within its terms.

The foundation argues that, if it were required to sell its interest in the corporation, the only potential purchaser would be large corporations which would move the business from its present location. The result, it is urged, would be the removal of an important employer from the local community.

The Treasury Department opposes S. 3076.

First, it has not been demonstrated that the foundation has exhausted the possible alternative solutions. For example, it may be possible to sell the stock to an employee stock ownership plan (ESOP) established by the corporation or, perhaps, to a group of local businesspeople.

Second, the concerns underlying present law apply to this situation. One of the reasons for the minimum investment return requirements of section 4942 is that, because the donor receives a current tax benefit from his charitable contribution, Congress felt that there should be a current benefit to the charity. Since the donor of the stock to the foundation presumably received an estate tax deduction for the donation and a concomitant estate tax savings, it does not seem unreasonable for the foundation to provide the requisite current expenditure for charitable purposes.

Finally, if the foundation is really arguing that providing jobs in the community by operating a noneconomic business is a charitable activity which ought to be recognized as such, this would be an issue of widespread impact. It should be addressed directly and not hidden in what is essentially a bid for private relief.

S. 3080

S. 3080 provides for the annual filing of gift tax returns, replacing the current requirement that such returns be filed quarterly. The Treasury Department does not oppose S. 3080.

The present quarterly filing requirement has resulted in compliance problems for and confusion among affected taxpayers and administrative burdens for the Internal Revenue Service. While a return to annual filing will result in a one-time revenue reduction in fiscal year 1981 and some modest continuing revenue loss attributable to the loss of accelerated tax receipts, we nonetheless believe that a simplified reporting system will be beneficial in terms of tax administration.

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ATTACHMENT

STATEMENT OF
DANIEL I. HALPERIN
DEPUTY ASSISTANT SECRETARY (Tax Legislation)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON MISCELLANEOUS REVENUE MEASURES
OF THE
COMMITTEE ON WAYS AND MEANS
September 29, 1978

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to appear this morning to discuss the tax aspects of product liability. As the long roster of witnesses suggests, this subject has sparked a great deal of public interest. The two current approaches to this issue are reflected in a variety of measures* that would permit deductions for contributions to product liability self-insurance trusts; and S. 3489, introduced by Senator Culver and supported by the Administration, which would extend from three to ten years the carryback period for net operating losses attributable to product liability.

As you may be aware, Mr. Chairman, the Treasury testified last month on product liability before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee. In my testimony before that Subcommittee, I discussed at length the chronology and reasoning that led to the Administrations conclusion, announced by Commerce Secretary Kreps on July 20, 1978, that it should not endorse the various set-aside proposals and to recommend instead the enactment of a special ten-year net operating loss carryback now embodied

* These bills include H.R. 10272, H.R. 12429, H.R. 7711 and H.R. 8064, together with some 25 identical bills.

B-1190

in S. 3489. I have attached to my testimony today a copy of my testimony before the Senate Subcommittee and I ask that it be made a part of the record of these hearings.

I will summarize briefly the reasons underlying the Administration's conclusions. First, the superficially appealing notion that the tax law discriminates in favor of commercial insurance and against self-insurance is based on a misconception. We concluded that existing law, with modification of the treatment of loss carryovers, would provide virtually the same tax benefits as commercial insurance. On the other hand, existing proposals for current deductibility of contributions to self-insurance trusts provide an opportunity for tax deferral and thereby would operate to subsidize self-insurance. Even if a subsidy were justified, the benefit to business from proposals providing current deductibility for contributions to a self-insurance trust cannot justify the administrative complexity involved.

I believe that at the heart of the debate over product liability tax proposals there is confusion over whether, or to what extent, it is possible to self-insure under current tax law and obtain benefits similar to those that would be provided by the set-aside proposals. Much of the discussion we have heard in support of such proposals is premised on the assumption that, without allowing deductions for contributions to a self-insurance trust, it is not possible, or is too costly, to "self-insure." I would like to explore with the Subcommittee the reasons why we have concluded that this is not so.

To be specific, it can be demonstrated under current law, as under the set-aside proposals, a portion of all product liability losses will be provided through tax savings as long as the business has earned enough taxable income to cover the loss. If there were no net income, neither provision will provide a benefit. It is true that current law, with or without S. 3489, would not provide all the same benefits as the set-aside proposals. After I have described the reasons for the identity, I will also describe the nature and significance of the difference.

The essential starting point for the analysis is to recognize that product liability claims are currently deductible in the year paid or incurred. Section 165 of the Internal Revenue Code permits a taxpayer, in computing taxable income, to deduct any business loss that is "not compensated for by insurance or otherwise." (There are

occasions when I think that proponents of set-aside proposals lose sight of this fact.)

To take a simple example, if a corporation, which we'll assume to be in the 50 percent bracket, incurred a $100 loss for this year, that loss would be deductible, its taxable income would be reduced by $100, and its tax liability would be reduced by $50. Through the deductibility of losses the government, in effect, pays a share of the loss according to the marginal income tax rate applicable to the taxpayer. In this example, the next cost of the loss is reduced by the $50 tax saving. Put another way, through the tax system the government is essentially a co-insurer of any loss--including any product liability loss--incurred.

Now, what is it that a set-aside proposal would do? The essence of this proposal is not to create a new deduction, but rather to alter the timing of the deduction under Section 165. Most of these bills specifically provide that, to the extent a product liability loss or a related expense is paid for out of a self-insurance trust, the deduction otherwise allowable under Section 165 would be denied. Thus, the essence of this measure is to permit a business utilizing a self-insurance trust to obtain an earlier deduction for a contribution to that trust in exchange for which it must forego a later deduction on account of an actual loss.

What do the intended beneficiaries expect to gain by securing an earlier deduction? As we see it, there may be two advantages, aside from tax deferral* to permitting advance deductions for contributions to a product liability self-insurance trust (assuming that the trust assets ultimately will be expended to pay product liability expenses that would in any event be deductible under Section 165). One is that in the year in which a loss is actually incurred the taxpayer may not have sufficient taxable income against which to deduct the loss. By permitting contributions to be deducted over a period of years, the tax savings from deducting the loss are more apt to be realized. The second possible benefit is that by building up a fund over a period of time a taxpayer can "salt away" funds on a periodic basis for that day when, notwithstanding all its efforts to manufacture safe products, it is faced with a product liability claim.

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* I would like to postpone my discussion of tax deferral. For that reason, in the discussion that follows, I will ignore the fact that the assets in these trusts would be earning income and ignore also the question of whether that income should be taxable or exempt. These issues are at the heart of the Administration's objections and I will deal with them in due course.

The points in response that I would like to make are that, first, under current law, particularly as modified by a measure such as S. 3489, a taxpayer can be assured that the deduction to which it is entitled by reason of a product liability claim can effectively be utilized. As to the second argument, a business is not precluded from establishing a reserve fund merely because it is not allowed a tax deduction for the contribution. Such a taxpayer can put aside a smaller sum in tax-paid dollars which, together with the tax benefits of deducting loss when incurred, will put it in virtually as good a position to defray the loss as if it had set aside larger amounts year by year under a set-aside proposal.

To illustrate the first point, suppose that in 1977 our corporation earned income of $1,000 and, again assuming it paid tax at a rate of 50 percent, its tax bill came to $500. Suppose further that in 1978, the year in which it incurred a $100 product liability loss, its taxable income, computed without regard for that loss, was zero. This is just one of those situations for which the set-aside proposals are designed. Considering the current taxable year alone, the corporation obviously can realize no tax benefit from being able to deduct that loss: even without the deduction it had no taxable income and therefore has no tax to pay. All the $100 product liability loss would do would be to create a $100 "net operating loss".

However, the Internal Revenue Code currently contains a means by which to average income earned and losses incurred in discrete taxable years. The mechanism is provided in the net operating loss carryover provision of Section 172 of the Code. Section 172, in general, permits a net operating loss to be carried back and applied against taxable income earned during each of the three years preceding the year in which the loss arose; and, if the income during those three years is insufficient to absorb the loss, to carry it forward and apply it against taxable income earned during any of the seven succeeding years.*

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* In general, a taxpayer is in a better position if a net operating loss can be applied against and absorbed by taxable income for a prior year, that is, by a net operating loss carryback. Use of a carryback gives rise to an immediate tax refund. In contrast, where a net operating loss must be carried forward to a subsequent taxable year, the taxpayer must await the carryforward year before realizing the benefits of the net operating loss. For that reason, S.3489, by extending the carryback for net operating losses attributable to product liability from three years to 10, will increase substantially the extent to which a tax refund from a net operating loss due to product liability would be obtained promptly.

Under existing law, the taxpayer in our example can, therefore, carry back its $100 net operating loss from 1978 (in this case due to product liability, but it could be due to anything else) and apply it against the $1,000 of taxable income it earned in 1977. Its taxable income would be reduced from $1,000 to $900, and its tax bill (at a 50 percent rate) from $500 to $450. Since it had already paid $500 in tax for 1977, it would be entitled to a refund of $50. Thus, the net cost of the product liability loss, the gross amount of which was $100, is reduced to $50, and the taxpayer is in precisely the same position as if it had been able to apply the loss against taxable income earned this year. (It is also in essentially the same position as if, last year, it had set aside and deducted a $100 contribution to a self-insurance trust.)

The availability of a net operating loss carryover tends to reduce the likelihood that if, because of inadequate taxable income, a taxpayer is unable to realize the benefits of deducting a loss in the year the loss is incurred, the benefit of the deduction will be lost. Instead, the deduction is effectively spread over a longer period, which tends to insure the realization of those benefits. Under current law, the general carryback period is limited to the three preceding years; for losses attributable to product liability S. 3489 would extend it to 10. Apart from deferral, this is the same as allowing a set-aside for a ten-year period limited only by the taxable income during those ten years. Put another way, the ten-year carryback provides the same ability to obtain the benefits of deducting a loss as would an unlimited ten-year set-aside. Of course, a taxpayer which did not have income in the preceding 10 years would not benefit from the carryback but neither would that taxpayer obtain any advantage from the deduction allowed by a set-aside.

Let's turn then to the second perceived advantage of the set-aside proposals, namely that they would permit taxpayers to salt away some money for the day when a product liability claim arises.

In each of the preceding examples, the taxpayer incurred a $100 product liability claim from which it realized tax benefits of $50. The other $50 of the claim it had to pay itself. In the example where the corporation had no taxable income in the year the loss was incurred, some may ask what the source of the payment will be.

But is there any reason, despite the absence of a set-aside deduction, why it could not have set funds aside specifically to cover such a contingency? Mr. Chairman, the crucial point is that it could have put money aside to pay a product liability claim, even though it had paid tax on the money. When it actually incurred the loss the tax benefits would fall automatically into place.

Let's look at year one, the year when the taxpayer earned $1,000 in taxable income, paid tax of $500 and had $500 left over in cash. Let's assume the taxpayer concluded that, despite its diligent efforts at making safe products, it was fortunate not to have incurred any product liability claims and might not be as lucky next year. Consequently, it concludes it should put something aside to make sure that if such a claim should arise, it will have cash to cover it.

How much should be put aside for this purpose, assuming the taxpayer believes that the loss (if it occurs) will amount to approximately $100? We know that if a $100 loss is incurred the government will pay for $50. This comes about, as we have already seen, by virtue of the ability to deduct that loss. Moreover, the taxpayer will be entitled to the tax benefit of deducting that $100 loss whether it has $1 million of taxable income next year or zero. Consequently, to provide for a $100 product liability claim, the taxpayer surely should not put aside $100. The appropriate amount is the estimate of the loss ($100) less the estimated tax savings ($50) that will accrue to the taxpayer by virtue of the deduction under section 165. In essence the trust contains the equivalent of $100, $50 in cash and $50 in a potential tax refund.

The point of all these examples, Mr. Chairman, is that, under current tax law, a business is quite able to set aside money to cover a self-insured risk even though it gets no deduction for, and thus must pay tax on, the money that is set aside for that purpose.

Up to now, we have tried to point out why businesses can obtain the protection they seek without a current deduction for a contribution to a reserve. Let me now turn to our objections to the proposal. The set-aside proposals advance the timing of deductions for contributions to self-insurance trust and exempts from taxation the earnings on that trust. In contrast, if a taxpayer were to self-insure with tax-paid dollars, he would be earning interest on a somewhat smaller amount and the earnings on that amount would be taxable. The combined benefits of current deductibility and tax exemption amount to tax deferral, to which the Administration objects.

But, it is argued, a taxpayer which purchases commercial insurance obtains a current deduction. Why is it reasonable to deny what seems to be a similar benefit to those who self-insure? There are several reasons for doing so. First, under current law, no deduction is permitted for losses that are compensated by insurance. It follows from this fact that an insured is no better off by deducting premiums at an earlier date than by deducting an uninsured loss when incurred. Moreover, casualty insurers are taxable on their income both from premiums and investment of those premiums. Finally, unlike commercial insurance premiums, which are lost forever to the insured, money placed in a self-insurance trust may very well revert to the self-insured. Taken together, these considerations lead to the conclusion that a self-insured might be better off with a self-insurance set-aside proposal than through commercial insurance.

Furthermore, the deferral benefits to a taxpayer from a set-aside measure must be weighed against the burden imposed on the tax system. First, there is no assurance that amounts set aside in an exempt self-insurance trust will ever be expended to pay product liability claims. Ultimately, they may revert to the business. For example, a business in all good faith could over ten years put several hundred thousand dollars in a self-insurance trust and never be obliged to pay one cent of product liability expense. Suppose that, at the end of that ten years, the taxpayer were to conclude in light of fortunate experience that it no longer needed the trust. Under most of these set-aside measures, the taxpayer would apply to the Commissioner for consent to terminate the trust and, if the circumstances seemed appropriate, consent would be forthcoming. The bill then provides that all amounts in the trust would be taken into income on termination. While the mathematics are complex, it can be

demonstrated to a certainty that, even taxing all amounts in the trust when it was terminated and its assets distributed, the taxpayer would be in a far better position than if he had never established the trust. We do not think that the sponsors of this proposal intend that businesses should be money ahead simply by establishing a product liability self-insurance trust and terminating it at some later date.

This possibility is especially objectionable in the context of measures like the set-aside proposals under which contributions need bear no relationship whatever to any particular taxpayer's likely level of product liability claims. For some businesses, the amounts set aside will be insufficient to cover all their product liability expenses. For others, the amounts set aside may well exceed by a substantial amount what they will need to pay for product liability. For the latter taxpayers -- those with least need of the trust -- there will be greater benefits from deferral and those benefits will be augmented the longer the period for which their money is tied up. We regard this to be an inappropriate result.

It is all the more inappropriate because it is needless. As I have already pointed out, all the benefits other than deferral could be obtained under current law, especially as modified by S. 3489. Under such an approach, in contrast with the set-aside approach, the benefits of deducting losses under section 165 would accrue only to those who actually incur such losses. It would not provide any windfall subsidy to those who set up a trust only to terminate it and receive back the assets in the trust after it had been in existence for a period of years.

For these reasons, Mr. Chairman, we urge the Subcommittee not to report H.R. 12429 and, instead, to act favorably on the principle embodied in S. 3489.

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Senator BYRD. Thank you, Mr. Halperin.

I probably support the Treasury's position more frequently than any other member of this committee. I very likely have the same view as Treasury on most of these bills before the committee today.

Mr. HALPERIN. Mr. Chairman, we appreciate that.

Senator BYRD. But when it comes to the Treasury suggesting what the committee should do in regard to scheduling bills, then I want to say frankly that the committee is going to schedule bills that we think ought to be scheduled.

Mr. HALPERIN. Obviously, Mr. Chairman, I do not disagree with that. I was trying to get across the impression that if other members took the views that you have indicated you have, the message might get across, and the committee might be faced with less proposals of that nature.

But, I certainly do not want to indicate that we want to suggest your agenda, or that you can ignore bills that have been introduced by other Members of the Senate. Obviously, you cannot, and we recognize that.

On the other hand, we all realize that we cannot do everything. There are a lot of problems that come up and this committee does

not have the time to deal with all of them that would be within its jurisdiction, and therefore it must set priorities, and we think that it inevitably does.

Senator BYRD. I will not pursue it except to say that this committee has set priorities. Whether our priorities agree with your priorities, that is something else.

Mr. HALPERIN. I understand that.

Senator BYRD. Senator Dole.

Senator DOLE. I have no questions. I have a statement, Mr. Chairman, which I would like to make a part of the record.

Senator BYRD. Yes, indeed.

Senator DOLE. It supports S. 2916 and also the installment sales bill, which I understand the Treasury does support, as amended.

Mr. HALPERIN. Yes, we do, Senator.

Senator DOLE. That is one that you would like to move very quickly, as I understand, and I agree with that.

I will just ask that my statement be made a part of the record in the interest of time, since there are a lot of witnesses, Mr. Chairman. I have no questions.

Senator BYRD. Thank you, Senator Dole. Your statement will be made a part of the record at this point.

[The prepared statement of Senator Dole follows:]

STATEMENT OF SENATOR DOLE

Mr. Chairman, I appreciate your providing this opportunity to examine several tax bills that deal with real, but manageable, problems in the Tax Code. In particular I welcome this opportunity to address some problems that are experienced in the farm community.

ALTERNATIVE MINIMUM TAX

On July 1, I introduced S. 2916, along with Senator Talmadge. The bill would correct a problem farmers have in using the investment tax credit. This problem began in 1978 when Congress passed the alternative minimum tax.

The alternative minimum tax was enacted to encourage capital formation by eliminating capital gains as an item of tax preference subject to the regular minimum tax. The minimum tax on capital gains was replaced by an alternative minimum tax applicable to capital gains and certan itemized deductions only to the extent that this tax exceeded an individual's regular income tax liability.

Unfortunately, the way the tax legislation was drafted, the alternative minimum tax applies to all taxable income over $21,000, unreduced by the investment tax credit, even if the taxpayer had no items of tax preference designed to be taxed by the minimum tax. As a result, a farmer who has a profitable year and decides to purchase needed equipment will not be able to take advantage of the investment tax credit for the purchased equipment.

An investment tax credit which was not used because of the alternative minimum tax may be carried forward to subsequent years, but the alternative tax may cause the tax credit to be denied in future years also.

This result could not have been intended: it simply is not fair. My bill would correct the problem by allowing the investment tax credit to offset the alternative minimum tax on a current basis so long as the investment credit is connected with the active conduct of business. This limitation would assure that the new legislation did not create a new tax shelter for passive investors. At the same time, the legislation would make sure that farmers and other small businessmen who have not incorporated their business will be able to use the investment tax credit as was intended by Congress.

The impact on revenues would be small, but the aid to farmers and small businesses would be great. I look forward to hearing the testimony on my proposal, and I am glad to see that Paul Fleener of the Kansas Farm Bureau will share his views with us.

INSTALLMENT SALES

Mr. Chairman, we are also moving forward with legislation to revise the tax treatment of installment sales. H.R. 6883, which has been approved by the House, is

a revision of the bill introduced last year. I was pleased to join Chairman Long in sponsoring this new version, which is S. 2451 in the Senate. The bill will rectify technical problems with installment sales, and the new version gives protection to family farms and small businesses.

Specifically the revision allows installment treatment even after resale by a related purchaser, so long as tax avoidance is not a principal purpose. This provision corrects a defect in the old bill, which would have caused problems or legitimate transaction within families. Now a farmer or small businessman can sell to, for example, a son, without fear that installment treatment will be lost if the son sells some of the property. This change is much fairer, and I know it is welcome in the farming and small business communities.

Mr. Chairman, there are other interesting proposals before us today, including your own bill to allow annual rather than quarterly filing of gift tax returns. I believe this would help ease the burden—really, the nuisance—of complying with the gift tax. I welcome the testimony we will hear on each of these items this morning.

Senator BYRD. Thank you, Mr. Halperin.

Senator Mathias.

Senator DOLE. Mr. Chairman, could I impose for just a second, and pass for insertion in the record a letter received by Senator Helms from Charles Morgan, Jr., of the firm of Peters, Maxie, Short & Morgan in reference to the installment sales provision.

Senator BYRD. Yes.

[Document to be inserted.]

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August 29, 1980

Honorable Jesse Helms
United States Senate
Washington, D. C. 20510

Re: H. R. 6883 - Installment Sales Revision Act of 1980

Dear Senator Helms:

I recently had an opportunity to review the Installment Sales Revision Act of 1980, H. R. 6883, which is an amendment to Section 453 of the Internal Revenue Code relating to reporting of installment sales. This bill passed the House of Representatives on June 17, 1980, and has been sent to the Senate Finance Committee for hearing in early September.

The proposed Section 453(e)(1) of the Act indicates that if any person sells property to a "related person" in an installment sale, and thereafter the related person sells the property within a two (2) year period, "the amount realized" on the second disposition is treated as having been received by the first person to that extent for purposes of reporting his gain on the installment basis.

The term "the amount realized" from sale or other disposition of property is defined in Section 1001(b) of the Internal Revenue Code as "the sum of any money received plus the fair market value of the property (other than money) received."

The language of the proposed amendment to Section 453 raised some questions in my mind. I discussed these with your aide, Sam Currin, and confirm same by this letter.

For purposes of illustration, assume that Taxpayer owned 100 acres of land which cost him $100,000 with a fair market value of $1,000,000. Taxpayer then sold the property to X Co., his wholly owned corporation, for $1,000,000, 25% down payment in cash and the balance paid over ten years.

X Co. immediately began to construct roads and on a three-acre parcel built an apartment house for $800,000. Upon completión, the apartment house and underlying real estate were sold for $1,000,000, 25% down payment in cash and an existing mortgage assumed for the balance.

1. On the second disposition by X Co., the sale included both the new building as well as the underlying three acres of real estate.

(a) Does the entire purchase price of $1,000,000 constitute the "amount realized" for purposes of this Act? If so, the entire "amount realized" would be imputed to Taxpayer, even though the portion allocable to the underlying real estate is very small in comparison to the cost of the building. Furthermore, with what cash would Taxpayer be expected to pay these taxes on this imputed income?

(b) Or would some type of allocation be made between the real estate and improvements thereon, so that only the $10,000 per acre price attributable to the real estate on the original purchase be considered as the "amount realized" on the second disposition?

(c) Or would $250,000 be considered as the "amount realized," being the amount of cash received by X Co. upon the second disposition? If so, Taxpayer still might not have the cash available to pay the tax, nor might the related party, since the terms of that sale were over a period of years.

I recommend that the Act be amended to provide that the "amount realized"

(a) be limited to the original sales price per acre, so that only $30,000 ($10,000 per acre) be imputed to taxpayer (The $30,000 can be applied to the first cash dollars realized), and

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(b) be defined to include only the cash or tangible personal property received by X Co., and exclude the installment notes receivable.

2. The Act does not provide any exclusion for taxpayers who have held property for long periods of time, but yet prior to sale, make a transfer to a related party or corporation for business or convenience purposes.

Notwithstanding the provision contained in Subsection (e)(7), which provides an exception to the Act where tax avoidance is not a principal purpose, it may still be advisable to add another exception when the taxpayer has owned the property for at least three years, and thus has demonstrated a sufficient investment intent for purposes of the holding period.

If such were the case, the property could be sold to a related party and thereafter resold without the application of Subsection (e).

3. When X Co. sells the apartment building in a transaction for cash and notes which would otherwise qualify for installment reporting under Section 453, does this Subsection disqualify installment reporting for X Co.? I assume not, but perhaps the Regulations could clarify that point.

4. Subsection (e) refers to the "first disposition" and the "second disposition." For purposes of this section, does the date of the contract for purchase and sale control, or does the closing date control? The Act is unclear at this point and would seem to leave that question to interpretation, unless further definition is forthcoming from the Regulations.

5. The effective dates of various portions of Section 453 are five different dates (See Section 5(a)). I recommend that all amendments made by the Act apply to dispositions made after the date of enactment of the Act in taxable years ending after such date (See Section 5(a)(1)).

Thank you sincerely for your attention to this matter.

Very truly yours,

PETERS, MAXEY, SHORT & MORGAN, P.A.

Charles O. Morgan, Jr.
For the Firm

COM:mw

Peters, Maxey, Short & Morgan, P.A.

Senator BYRD. Senator Mathias, welcome. We are glad to see you again before the committee. Which pieces of legislation will you be discussing?

Senator MATHIAS. I want to very briefly describe the Service Liability, Partial Self-Insurance Act, which is Senate bill 2512, sketch very briefly the reasons for the bill, and my involvement in this very troubled area of product liability.

I would like also, Mr. Chairman, to conserve the time of the committee, to present a somewhat longer statement.

Senator BYRD. It will be inserted in the record.

STATEMENT OF CHARLES McC. MATHIAS, U.S. SENATOR FROM THE STATE OF MARYLAND

Senator MATHIAS. I have been working very closely with a great many business people, professional engineers from Maryland, and also beyond the borders of Maryland, from all across the country, in shaping a product liability bill that would help small design firms survive liability problems in our increasingly litigious society.

Faced with a growing number of law suits, and with great increases in liability insurance premiums, small enterprises have really reached a near crisis situation. In fact, not only small firms—it came to my attention recently that even some of the biggest firms in the country, who deal with enormous projects on Government contract, such as Project Skylab, or the complete revamping of the Civil Air Control System, are beginning to worry about the liability problems.

But over the past 20 years product liability law has changed substantially, particularly with the adoption of very strict tort liability standards. As the committee well knows, product liability law traditionally required an injured user of the product to show that the manufacturer had been negligent in making the product, and that the negligence was directly connected with the injury suffered.

Under current product liability law, however, no showing of negligence is necessary. An injured user of the product need only prove that the injuries were caused by a defective condition in the product, and that such a condition made the product unreasonably dangerous, and that the defective condition existed at the time the product left control of the manufacturer.

Of course, this change has exposed the supplier of the product, as well as the designer, to potential ruinous liabilities, and that, in turn, has dramatically increased the cost of insurance that manufacturers and engineers must pay to protect themselves from that liability.

As members of the committee may know, the Commerce Committee is currently considering a risk retention bill, that is Senate bill 1789, that will help manufacturers to cope with the problems by allowing them to form cooperatives to provide product liability self-insurance. The House has moved on this legislation, passing the Risk Retention Act by a margin of 332 to 17 last March.

But the problem is not confined to manufacturers. The members of the design profession, the architects, the engineers, are finding it increasingly difficult to purchase liability insurance at any price,

and they are being forced to the wall in some cases by the rate of insurance.

Surveys indicate that the average cost of professional liability insurance has gone up more than 26 percent in the last year. Over the past decade, premiums paid by architects and engineers for liability insurance rose from $25 million to $175 million. This kind of astounding jump, I think, has to be a large part of the reason for the trend in the industry to risk going without any insurance coverage altogether, which of course creates problems for the public.

The bill we are considering, S. 2512, will specifically address the heavy cost of liability insurance faced by design professionals by allowing companies or individuals engaged in the design profession to set up tax-free partial self-insurance trust funds to cover the low end of product liability. I would not contemplate that this would eliminate the need for coverage through the standard and traditional insurance industry.

I think that that need will continue, but this will cover the low end of the product liability which is often unprotected because of the high deductibles. It will rely on conventional insurance to cover the upper exposure. I think that this ought to be clear. This would in no sense exclude the insurance companies from this part of the business.

With the high risk end covered, they will pay a lower premium, and could even afford more insurance, which is not only good for the consuming public, but which is in everyone's interest. This arrangement for the design profession will complement and round out the progress we are achieving for the manufacturers under the risk retention bill now before the Commerce Committee.

Mr. Chairman, I think that this is the essence of this proposal. I will submit the balance of the statement for the record.

Senator BYRD. Let me ask you this, Senator Mathias. Why is the scope of this bill so narrowly drawn? As I understand it, it would deal principally with those who design structures.

Senator MATHIAS. The problem has arisen in that area. That is one of the principal areas where the shoe is tight, for those who do construction design. It may be that upon examination the committee will find that the problem is more widespread than that. We may want to extend this principle to some other areas of commercial activity. But this is the problem area which has been most forcibly brought to my attention.

Senator BYRD. Product liability insurance can now be purchased, can it not?

Senator MATHIAS. Yes, and these people can purchase it. There is no question about that. It is because of the change in the underlying principles that the courts are applying to liability that the cost of this insurance has risen so dramatically.

Senator BYRD. Is protecting against product liability losses really a great problem today?

Senator MATHIAS. Yes. It is a very big problem for architects and engineers.

Senator BYRD. Senator Dole.

Senator DOLE. I have no questions, Mr. Chairman.

Senator MATHIAS. Mr. Chairman, while I have the ear of the committee, if I could just trespass on your patience for 1 more minute.

You have another bill before you today, and that is Senate bill 2900, which would correct a minor anomaly in the Federal unemployment tax law, which unfairly taxes many commercial fishermen across the country, and that would include, Mr. Chairman, those commercial fishermen who live in Virginia, but who fish in Maryland's river.

Senator BYRD. Does that ever occur?

Senator MATHIAS. The Potomac River. We are glad to have them fish in our river, and I want them to be included in the benevolent provisions of this law.

Currently, crew members on small fishing boats, those under 10 tons, and those are typically the kind of fishing boats that we have on the Potomac and the whole Chesapeake Bay area generally, are not required to pay unemployment insurance taxes, nor are they allowed to collect unemployment compensation benefits.

This exemption, which was a provision of the original Federal Unemployment Tax Act, recognizes that most small boat fishermen are seasonal workers who routinely move from one job to the next every couple of months. These fishermen are, therefore, unlikely to either meet the qualifications to receive or have the need for unemployment compensation benefits.

Further, they are not paid an hourly or weekly wage but, rather, they receive a percentage of the catch. Under this system, unemployment taxes, which are usually paid by both the employer and the employee, are taken directly out of the crewmembers' percent of the catch, directly reducing their paychecks.

Since these fishermen are unlikely to ever get the benefits from it, yet they have to bear the entire tax burden, I think the need for extending the exemption should be clear.

I will submit a full statement detailing this in more detail to the committee.

Senator BYRD. It will be published in the record.

Senator MATHIAS. The effect of the legislation that I have offered would be to increase the exemption from 10 tons to 15 tons, which is, I think, a more equitable and realistic exemption in light of current fishing practices in areas such as the waters of Virginia and the waters of Maryland, and other waters of other jurisdictions of the United States, even the waters of Kansas.

[The prepared statement of Senator Mathias follows:]

PREPARED STATEMENT OF SENATOR CHARLES McC. MATHIAS

I appear before the Finance Subcommittee on Taxation and Debt Management today to present testimony describing the Service Liability Partial Self-Insurance Act, S. 2512, which I introduced on April 1st, 1980. I have worked closely with many business people and professional engineers from Maryland and across the country in shaping a product liability bill that will help small design firms survive this problem in our increasingly litigious society. Faced with a growing number of lawsuits and great increases in liability insurance premiums, small enterprises have reached a near-crisis situation.

Over the past 20 years, product liability law has changed substantially, particularly with the adoption of strict tort liability standards. From being an obscure nook in the law, product liability has graduated into a preeminent concern for nearly all manufacturers and distributors of services. As the Committee knows, product liability law traditionally required the injured user of a product to show that the manu-

facturer had been negligent in making the product and that the negligence was directly connected with the injury suffered. The late Dean William Prosser, a professor of law at Hastings College of Law and an eminent legal commentator, has called this high standard of proof a "citadel" that shielded the manufacturer from liability.

Under current product liability law, however, no showing of negligence is necessary. An injured user of a product need only prove that his injuries were caused by a defective condition in the product, that such a condition made the product unreasonably dangerous, and that the defective condition in the product, that such a condition made the product unreasonably dangerous, and that the defective condition existed at the time the product left the control of the manufacturer. This change has exposed the supplier of the product as well as its designer to potentially ruinous liabilities, and, in turn, has dramatically increased the cost of insurance that manufacturers and engineers must pay to protect themselves from such liability.

The severe problem of product liability and professional liability was addressed in the 95th Congress to a limited degree. In 1978, we amended the tax code to make it lawful for a corporation to build up a reserve loss account for product liability, but only with after tax dollars. We also extended from three years to ten years the carryback of losses attributable to product liability. Unfortunately, however, these actions don't help small companies much and they are the ones with the most severe problem.

In the last Congress, a special ad hoc panel, chaired by former Representative Whalen, studied the product liability insurance problem and presented its findings to the House Small Business Committee in April 1977. The study found that small manufacturers were suffering from dramatic increases in product liability insurance costs. There was an average cost increase of 944.6 percent over a six-year period, while the increase in sales volume was 162 percent. That means that the premium grew at a rate almost 6 times that of sales.

The panel also found that 21.6 percent of the manufacturing companies surveyed said they were involuntarily operating without any commercial insurance coverage for product liability. And other companies declared that they were forced to buy policies with very high deductibles, paying exorbitant premiums for only partial coverage of their risk.

It has become obvious that many small businesses are operating either wholly or partially outside the product liability insurance market. Congressman Whalen's study concluded that one of every three companies surveyed said it had been forced to increase the price of at least one product line as a direct result of increased product liability premiums. His study also showed that one of every six firms surveyed had been forced to abandon at least one product line as a direct result of product liability problems.

Now, while many large companies have the resources to deal with the liability insurance problem, including simply buying or beginning their own captive insurance companies, the small business owner or the privately practicing professional cannot afford these high-priced options. And, increasingly, because of IRS rulings, even captive insurance companies are being pressured to enter the competitive insurance market, with the result that larger companies, too, are starting to look into self-insurance.

As the members of this Committee may know, the Commerce Committee is currently considering a risk-retention bill, S. 1789, that will help manufacturers to cope with these problems by allowing them to form cooperatives to provide product liability self-insurance. The House has already moved on this legislation, passing the Risk Retention Act in March by a huge margin, 332-17.

But the problem is not confined to manufacturers. The members of the design profession—architects and engineers—are finding it increasingly difficult to purchase liability insurance at any price. They are being forced to the wall by rising insurance rates. Surveys indicate that the average cost of professional liability insurance has gone up more than 26 percent in the last year alone. Twenty four percent of the engineering and architectural design firms do not carry liability insurance, compared to 17 percent in 1978 and 12 percent in 1977. The most recent study I have seen, commissioned by the American Institute of Architects and the American Consulting Engineers Council, interviewed over 200 sample architect and engineering firms, and found that the average cost of insurance premiums for companies with under ten employees was $4000, and for those with 10 to 20 employees, $12,000. Over the past decade, premiums paid by architects and engineers for liability insurance rose from $25 million to $175 million. Such an astounding jump must be a large part of the reason for the trend in the industry to risk going without insurance coverage altogether. Of the 24 percent of the industry that

does not currently carry liability insurance, 80 percent cited exorbitant cost as the major reason.

The AIA/ACEA survey revealed that the design industry is dominated by smaller firms—of the 2366 companies they interviewed, 64 percent had under ten employees, with gross billings averaging $135,000, while 79 percent had under 20 employees and averge gross earning of $447,000. Over one third of these firms reported that they had suffered at least one liability claim over the past five years. Among the firms with over thirty employees, two-thirds reported at least one claim during this period. The average dollar amount for firms under ten employees was $180,000, for firms with 10-19 employees, $1,209,000.

The bill we are considering today, S. 2512, will specifically address the heavy cost of liability insurance faced by design professionals, and so will complement and round out the progress we are achieving under the risk retention bill now before the Commerce Committee. S. 2512 allows companies or individuals engaged in the design profession to set up tax-free partial self-insurance trust funds. The second section of the bill makes adjustments in the Internal Revenue Code to confer tax-exempt status on the service liability trust and on earnings accumulated by the trust. A deduction is allowed for the sum of any amounts that the taxpaying company places in the trust and any amounts paid by the company to an insurer owned by the company: so-called captive insurers. The AIA/ACEC study revealed that only 4 percent of the industry sets aside reserve funds, in addition to their insurance coverage, for liability purposes. Over two-thirds of the firms interviewed said they would be likely to establish a separate trust if it were tax exempt. Furthermore, 53 percent indicated that they would increase their insurance coverage once they had established a separate liability trust, such as the kind envisioned by S. 2512. This statistic helps to corroborate my view that a product liability bill would not cut into the business of the insurance companies. Instead, most design professionals will use the trust fund to cover the low end of their product liability, which is often unprotected because of high deductibles, and will rely on conventional insurance to cover their upper exposure. With the high risk end covered, they will pay a lower premium and could even afford more insurance, which is in everyone's interest.

Under Section 3 of my bill, the amount of the deduction allowed is subject to a limit figure, determined by the least of: (1) 2 percent of gross receipts during the taxable year, (2) the difference between 10 percent of the average annual gross receipts during the preceding five-year base period and the previous year's contributions, or (3) $25,000. Many firms in the AIA/ACEC survey indicated that they would set aside less than the maximum amount permitted under the limits established in my proposal: the average estimate was 2-3 percent of the gross receipts.

A separate limitation is provided for companies with severe liability problems. This special status is defined later in the bill as arising when the company cannot obtain liability insurance with coverage of up to $1 million with a reasonable deductible amount, or one to whom the lowest premium quoted for such coverage was equal to more than 2 percent of its annual gross receipts. The deduction in this case is limited to the least of: (1) 5 percent of the gross receipts during the taxable year, or (2) 15 percent of the average gross receipts annually during the five preceding years, or (3) $100,000.

It is imperative that in protecting the hard-pressed professionals, we also take into account the concerns of the Treasury Department regarding possible revenue loss. While we want to provide adequate first-layer self-insurance to professionals, we want to make sure that we do not bring about a run on the Treasury. The limitations on contributions to the self-insurance fund should take care of that concern.

The privately-commissioned study by the AIA and ACEC that I have been referring to estimated that the federal income tax savings to the architecture and engineering professions—hence the revenue loss to the Treasury—for the calendar year 1981 was approximately $50 million. This figure is by no means prohibitive, especially when it is recognized that some part of that loss would eventually be tax-deductible anyway, when it is used for losses incurred as a result of liability claims. Based on the pattern of the past five years, over half of the $50 million would fall into this category in the next five years.

I understand that higher figures have been circulating in some quarters, but they must be based on a misconstruction of the scope of my bill, which would apply only to members of the architect and engineering professions. Or the higher figures might be a result of a failure to consider the safeguards I have included to prevent abuses of the new trust fund. Sections 4 and 5 of the bill, for example, spell out the treatment of amounts that are withdrawn from the trust. In general, no money distributed from the account would be eligible for the deduction. In addition, a

penalty is imposed for unauthorized withdrawal of funds from the trust by the company, for purposes other than satisfying service liability claims. The tax liability of the company is increased 10 percent of the amount of the unauthorized withdrawal. I hope the hearings today will allow the Committee ample opportunity to examine these safeguards. If further protections against abuse are found to be necessary, I will of course be happy to consider having them added by the Committee.

Certain legitimate purposes other than liability payments for withdrawing funds from the account are listed in section 5, and distributions made for these purposes would not be subject to the penalty. They include withdrawals made due to inadvertant overpayments into the fund, which exceed the upper limits stipulated in section 3, withdrawls made because of a change in circumstances of the company that alter its service liability exposure, withdrawal of amounts to transfer to other service accounts not later than the 90th day from the date of the withdrawal, and withdrawals due to liquidation or change of ownership of the company. The bill also instructs the Secretary of the Treasury to frame regulations dealing with the circumstances under which a partial sale of a company (over 50 percent of the controlling assets) constitute a presumed distribution of the service liability account, which would terminate its tax exempt status.

Section 9 treats the case of an individual member of a controlled group of corporations. It states that only gross receipts attributable to that member can be used in calculating the limits on the size of the account as provided in section 3.

Both my service liability bill and the Risk Retention Act I mentioned were originally inspired by the findings in the monumental study by the Department of Commerce, under the guidance of Dr. Victor Schwartz. I have heard from many insurance executives about the two bills, and most of them have told me that they prefer the approach of my bill with independent, self-contained self-insurance funds to the group-cooperative approach of the risk retention bill. I think they see risk retention as an alternative to conventional insurance, while the plan of S. 2512 is seen more as an insurance supplement. In any case, if we are to usher in a rising tide of product liability reform, we should see that it lifts all boats, and that we do not leave the design industry with a short anchor line.

We must realize that we all stand to suffer if certain manufacturers and professionals are forced to curtail their activities and their innovations, or even go out of business, because of their inability to get adequate protection for themselves. The product liability reforms that I am proposing will not only benefit the self-insurer, but will help to see that the injured consumer is compensated. The legislation deals fairly and constructively with the needs of small business at a time when boosts from any direction are sorely needed by our private sector enterprises.

Senator BYRD. I was going to ask about Kansas.

Senator DOLE. It has not rained there for years. [General laughter.]

Senator BYRD. Senator Dole.

Senator DOLE. I have no questions.

Did the Treasury support this?

Senator BYRD. The Treasury, I believe, opposes this legislation.

Senator MATHIAS. I am glad the Senator from Kansas asked about the Treasury because the Treasury, I believe, has used the word "frivolous" in connection with this bill. The Treasury views this as a frivolous suggestion.

If some of those fellows over at the Treasury Department who call this a frivolous bill were to get up at 4:30 in the morning, and get out on the water, and pull crab traps or spend all day long with an oysterman getting oysters off the bottom, and then had a percentage of the catch taken out for a program under which they will never benefit, then I think they would be entitled to call it frivolous.

But to call it frivolous when when you are actually taking the earned wages of very hardworking watermen from them for a program under which they cannot benefit, I think is an outrageous travesty.

Some of those chair-bound lawyers in the Treasury Department ought to have a redefinition of what frivolous is, and I can arrange for them to get out on the Chesapeake Bay any morning they want, and we will get them that new definition.

Senator DOLE. They are here now, so maybe you could work it out on the way out. [General laughter.]

Senator MATHIAS. With permission of the Chair, I will ask for volunteers 4:30 tomorrow morning at the dock in Annapolis.

Are there any volunteers; I don't see any hands back there.

Senator DOLE. It takes a while to persuade the Treasury. They don't volunteer anything, believe me. [General laughter.]

Senator BYRD. All volunteers can meet Senator Mathias in the corridor. [General laughter.]

Thank you, Senator Mathias.

Senator MATHIAS. Thank you, Mr. Chairman.

Senator BYRD. Next will be a panel consisting of Mr. Harvie Branscomb, Jr., chairman, Tax Section, American Bar Association, accompanied by Edward N. Delaney of Washington, D.C., and Mr. Donald W. Thurmond, chairman of the taxation committee, Trust Division, American Bankers Association, Atlanta, Ga.

Welcome, gentlemen.

Senator DOLE. Mr. Chairman.

Senator BYRD. Senator Dole.

Senator DOLE. It is my understanding that the next three panels all support 6883 with some modifications. So perhaps if it is just to state your support, you might eliminate that, and give us what modifications you think are necessary.

STATEMENT OF HARVIE BRANSCOMB, JR., CHAIRMAN, TAX SECTION, AMERICAN BAR ASSOCIATION, ACCOMPANIED BY EDWARD N. DELANEY, ESQ.

Mr. BRANSCOMB. My name is Harvie Branscomb, Jr., of Corpus Christi, Tex., chairman of the Tax Section of the American Bar Association.

Let me state briefly that I am authorized to speak on behalf of the section of taxation under our association rules. In addition, on matters of simplification, and to the extent these bills lend to simplification, I am authorized to speak on behalf of the American Bar Association.

The modifications in S. 6883 being considered by the subcommittee will be discussed in detail by a subsequent witness, Martin Ginsburg from our association, but I would be pleased to limit my discussion to a statement with respect to such modifications.

The modifications relate primarily to problems involved in the installment sale area where sales have been made to members of the family and other related parties for the purpose of avoiding payment of a tax that would otherwise have been due.

These provisions are designed to prevent the use of a sale between a husband and wife, or a husband and a member of a family, to circumvent the basic intent of the installment sales statute, as we understand it, and to permit the avoidance of taxes which would be due in the absence of a manipulation between the parties.

The section on taxation has studied these provisions very carefully, and is of the opinion that these are reasonable limitations to put in the bill.

We support S. 6883 and S. 3080, and feel that although there are some who have suggested that these modifications may be inappropriate, it is our very considered opinion, after very careful study by people who we believe are very well qualified in the area, that the overall impact of the statute is clearly liberalizing and clarifying, that the statute relates to an area of the tax law that affects a great many small business people and individual taxpayers, that without the bill there are tax problems which require a great deal of sophistication, and in our opinion these matters do not materially affect the overall impact of the bill as a very desirable one.

If that is a sufficient response to Mr. Dole's question, I would like to talk very briefly about S. 3080, the bill to return to the annual filing of the gift tax returns.

Senator BYRD. Very well.

Mr. BRANSCOMB. Mr. Chairman, we have written statements which we would like to file with the record, and I will not duplicate what is in those statements.

Senator BYRD. They will be received.

Mr. BRANSCOMB. In our written statement on gift tax, we set forth the amount of gift tax collected according to the report of the Commission of Internal Revenue for 1969 through 1979.

These figures show that the expected increase in gift tax which was designed to be obtained in 1970, when the law was changed to require quarterly filings of gift tax returns, was not in fact obtained.

That is to say, in our opinion, the quarterly filing procedure, which was instituted in that year, did not achieve the purpose that the records indicate that it had. Actually, in 1978 and 1979 the total gift taxes have declined substantially because as a result of the Tax Act in 1976 the use of the gift tax to circumvent estate tax was decreased. So in our opinion there is no justification for the quarterly filing requirement.

On the other hand, the amount of labor and the complications, both to the taxpayer and to the Service, in having to file a tax return four times a year, and under each gift tax return having to recapitulate all the prior gift tax returns filed, is substantial.

For those reasons it is our view that S. 3080 is in the public interest and would lend to simplification of the tax laws. We hope that it will be enacted.

[Statements of Harvie Branscomb, Jr., follow:]

STATEMENT OF HARVIE BRANSCOMB, JR.
CHAIRMAN OF THE SECTION OF TAXATION OF THE
AMERICAN BAR ASSOCIATION

BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE

SEPTEMBER 10, 1980

Re: S. 3080 -- To Provide for the Annual Imposition and and Payment of the Gift Tax

Mr. Chairman and Members of the Subcommittee:

My name is Harvie Branscomb, Jr. I am the Chairman of the Section of Taxation of the American Bar Association. In that capacity I am pleased to express the views of the Section of Taxation and the American Bar Association on S. 3080, dealing with the filing of gift tax returns and payment of gift tax on an annual basis.

The Section of Taxation fully supports S. 3080. In addition, it has determined that S. 3080 will implement the position of the American Bar Association in favor of simplification of the tax laws. The Section urges the adoption of S. 3080 pursuant to authority granted to it by the Association to support simplification.

A review of filing requirements for gift tax returns over the last decade will demonstrate the need for S. 3080. Prior to 1971, gift tax returns were required to be filed annually. Beginning in 1971,[1/] gift tax returns were required to be filed quarterly, with the expectation that quarterly filings would increase 1971 revenues by $100 million and that there would be "significant interest savings" to the government each year thereafter.[2/]

Such quarterly filings have not produced an increase in tax, as shown by the following information taken from the annual reports of the Commissioner of Internal Revenue:

Fiscal Year	Number of Gift Tax Returns Filed	Gift Tax Payable
1969	150,785	$393,373,000
1970	147,693	438,755,000
1971	165,481	431,642,000
1972	190,743	363,447,000
1973	243,895	636,938,000
1974	252,653	440,849,000
1975	260,094	375,421,000
1976	302,464	431,730,000
1977	386,802	1,775,866,000[3/]
1978	195,194	139,419,000
1979	201,785	174,899,000

1/ Excise, Estate and Gift Tax Adjustment Act of 1970.

2/ See H.R. Rep. No. 91-1635, 91st Cong., 2d Sess. 13 (1970).

3/ The large increase in gift tax revenue in fiscal year 1977 resulted from gifts made at the end of 1976 in anticipation of the major change in the gift tax laws which became effective January 1, 1977.

It soon became apparent that quarterly filing was creating a trap for unwary taxpayers, an additional burden for taxpayers and the Service alike, as well as technical problems. For these reasons 4/ the Congress eliminated the quarterly filing requirement for gifts of $25,000 and under in the Tax Reform Act of 1976, and in 1979 changed the due date of the return for the fourth quarter from February 15 to April 15.

These amendments were consistent with recommendations adopted by the American Bar Association in 1974, on the recommendation of the Section of Taxation, that quarterly filing be abandoned unless taxable gifts of the year exceeded $100,000. However, they failed to resolve entirely the technical problems created by quarterly filing, including the possibility of the unintended loss of the marital deduction, 5/ and

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4/ General Explanation of the Tax Reform Act of 1976 prepared by the Staff of the Joint Committee on Taxation 586 (December 29, 1976).

5/ Section 6075(b) as amended continues the calendar quarter as the taxable period. Suppose donor (D), who has already given his spouse (S) over $200,000 in prior years, makes a gift of $4,000 to S in the first quarter of 1980, and also a gift of $28,000 to X in that quarter. A gift tax return is required for that quarter, and the gift tax marital deduction is limited to $1,000, just as under prior law. If D gives S $2,000 in the second calendar quarter of 1980, and also gives X $25,000 in that quarter, another return is required for the second quarter, and the marital deduction is $1,000. Thus D has received only a $2,000 marital deduction, whereas a $3,000 marital deduction would have been allowed if the gifts to S had been made in the same quarter.

practical problems created by the requirement of quarterly returns for larger donors. Moreover, the decreased importance of the gift tax in recent years, as shown by 1978 and 1979 collections, is an additional reason for the proposed change.

In April of 1976 the Board of Governors of the American Bar Association adopted a resolution in favor of simplification of the internal revenue laws, and subsequently the Association authorized the Section of Taxation to speak for it on simplification matters. Pursuant to such authority, the Section has been actively pursuing various approaches to tax simplification, working within its own organization and with other groups.

Earlier this year a special task force within the Section, appointed to deal with simplification in the gift tax area, adopted a recommendation that quarterly filing of gift tax returns be wholly eliminated. S. 3080 would achieve this purpose and would, in the opinion of the Section, provide a simpler, more efficient approach to taxation in this area.

For these reasons we respectfully recommend the adoption of S. 3080.

STATEMENT OF HARVIE BRANSCOMB, JR.

CHAIRMAN OF THE SECTION OF TAXATION OF THE

AMERICAN BAR ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

SENATE FINANCE COMMITTEE

SEPTEMBER 10, 1980

Re: H.R. 6883--The Installment Sales Revision Act of 1980

Mr. Chairman, members of the Subcommittee:

My name is Harvie Branscomb, Jr. I am Chairman of the Section of Taxation of the American Bar Association. In that capacity I am pleased to express the views of the Section of Taxation with regard to H.R. 6883, the Installment Sales Revision Act of 1980. These views are only those of the Section and should not be construed as representing the position of the Association.

Mr. Chairman, I would like to state that the Section of Taxation fully supports H.R. 6883. In our view, the bill will achieve fundamental simplification, clarification, and desirable restructuring of the tax treatment of installment and deferred payment sales -- transactions commonly occurring among taxpayers at all income levels. As you are aware, there is a companion bill in the Senate, S. 2451, but it does not reflect the amendments made by the House.

H.R. 6883 is the direct result of a unique, cooperative effort begun last year involving key members of the Congressional tax-writing committees, members of their staffs, the Treasury Department, the staff of the Joint Committee on Taxation, and professional tax practitioner groups. We hope that this collegial effort will be the critical beginning of an on-going process to review and revise the tax law to bring simplification and improvement to the system. Efforts at simplification of the tax law have been made in the past, but this is the first time, to our knowledge, that tax practitioners - professionals with extensive experience in the way the tax law actually operates in practice - have been deeply involved with the staffs of the tax writing committees and the Treasury Department in a specific simplification effort. Continuation of this collegial process offers a new and, we believe, promising approach to the continuing problem of simplifying our complex tax laws and their administration and enforcement.

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The Tax Section is fully committed to this process. In 1976, the following recommendation of the Tax Section was approved by the ABA Board of Governors:

> "It is recommended that (1) the Congress simplify the internal revenue laws so that they can be easily understood and complied with and fairly and consistently administered; (2) the Ways & Means and Finance Committees adopt and announce a scheduled long-range program to achieve such simplification; (3) those Committees employ to the maximum extent possible the resources and experience of the Treasury Department in designing and developing such a program; and (4) the Congress designate and establish an appropriate body of advisors, whether it be a separately funded section of the staff of the Joint Committee on Internal Revenue Taxation, a separate commission, or some other appropriate organization, to assist in this program by assembling and analyzing basic information and advising the tax-writing committees of various alternatives."

In implementing that resolution, the Tax Section has been authorized to speak for the American Bar Association on matters involving simplification of the tax laws. The Tax Section has concluded that the bill is in keeping with the purposes of the resolution.

The bill will simplify the installment sale area by eliminating the 30-percent limitation, the two-payment rule, and the $1,000 limitation on sales of personal property. The bill will bring additional simplification to taxpayers from a transactional standpoint with respect to liquidations under section 337 involving installment and

deferred payment sales of corporate assets. The bill will extend installment reporting to sales where there is a contingency as to price. The bill will also accomplish simplification, and eliminate an existing trap for the unwary, by providing that installment sale treatment will be applicable unless the taxpayer elects otherwise. Thus, under the bill, taxpayers who report their gain as they receive the proceeds of sale will be taxed as they would normally expect. The bill will bring additional clarification of the taxation of installment sales by new provisions dealing with the problem of a cancellation or bequest of an installment obligation; by permitting installment treatment for installment obligations received as "boot" in "like-kind" exchanges; and by providing relief in the case of a foreclosure by an executor or beneficiary of a deceased taxpayer who made an installment sale of realty during his lifetime.

The bill contains provisions denying installment sales treatment to certain sales between related parties. These provisions are designed to prevent the use of installment sales for tax avoidance purposes in some situations where in the past transactions between related parties have been set up in order to avoid the payment of taxes which would otherwise be due. These provisions set forth specific rules governing the tax consequences of such

transactions and thereby also serve the purpose of reducing litigation and uncertainty. Thus, with respect to deferred payment sales between related parties other than husband and wife, installment sale treatment is lost only if, when, and to the extent that the property is resold within two years (or at any subsequent time in the case of marketable securities). In the case of a deferred payment sale between husband and wife, installment sale reporting will not be allowed unless the purpose of the transaction is not tax avoidance. The legislative history will make it clear, however, that installment sale reporting is allowable on a deferred payment sale between husband and wife in a variety of cases in which there is no tax avoidance purpose. For example, if the result of the transaction is not to increase depreciation deductions without commensurate recognition of the deferred gain which would justify such increased depreciation, installment reporting will be allowed as between husband and wife.

These special related party rules seek to balance the allowance of installment reporting in appropriate cases of sales between related persons and the denial of it where the result would be tax avoidance. While these new rules will have the effect of narrowing the availability of installment reporting in a relatively small number of related party cases, the bill as a whole will substantially liberalize and simplify installment reporting.

The development of this bill to simplify and improve the installment sale provisions has not been easy. Many difficult and complicated issues had to be resolved. Representatives of the Tax Section of the American Bar Association in cooperation with the tax committees in the New York State and City bars and the Federal Tax Division of the American Institute of Certified Public Accountants have labored long and hard in working with the Joint Committee staff, the Treasury, and others to develop this bill. Speaking for the Tax Section, this meant extended work by members of our Special Committee on Simplification, our substantive committees dealing with Tax Accounting Problems and Sales, Exchanges, and Basis, and other Tax Section groups.

We have been fortunate to have available to us within the Tax Section the talents of Martin Ginsburg, who is the new Chairman of our Committee on Simplification. Ed Hawkins of the Senate Finance Committee has played a valuable role in this process, and we are greatly indebted to him as well.

Since the hearings held last year before this Subcommittee on the original installment sale bill (S. 1063), extensive discussions have occurred among all of the above participants to refine, expand, and improve that original bill. The bill as enacted by the House of Representatives

should be further improved in certain relatively minor respects, as Mr. Ginsburg will explain. We understand that all of the interested groups, including representatives of the Joint Committee Staff and the Treasury, are agreed as to the advisability of these changes. Throughout, our effort has been to insure that the bill will operate in a fair fashion, and that all taxpayers, whether sophisticated or not, could reasonably expect the same tax treatment.

I will leave to Mr. Ginsburg and others commentary upon specific provisions of this bill. We endorse the enactment of this bill as soon as possible, not only because of its simplification of the installment sale area, but also as a first step in additional simplification efforts of the same type in other areas. The Tax Section and the other parties involved in this effort have several additional simplification projects under study and are ready and anxious to carry forward this tax simplification process.

Senator BYRD. The Treasury has testified that it has no objection to that proposal.

Mr. BRANSCOMB. That is my understanding.

Senator BYRD. Thank you, sir.

The next witness.

STATEMENT OF DONALD W. THURMOND, CHAIRMAN, TAXATION COMMITTEE, AMERICAN BANKERS ASSOCIATION

Mr. THURMOND. Mr. Chairman and Senator Dole: I am Donald Thurmond of the Trust Community Bank of Atlanta, Ga. I appear here on behalf of the American Bankers Association.

We are in support of H.R. 6883 and S. 3080. The installment sales bill represents a long process that was begun with a hearing last summer before you. Many changes have been made since then. We endorse those changes, and endorse the bill in its entirety.

The annual gift tax return bill, S. 3080, again recognizes an area of needed simplification. As Mr. Branscomb has testified, the rationale in 1971 no longer exists due to gift to the wife and unified credit provisions of the 1976 Tax Reform Act, and is just a trap for the unwary, a burden on the taxpayer and I think on the Internal Revenue Service. So we heartily support this bill.

In light of Senator Dole's comment, I will reduce my statement and I will answer any questions you might have.

[Statement of Donald Thurmond follows:]

Summary of Testimony of
Donald W. Thurmond
On Behalf of
American Bankers Association
on
The Installment Sales Revision Act of 1980 (H.R. 6883)
and
The Annual Gift Tax Return Act (S. 3080)
Before the
Subcommittee on Taxation and Debt Management
Committee on Finance
United States Senate

September 10, 1980

-- The ABA enthusiastically supports the commencement of a process of targeted amendments of the tax law with a view to simplify its operation on selected areas.

-- The Installment Sales Revision Act of 1980 is of particular importance because it is the first comprehensive tax simplification act to emerge from this session of Congress.

-- An example of the type of needed reform that is envisioned in the bill is the provision in H.R. 6883 which would permit installment method reporting between related parties. Such a proposal recognizes the applicability of installment sales treatment to legitimate family transactions.

-- The ABA is pleased to offer its support of the Annual Gift Tax Return Act. The elimination of the quarterly gift tax return requirement as proposed in S. 3080 represents much needed simplification in our tax law.

Testimony of Donald W. Thurmond
On Behalf of the
American Bankers Association
on
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Mr. Chairman and Members of the Committee:

My name is Donald W. Thurmond. I am the Chairman of the Taxation Committee of the Trust Division of the American Bankers Association and Group Vice President of the Trust Company Bank, Atlanta, Georgia.

I appear on behalf of the ABA, a trade association composed of over 90 percent of the nation's more than 14,000 full service banks. Approximately 4,000 of our members have fiduciary powers serving their customers as trustees and executors. The Association enthusiastically supports the commencement of a process of targeted amendments of the tax law with a view to simplify its operation in selected areas. We appreciate this opportunity to present our views on the Installment Sales Revision Act of 1980, H.R. 6883, and the Annual Gift Tax Return Act, S. 3080.

H.R. 6883 - The Installment Sales Revision Act of 1980

The Installment Sales Revision Act is intentionally narrow in scope and would simplify installment reporting of gain on installment sales and deferred payments sales. The proposal under consideration by your Committee is an amended version of a bill that was considered by the Select Revenue Measures Subcommittee of the House Ways and Means Committee earlier this year. The ABA was one of a number of trade associations and professional

groups that submitted testimony on the need to reform the installment sales provisions of the Code. The bill that emerged from the Ways and Menas Committee and ultimately passed was the product of months of work and discussion by numerous organizations and individuals.

Although the ABA may not agree with every single technical aspect in H.R. 6883, we support the changes made as a result of the hearings last year. The bill is now balanced by making revisions which assure that taxpayers making installment sales are treated fairly. An example of the type of needed reform that is envisioned in the bill is the provision in H.R. 6883 which would permit installment method reporting for sales between related parties when the related party does not sell the purchased property within a short period of time after acquisition. Such a proposal recognizes the applicability of installment sales treatment to legitimate family transactions. In many cases, installment sales are made between related parties when the purchaser has no intention of seeling the acquired property, the purchaser simply may not have sufficient assets to pay cash for the property at the time of acquisition. This occurs most frequently when real property or closely-held business assets are involved. The related party sales provisions contained in H.R. 6883 are an example of the kind of tax reform that would assure that taxpayers are treated in an equitable fashion.

The Installment Sales Revision Act of 1980 is of particular importance because it is the first comprehensive tax simplification bill to emerge from this session of Congress. This bill is intentionally narrow in scope and greatly simplifies installment sales reporting. We would like to point out, however, that installment sales are only one aspect of the broader subject of sales for deferred payments. At some time Congress should address this subject and attempt to develop a coherent and consistent approach in terms of both seller and purchaser.

S. 3080 - The Annual Gift Tax Return Act

The elimination of the quarterly gift tax return requirement as proposed in S. 3080 represents much needed simplification in our tax law. The current quarterly requirement is burdensome on the taxpayer and the Internal Revenue Service. Furthermore it frequently amounts to a trap for the unwary since many taxpayers rely on a tax return professional to handle their return requirements on an annual basis - at the time for filing the income tax return. It is possible the rationale that supported going to a quarterly return in 1971 no longer exists since the addition of the unified credit and the $100,000 gift to spouse provisions by the Tax Reform Act of 1976.

It has been clear since 1971 that the quarterly return has increased complexity and added expense for the taxpayer and the Internal Revenue Service. Last year's change that coordinated the fourth quarter gift tax return filing with the income tax return was a step in the right direction to reduce this complexity but did not go far enough. The current proposal that substitutes an annual filing requirement for a quarterly filing requirement will complete the needed simplification.

The ABA is pleased to offer support for these important pieces of legislation. I would be happy to answer any questions the Committee might desire.

Senator BYRD. Let me ask you this question. Suppose a husband and wife own a home jointly, and one wishes to sell to the other. Would this prevent the wife selling to the husband, or the husband selling to the wife on an installment sale basis?

Mr. THURMOND. This is on the related party transaction?

Senator BYRD. Yes.

Mr. THURMOND. It would not prevent the sale.

Senator BYRD. It would not prevent the sale on an installment basis?

Mr. BRANSCOMB. Mr. Chairman, I believe I can answer the question.

I do not think that it would prevent it. As is now proposed, the husband and wife sale on an installment basis would be denied only where it is primarily a tax-motivated transaction. Unless there was some other transaction—the parties indicated that this was a step toward finding some way to circumvent taxes that would ordinarily be due—I doubt that it would be prevented.

It is not depreciable property. There are no depreciation deduction gains from owning the home. Therefore, it would not be prevented by the legislation. It is meant to prevent the husband and wife from manipulating the tax law, and get a deduction that they would not have had.

Senator BYRD. I realize the intent of it, and I approve the intent of it. But I am just wondering how in practice it actually works.

Let's take a couple owning a farm. The wife would prefer to no longer be an owner of the farm, or maybe the husband would. Under this bill, would one be prevented from an installment sale to the other?

Mr. BRANSCOMB. Mr. Chairman, it is my understanding that if, for example, this deal were motivated by a change in family circumstances, by a divorce, or by some other situation, and that was a reason other than tax avoidance, the sale would be permitted.

Senator BYRD. The burden of proof is on whom under those conditions?

Mr. BRANSCOMB. The Commissioner would have to make the determination, but it is proposed that the committee report will outline some examples so that the types of transactions would be clarified.

Ordinarily, insofar as a farm is concerned, you are dealing primarily with nondepreciable property. In that situation also there would be no denial under the provision.

But it is my understanding that if, for example, there were a herd of depreciated cattle that husband wished to sell to wife in order to start depreciation over again on cattle that had previously been depreciated without any kind of motivation other than the circumvention of the tax laws, in that case the sale would not be allowed.

Senator BYRD. A so-called Mom and Pop operation. Mom decides that she does not like the way Pop handles things, and says: "Look, I would just rather get my money, and invest my money into something else. I want to sell my interest to you." Does this prevent that sort of a sale?

Mr. BRANSCOMB. The statute, of course, Mr. Chairman, would not prevent any sales.

Senator BYRD. I mean on the installment basis.

Mr. BRANSCOMB. In the event there were a desire to change the way that the family's financial affairs were being managed, and not simply a proposal to circumvent a tax that otherwise was due, it would be eligible.

Let me say, Mr. Chairman, there is a very big problem that faces the "Mom and Pop" situation that does need to be addressed, and that in our judgment this statute does address.

The installment sale is an everyday thing to people in every walk of life—small taxpayers. There are many circumstances now when a taxpayer makes a sale, is not highly tutored by a tax expert, and thinks he will pay income tax on his money as he gets it.

Under existing law there are many technicalities, as a result of which he may discover that in the year of sale he has to pay tax on money he may not get for many years. This statute addresses itself to this problem, and we think that for that reason it is very desirable.

Senator BYRD. I agree, and I am not arguing against the proposal. I favor the proposal.

I am just trying to understand that part of the proposal as it applies to related parties.

Mr. BRANSCOMB. Mr. Chairman, I would like, if I might, to refer those questions to Mr. Ginsburg who will testify later, who has spent a great deal of time on the detailed idiosyncrasies of the statute.

Mr. THURMOND. I think that the intent is strictly for tax avoidance situation to be caught with that, and the Commissioner has some discretion, I think, on addressing tax avoidance, and will be given guidelines as has been suggested. I think the legitimate transactions will have no problem under the bill.

Mr. BRANSCOMB. Mr. Chairman, if I may make one more point.

The section on taxation perceives that the number of instances in which installment sales have been used as a gimmick to avoid taxes otherwise due to be very few and far between in the past. But we do not feel that we should appear before you to recommend legislation in this area which would permit a continuation, and perhaps escalation of transactions that have no reasonable justification within the economic world.

For that reason, we have felt that we should join with the others who are supporting this bill in permitting the insertion of provisions designed to deal with that area. It sometimes is difficult to make a tax statute fit the exact situations that you anticipate only. But we feel that as good a job has been done as reasonably can be done in this statute to deal with that kind of a problem.

Senator BYRD. Thank you, sir.

Senator Dole.

Senator DOLE. I think I understand, and I will understand better later, that there are three factors involved. One is that the property is not depreciable; the second is that there is not substantial tax deferral; and the third is tax avoidance.

Mr. BRANSCOMB. That is correct, sir.

Senator DOLE. If those three things are missing, you have satisfied the statute, and you can have an installment sale.

Mr. BRANSCOMB. That is correct.

Senator BYRD. Thank you, gentlemen.

The next panel, Mr. Converse Murdoch of Wilmington, Del.; Mr. Gerald W. Padwe of Washington, D.C.; and Mr. John P. Holman of Washington, D.C.

STATEMENT OF CONVERSE MURDOCH, ESQ.

Mr. MURDOCH. I am Converse Murdoch, an attorney from Wilmington, Del. I am here to both support and oppose the installment sale bill.

For many years the Philadelphia Bulletin has run an advertisement that shows a crowd of people standing around reading the Philadelphia Bulletin while some terrible calamity is about to befall them. There is a building about to topple over them. There is one little man who is not reading the Philadelphia Bulletin and who is trying to get their attention and point to the building falling down.

I guess I stand in that role. The Philadelphia Bulletin ad said, "Nearly everyone reads the Philadelphia Bulletin." I guess my role is, I am the one little guy that does not approve wholeheartedly of this bill.

In your opening statement, Mr. Chairman, you indicated that there were complicating factors put into this bill, and you questioned whether the value of the simplicity part of the bill was such that it was worth putting in the complicating factors.

I don't think there are any of the simplifying parts of this bill which open up any loopholes which require complicated closing provisions. I think what everyone agrees on is that the simplifying parts of this bill could be enacted without any of the complications. It is because of this process that I despair of ever getting tax simplification.

What seems to happen always is that someone comes up with a simplifying provision to the tax laws. The Treasury immediately starts to figure out how somebody out in the provinces could misuse this provision and climb through some loophole, and they have to come up with a very complicated way to close that loophole.

Senator Mathias mentioned the watermen who get up at 5:30 in the morning and go out on the water to get oysters and crabs. I am familiar with people who get up early in the morning, too. I can assure the Treasury that most of the people out there in the provinces do not wake up and have as their first thought, how I can get in touch with my tax lawyer this morning and find a loophole in the law. They have many more important things on their mind—just how to make a living.

They are not thinking up ways of beating the installment sales rule. That is not what most Americans are doing. But they do despair when they fall into the terrible traps that are in complicated tax laws. From that point on, they feel they have to spend a lot of money to consult experts on how to avoid these terrible traps. I think this bill has some terrible traps in it.

There was some discussion about a sale between a husband and wife. In my statement I mention a hypothetical situation. I assure

you that it is purely hypothetical. I do not have a client who has that situation, but I can well imagine it arising.

The situation is, a husband has lost his first wife. He has children by his first marriage. He owns a summer home in Rehoboth, or any other place, and he wants to give his new wife that summer home. However, he feels, it is unfair to his children to just give it to her and deplete his estate to that extent. Also, he does not like the idea of paying a gift tax on that transaction.

So he consults a lawyer—probably not a tax lawyer, or any of the sophisticated people in this room. He consults a person who handles real estate transactions. The normal answer would be,

> Well, the answer to your question, sir, is, why don't you sell your wife this vacation home on an installment basis. She can pay interest of 6 percent a year for 15 years, and at the end of the 15 years she will pay you or your estate the $100,000 it is worth. The odds are that you are going to die in 15 years. You will have life insurance and she will have the money to pay for it. Everything will be fine. Your children by your first marriage will not get cheated. It is perfect.

Then years later, an Internal Revenue agent comes along and looks at that transaction. If this present bill is passed what that agent is going to say to the man is,

> That was depreciable property. That was rented much of the year, and it was subject to depreciation. You sold it to your wife in an installment transaction calling for $100,000 of principal and 6 percent interest for 15 years. In the year you transferred it to your wife, you had $190,000 of income—not $100,000 but $190,000.

That is what the bill says. It says, "All amounts to be received under the contract are immediately pushed into the year of the sale."

The agent will say to the man,

> I talked to my buddy who is a gift tax agent, and the gift tax agent told me that you also made a gift of $50,000 to your wife because the going rate of interest when you did this was 12 percent, and a note bearing interest at 6 percent is only worth half of face, so the note was only worth $50,000. You made a gift to your wife.

He is then going to say to the man,

> I have got some other bad news for you. When you die, this note of your wife's is going to be part of your estate but at its fair market value, which is $70,000. When your wife pays off your estate years later, the estate is going to realize another $30,000 of ordinary income because your estate will be have a base in that note equal to its fair market value, and not its face.

I agree that all of these things could be taken care of if we had time to rewrite the statute properly. I am told, when I bring up things like this, "Don't worry about it. The Treasury will be fair. They will say that there is no tax avoidance there. So don't worry."

The next thing I am told is, "Don't worry about it. We will take care of that in the committee report."

On the idea of the Treasury being fair—sometimes they are, and sometimes they are not. But the Treasury is not a monolithic thing. It is the thousands of revenue agents out there in the field that one deals with. You don't deal with the Secretary of the Treasury when you have an audit. Each one of these people has his own particular pet projects. I don't think that it is fair to say to the taxpayers, "Trust us. Our agents will be fair."

If there is going to be a provision which lets bona fide transactions out, the provision should be stated in terms of: If it is demonstrated there is no tax avoidance, then you are home free. That is not what this bill says.

The bill says: If it is demonstrated to the satisfaction of the Treasury that there is no tax avoidance, you are home free.

I can tell you the way that works in practice. The agent says: "Fine, you want me to determine that it is not tax avoidance. I will determine it. The price is that you will agree to the following things." Then you say, but that is not in the law. He says, "But you want my approval, don't you. It is going to be that or no deal."

I ask the committee to please strip that out of it, so that if we have a bona fide case we can go to a court and convince a judge that there is no tax avoidance, and not be beholden to the Treasury agent for a ruling in our favor.

I would like to submit my statement for the record.

Senator BYRD. It will be received.

Mr. MURDOCH. I want to take this last minute to speak in favor of S. 3080. This is my idea of real simplification. I think that it is a great idea to go back to annual filing of gift tax returns.

I have never understood the revenue loss from going to that. It seems to me that there is only a budgetary effect to accelerate some receipts, which would otherwise come in next April, in the current year's budget. That to me is sort of budget trickery, and not anything to do with overall revenue.

There is a very practical reason why I favor going back to the annual filing system. Most income tax returns are prepared by accountants and not by lawyers. In the process of doing up an income tax return, a good accountant normally asks a client whether he has made a gift during the year requiring a gift tax return. But unless he is talking to his accountant, he is not even aware often that he has made a gift.

I will conclude by saying that it is a great idea, and I hope the committee will approve that bill.

[Statement of Mr. Converse Murdoch follows:]

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

FINANCE COMMITTEE

Hearing on HR-6883
Revision of Installments Sales Reporting
September 10, 1980
Statement of Converse Murdoch, Esquire
P.O. Box 949
Wilmington, DE 19899
(302) 658-8662

Summary of Statement

I believe that the now proposed legislation is a substantial improvement over the legislation considered by the subcommittee at hearings during the summer of 1979.

However, I urge:

1. The rules regarding resales by related parties be improved by better stating the exceptions and by adding other needed exceptions.

2. Demonstration of lack of tax avoidance not require the concurrence of the Internal Revenue Service.

3. An extension of the statute of limitations on tax deficiencies not depend on actions of related, but uncontrolled, parties.

4. The legislation not give the Treasury such broad rule making authority.

5. Rules proposed to be "covered in the Committee Reports" be included in the statute.

6. The punitive new rules on sales between closely related parties be dropped.

7. Directions to curtail long standing rules on taxation of receipts from deferred payment sales be deleted from this legislation and accompanying committee reports.

8. The effective dates be revised in the interests of fairness to the many taxpayers who are uninformed about the legislation.

General Statement

During nearly 33 years of practicing law, I have participated extensively in purchases and sales of interests in closely held businesses, family farms, and other small business type properties. Most of the clients of our firm are principals in small business enterprises.

I am the immediate past president of the Small Business Council of America, Inc. As such, I have been and continue to be in touch with tax problems of small business persons. However, this statement is not submitted on behalf of the Small Business Council of America, Inc.

I was a delegate to the White House Conference on Small Business and have remained active in post-conference activities by delegates looking towards implementation of the proposals which came out of that conference.

In short, I am an attorney who has a great interest in the problems of small businesses. Any tax proposals which impact particularly on small businesses are matters of concern to me.

Interests in small businesses (including farms and ranches) have customarily been transferred in transactions involving the purchaser's payment of the consideration over an extended period of time. In some cases, such transactions involve sales of businesses between related parties. For example, it's not unusual for a parent who has owned and operated a small business to sell the business to one or more of his children on an installment basis. In other situations, such sales are made to unrelated parties. In either event, it's common for the purchase price to be payable over an extended period.

In today's climate of high interest rates and limited availability of bank loans for small businesses, a sale of a small business on anything other than an extended payment basis is a rarity. Except for large publicly-held organizations interested in passive investments in small businesses (coupled with a hoped for sale in a short time at capital gains rates), it's almost unheard of for the purchaser of an interest in a small business to have enough capital to pay a substantial part of the purchase price in cash.

It's for the foregoing reasons that small businesses have a particular interest in income taxation of gains from sales on an installment or other deferred payment basis.

Complexities which interfere with the ability to consummate deferred payment sales have a substantial negative impact on small businesses.

This is not to say that only small businesses have an interest in matters of this kind. However, small businesses have a particular concern in this area.

If transfers of small businesses to related or unrelated parties cannot be accomplished with understandable, simple and workable installment sales rules--more and more small businesses will be transferred to large corporations with publicly traded stock in tax-free "stock for stock" or "stock for assets" transactions. Accordingly, anything which inhibits installment sales of interests in small businesses to other small business people (whether related or unrelated) is bound to accelerate the trend towards concentrations of economic power in the hands of large corporations with publicly traded stock available for use in acquisitions of smaller businesses.

The Background of This Legislation

In the summer of 1979, this Subcommittee and the Select Revenue Measures Subcommittee of the House Ways and Means Committee held hearings on HR-3899 and S-1063. A substantial number of individuals and organizations appeared at those hearings and voiced strenuous objections to various parts of those bills. The cited bills would have made substantial changes in the tax rules regarding installment sales. Comments as to the earlier bills centered on the provisions which would have, in effect, forbidden installment sales reporting of gains from sales between related parties.

Presumably as a result of opposition expressed at those hearings and elsewhere, HR-3899 and S-1063 were substantially revised and reintroduced as HR-6883 and S-2451.

On April 17, 1980, the Subcommittee on Select Revenue Measures of the Ways and Means Committee held a public hearing on HR-6883. Following that hearing, there were some substantial revisions in the bill. It is HR-6883 as revised in the House which is now before this Subcommittee for consideration and comment.

However, I've been informed that various groups working with staff technicians of the Treasury and the Joint Committee have been revising the bill passed by the House. It may be that some of the objections I'll set forth in this statement will be "taken care of" in pending revisions. However, because I was not a direct participant in any of the revision sessions, I have to address my remarks to the bill as it's known to me and the public in general.

In my opinion, the now pending bill is a considerable improvement over the originally introduced bills. For that improvement, I'm grateful.

However, I believe that HR-6883 is in need of substantial revision. The revisions are of such a nature and magnitude that they should not be undertaken in the somewhat hectic atmosphere of the closing days of an election year session of Congress.

When HR-3889 and S-1063 were first introduced, they were identified and touted as "simplification" legislation. HR-6883 is no longer so identified. This is as it should be.

As a long time proponent of simplification of our tax laws, I would be disturbed if the pending legislation were to be identified as part of a simplificationproject. To do so would give simplification a bad name. That is not to say that because the legislation is not simplifying, for that reason alone it should be rejected.

I believe that we should all drop any pretense that we are simplifying the law and should discuss this legislation for what it is -- a very complicated amendment to an already overly complicated Internal Revenue Code designed to deal with a subject which may not lend itself to simplification.

However, I continue to urge that in connection with legislation such as this, everyone concerned strive for simplification to the extent that can be done consistent with the finally determined objectives of the legislation. However, if in achieving the finally determined objectives simplification cannot be accomplished -- we should frankly concede that and not engage in false labeling of a complex piece of legislation as "simplification".

In the balance of this statement, references to "Prop. Sec." will be deemed a reference to Proposed Sections of the Internal Revenue Code, as per the amendments to be made by HR-6883.

Related Parties Sale Rules

Because so many interests in small businesses (including farms and ranches) are sold on an installment basis to related parties who are members of the younger generation in the family, the rules with respect to sales to related parties are a matter of particular concern to small business people. They are obviously gratified to note that the flat prohibition against installment sales between related parties has now been dropped from the legislation. Instead, the pending bill provides a general rule that if an installment sale between related parties is followed by a resale within two years, the first seller must immediately report gain with respect to any amounts received by the second seller. That will follow whether or not the first seller receives additional cash and regardless of whether he has the right to ask for such added cash. While that is an obvious improvement over a rule which flat prohibits installment sales between related parties -- it still will result in many perfectly bona fide transactions either being subject to the penalty provisions of the proposed legislation or subjecting the parties involved to uncertainties as to whether the penalty provisions will apply.

At the time of public hearings on the House side with respect to HR-6883, there was no public announcement (or even a hint) that the Treasury or the Joint Committee Staff was considering a drastic change in the related party sales rules over and above that set forth in HR-6883 as it was published prior to the House hearings.

Accordingly, all of the public comment at the House hearings focused on what the witnesses assumed were the final Treasury proposals in this area.

It came as a considerable surprise to most persons familiar with this matter to learn that following the public hearings, the bill was changed to add a new (and further complicating) special rule for sales of depreciable property between what are referred to as "closely-related parties". Prop. Sec. 453(g).

At a later point in this statement, I will address that special rule. It's sufficient to state at this point that this is the first public hearing at which there is an opportunity to comment about this new special rule.

The Exceptions to the Two-Year Resale Provision

Involuntary Conversions

One of the exceptions to the two-year retransfer rule is found in Prop. Sec. 453(e)(6)(B). That exception is with respect to a second disposition which is part of a compulsory or involuntary conversion within the meaning of Code Section 1033. However, there is an exception to an exception to the effect that the penalty provision will apply unless "the first disposition occurred before the threat or imminence of the conversion." This assumes that there is a precise and easily identifiable point in time when there is first a threat of involuntary conversion, such as a threat of condemnation. That simply isn't the way it is in the real world. Anyone who

has had experience with condemnations knows that it is impossible to point to a particular day and say positively that this was the first day when there was a threat or imminence of condemnation. This exception to the exception is simply not workable.

If it is felt that there must be this exception to the exception -- it should be gauged by an easily identifiable event, such as the filing of a court proceeding for condemnation.

Death of Transferor or Transferee

Another exception to the two-year resale rule has to do with a second transfer following the death of the person making the first disposition or the death of the person acquiring the property in the first disposition. See Prop. Sec. 453(e)(6)(C).

This is a good provision but it does not go nearly far enough. The provision as drafted would cover only a simple situation such as one in which a father transfers a farm to a son in an installment transaction and then either the son or the father dies before the son has made a further disposition. However, there will be many situations which do not neatly fall into that particular mold. For example, the father may enter into an installment sale of property to a corporation controlled by the son or to a partnership of which the son is a substantial participant. Assume in such a case the son died within two years. Assume that for the same reasons which would have impelled a resale had the deceased son held the property directly -- the acquiring entity resells. That transaction would presumably not be exempt under the cited part of the proposed new law.

Real estate (including farms) is often held by a father and mother as joint owners. The exception would apparently not apply if the parents sold property to a child and within two years the father (but not the mother) died.

Another very common form of transaction not covered by this exception is the one in which a father transfers property to a son and daughter-in-law as tenants by the entireties. Within two years of the father's sale on the installment basis to the son and daughter-in-law, the son dies. Apparently, this transaction would also not qualify for relief. It should.

This exception should be considerably broadened to include situations such as those just posed.

Lack of Tax Avoidance

Prop. Sec. 453(e)(7) is meant to be a general relief provision for situations in which it can be demonstrated that there was no tax avoidance associated with either the first disposition (i.e., the original installment sale transaction between related parties) or with respect to the second disposition (i.e., the one occurring within two years of the first disposition).

Subject to some revisions to be suggested in a minute -- this is a good and needed type of general relief provision.

The provision should be revised to eliminate the requirement that the lack of tax avoidance must be "established to the satisfaction of the [Internal Revenue Service]". Stating the

exception in its now proposed form will put an intolerable burden on many properly motivated taxpayers.

The requirement that lack of tax avoidance be demonstrated <u>to the satisfaction of the Internal Revenue Service</u> will impel well advised and sophisticated taxpayers to undergo the expense and delays associated with trying to get advance rulings from the Internal Revenue Service. Often the delays associated with getting a ruling are so long that the proposed transaction aborts.

In addition, giving that sort of power to the Internal Revenue Service inevitably leads to situations in which the Internal Revenue Service imposes extralegal demands for concessions by the applicant for the ruling as a condition to getting a favorable ruling. This is "government by bluff" at its worst.

In the event of litigation regarding the availability of this exception in its present form, the taxpayers will be subjected to a well nigh impossible task of proving not only that there were no tax avoidance motives associated with either transaction, but <u>in addition</u>, that the Internal Revenue Service abused its discretion in refusing to so find.

This exception should be changed to merely a simple proposition that the two-year resale rule does not apply if lack of tax avoidance can be demonstrated. That would mean that in litigation, if a judge or jury became convinced of the lack of tax avoidance, the taxpayer would win whether or not the Internal

Revenue Service acquiesced in such a finding. Such a rule would conform with the provisions of Code Section 302(c)(2) having to do with waiver of the family attribution rules in stock redemption situations where tax avoidance was not one of the principal purposes of a transaction.

Another flaw in this general escape provision is that it requires that there be a demonstration that <u>neither</u> the first <u>nor</u> the second disposition had tax avoidance as one of its principal purposes. Assume the situation in which an individual sells property on an installment basis to a corporation controlled by him at the time of the transfer. Assume that thereafter the first transferor lost control of the transferee - corporation and the corporation thereafter sold the property in a transaction which IRS thought had a tax avoidance motive. The result would be that the first transferor would be subject to the penalties of the statute. This is particularly unfair in the situation where the first transferor has no control over either the event of resale <u>or</u> the motives of the second transferor. This is an example of "beating the wrong dog".

It should be sufficient to show that there was no tax avoidance motive on the part of the first transferor in connection with the first disposition.

<u>Foreclosure Type Resale</u>

There is a need for an exception to the two-year resale rule where the second disposition is in connection with a foreclosure of a lien on the transferred property. Such a

foreclosure sale can be just as involuntary for this purpose as one falling under Code Section 1033. In fact, the penalty aspects of this can be even more harsh in the case of a disposition in the form of a foreclosure sale. If the second disposition is a lien foreclosure sale, it will almost always mean that the second transferor has absolutely no cash as a result of the so called "sale". Thus, even if the second transferor is inclined to help the first transferor out of his cash difficulties, he couldn't do so.

Do Not Rely on Committee Reports to Guide the Treasury In Promulgating Regulations or Issuing Rulings

Some proponents of the bill in its present form argue that it is not necessary to expand the statute to create additional exceptions for worthy cases in which the statute falls short of granting an exception. Those persons argue that the parts of the statute giving the Internal Revenue Service the authority to rule that a particular transaction is devoid of tax avoidance motives will solve the problem, and that the Committee reports can urge particular points of view which are to be reflected in the Treasury's regulations and the Service's administration of the law.

For many years, it was assumed that if the Committee reports accompanying legislation gave instructions to the Internal Revenue Service as to how Congress wanted the statute interpreted -- such committee report directions would be followed.

As long as that rule worked, it served a good purpose. It avoided the necessity of expanding the Code and it gave assurance to taxpayers and their advisors that if the Committee reports ordered a particular line of interpretation -- that would take care of the matter. Recent actions by the Treasury Department have now cast doubt on whether such use of Committee report directions can be relied on by Congress, taxpayers, and their advisors.

The Treasury Department recently issued proposed new regulations on vesting for qualified deferred compensation plans. These proposed regulations brought down a firestorm of protest and, as a result, the Treasury did the somewhat unusual thing of withdrawing the first proposed regulations and issuing a new set in a "reproposed" form. The newly issued set of regulations were for most taxpayers more objectionable than the first set. It's inappropriate at this point to get into an extended discussion of the merits of the still raging controversy about the propriety of the Treasury's proposed and reproposed regulations on vesting for qualified plans. The point is that in connection with this controversy, through a Freedom of Information Act proceeding in court, the Treasury was forced to disclose its Work Plan for this regulations project. But for the forced disclosure of this Work Plan, it's unlikely that those outside of the Treasury Department would ever have known about the current thinking of the Treasury Department regarding congressional committee report directions which are contrary to the Treasury's wishes.

One of the points of controversy in connection with the now proposed Treasury vesting regulations has to do with whether 4/40 vesting schedules are to be respected as furnishing a safe harbor. The Treasury adamantly refuses to recognize such a safe harbor rule in its proposed regulations. Therein lies much of the basis for the controversy between the Treasury and the taxpayers. Representatives of various taxpayers' groups have stressed in discussions of this issue that the Conference Committee report on ERISA clearly directed the Treasury Department to recognize 4/40 vesting as a safe harbor pending further congressional action. See Conference Report 93-1280 accompanying ERISA, 1974-3 CB 415, 437-438.

Attached to this statement as Exhibit A is a copy of the Treasury Department Work Plan dated January 29, 1979, and the July 3, 1980, letter accompanying its transmittal to Mr. Chester Salkind, the Executive Director of the American Society of Pension Actuaries.

Anyone who still believes that the Treasury Department will automatically respect directions in congressional committee reports should carefully read paragraphs 1 and 2 on page 3 of the attached Work Plan. In the first paragraph, the Treasury acknowledges that the 4/40 safe harbor vesting rule as described in the Conference Committee report has heretofore been followed by the Service. In the second paragraph, the Treasury in effect

states that it is considering a departure from the Conference Committee direction and is prepared to defend this departure based upon the argument that:

> "***From a strictly legal standpoint, it is arguable that the conference report does not represent a contemporaneous construction of §411(d)(1), which was passed by the House several months earlier without the gloss contained in the conference report."

With such a Treasury additude about the effects of congressional committee reports, how can one assume that directions given in committee reports with respect to the now pending bill will earn any more respect at the Treasury.

The Newly Inserted Provision Regarding
Sales of Depreciable Property Between Closely Related Parties

Following the completion of the House public hearings on the pending bill and with no advance notice to effected taxpayers, the bill was amended to include a special new rule covering sales of depreciable property between a taxpayer and a spouse, and a taxpayer and certain 80% controlled entities. See Prop. Sec. 453(g). Unlike the rules now applicable to installment sales of other properties to other related persons, this special rule has an especially punitive provision to the effect that if a taxpayer sells property on an installment basis to a spouse or 80% or better controlled entity, the transferor

will be taxed in the year of the sale as if in that year the taxpayer had received all payments to be received under the contract.

This provision is shot through with technical problems of such a magnitude as to warrant its removal until all of the technical problems can be both identified and solved.

One way to point up some of these problems is to consider a hypothetical (but not fanciful) situation.

Assume that a husband owns a vacation home used most of the season by himself and his family, but rented out during other parts of the year. The taxpayer's first wife has died leaving children of the taxpayer and the first wife. The taxpayer has remarried and wishes to assure his new wife of the ownership of the summer residence, but without depleting his estate to the detriment of the children of the first marriage. Assume further that an added reason for not making an outright gift of the summer residence to the new wife is because the taxpayer wishes to avoid gift tax consequences from such a transfer.

Assume that the husband is told that the solution to his problems is to sell the summer vacation home to his wife for its present market value (assumed to be $100,000) in exchange for the wife's promissory note payable in 15 years with interest at 6% payable quarterly until maturity. The property has a tax basis in the hands of the transferor husband of $40,000. Under the workings of Prop. Sec. 453(g), the following will happen to the transferor spouse:

1. He will be deemed to have received $190,000 in the year of transfer (the $100,000 of principal <u>plus</u> $90,000 of interest to be received during the next 15 years).

2. Because in the hands of the transferee spouse the property is "of a character which *** is subject to the allowance for depreciation provided in §167" all of the gain will be treated as ordinary income. See Code §1239. This would seem to follow even though under the so-called vacation home rules the depreciation deduction allowable under Code §167 becomes non-deductible (or only partially deductible) under Code §280A.

3. IRS will determine that the taxpayer has made a gift for gift tax purposes equal to the difference between the face amount of the note ($100,000) and the value as determined by the Internal Revenue Service on the basis of an argument that the 6% interest provided in the note is less than the market rate under current conditions. See <u>Estate of Meyer B. Berkman</u>, 38 TCM 183, 185-187, TC Memo 1979-46 (1/31/79) and IRS Letter Ruling 7905090 (11/2/78).

4. The transferee-wife will not be permitted to deduct interest until its actually paid in cash, even though the transferor-husband has already been required to pick up as ordinary income all future interest payments.

5. The transferee-wife will have a basis for the property of only the principal amount of the installment note.

Assuming further that the transferor-husband dies five years after the transaction, the results will be:

1. The decedent's estate will take as the basis for the wife's note the fair market value of the note at the date of the decedent's death. If the stated interest in the note is less than the market rate prevailing at the date of the husband's death, the note will be valued at a substantial discount.

2. Payments on the principal of the note by the surviving wife will be reportable by the estate as ordinary income, despite the fact that the deceased spouse has already paid an ordinary income tax on the same dollars. In addition, the decedent's estate will presumably have to report as ordinary income the interest payments made by the surviving spouse since, as to the decedent's estate, these are not items of income previously reported.

The hypothetical I posed is not fanciful.

It is not a satisfactory answer to these problems to state that a well advised taxpayer would never get into such a jam. The sophisticated tax technicians who devised these rules tend to think that all taxpayers are advised by persons who are almost as sophisticated as the architects of the statute and who know all of these rules and can guide taxpayers around the rules. That isn't the case. Rules such as we're here discussing are serious traps for taxpayers who go into transactions without tax avoidance motives and without guidance from highly sophisticated advisors who not only know of the existence of, but likewise understand, these arcane provisions.

If devious taxpayers are somehow taking advantage of a loophole which only Prop. Sec. 453(g) can close, and if this situation cries out for immediate attention at the risk of seriously damaging the government's revenues -- then I say adopt Prop. Sec. 453(g). However, I don't believe that's the situation, and I have yet to see any statistics which indicate that the so-called "loophole" on transfers of property between the spouses on an installment basis is of such a magnitude as to justify complicating the Code and upsetting perfectly bona fide transactions.

The Anti-Burnet v. Logan Rule

Another provision which found its way into HR-6883 after the public hearing before the Ways and Means Committee is in Prop. Sec. 453(i)(2) providing:

> "(2) Selling price not readily ascertainable. The regulations prescribed under paragraph (1) shall include regulations providing for ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained."

At first reading, that provision seems bland and innocuous. However, it is important and potentially capable of drastically changing law which has existed for fifty years.

The Ways and Means Committee report on the bill states in Section II A in connection with the general explanation of the bill:

"Although the bill makes structural revisions of existing law and makes the specific changes described below, most of the basic concepts of existing law are continued.***"

Later in the House Committee report, the rule of Burnet v. Logan, 283 US 404 (1931) is mentioned. That's the rule which in essence provides that where there are open ended transactions calling for indefinite later payments, the selling taxpayer may recover his basis before reporting gain.

There are thousands of transactions which for reasons in no way associated with tax avoidance are so structured that it is impossible to tell at the outset how much income (if any) will be realized by a transferor and over what period. For example, an interest in a natural resource may be sold with the timing and amount of payment from the purchaser determined entirely by the production of the natural resource. Often it is impossible for either the seller or buyer to determine at the time of the transfer how much will be realized from the sale and when the payments will occur. Patents are another property routinely sold on the basis of indefinite future payments based upon production, sales and like factors. It's because of the nature of the transaction and not because of any tax gimmickry that transactions of the described kind are arranged in the way they are.

During the early stages of devising this legislation, questions were raised regarding the continued efficacy of the Burnet v. Logan rule. Proponents of the legislation stated that since a taxpayer could elect out of taxation under the proposed legislation, anyone who believed he was entitled to the benefit of the Burnet v. Logan rule could simply opt out of the new installment sale rules and rely on existing law. However, the quoted provision in Prop. Sec. 453(i)(2), supra, in effect authorizes the Treasury to destroy the Burnet v. Logan rule regardless of whether a taxpayer opts out or stays under the now proposed legislation. In the House Committee report, it is stated after discussing the effect on Burnet v. Logan of the now proposed legislation:

> "In any event, the effect of the new rules is to reduce substantially the justification for treating transactions as 'open' and permitting the use of the cost-recovery method sanctioned by Burnet v. Logan, 283 U.S. 404 (1931).***"

The just quoted language in the Ways and Means Committee report, coupled with the statutory langauge recited above, will undoubtedly create an inference of congressional intent to reverse Burnet v. Logan, or to so severely limit its application that the law in this area will be in flux for years.

I urge that the statute state clearly that there is no intention on the part of Congress to change the rule stated in Burnet v. Logan and its progeny. To do otherwise will put

in jeopardy many perfectly bona fide transactions and will subject taxpayers to severe tax penalties. This can be demonstrated by a hypothetical.

Assume an inventor who has a $100,000 basis for a patent which he has developed. The inventor has insufficient capital to exploit the patent himself and decides to give an exclusive license with respect to the patent to a substantial corporation which does have the capital to exploit it. The inventor and the substantial corporation enter into an agreement providing that over the next ten years the licensee will pay 5% of the sales from use of the patent. The deal is made and the licensee proceeds to use the patent. During the first year of use, the royalties payable to the inventor amount to $15,000. During the second year, the royalties amount to $25,000. During the third year, the patent is successfully attacked and the licensee announces that it intends to make no further payments or royalties because of the invalidity of the patent.

The Treasury favors (and the House version of the bill and the House Committee report furnish some basis for a Treasury announced rule to this effect) a rule that the inventor is to ratably recover his $100,000 cost over the ten year life of the license. Under this approach in the first year, the inventor would report $5,000 of income ($15,000 of royalties less 1/10 of his cost basis). During the second year, the inventor would report $15,000 of income ($25,000 or royalties less the same 10% of basis). During the third year when the patent is declared

invalid, the inventor would have a loss of his remaining basis -- $80,000. Looked at as a whole the transaction has resulted in an overall loss to the inventor of $60,000 -- his $100,000 cost for the invention minus $40,000 of royalties. However, under the Treasury approach, the taxpayer would have paid tax on $20,000 of income and have a remaining unrecovered cost basis of $80,000. For many inventors having a loss in the third year furnishes no solace because the inventor will probably not have later capital gains which he can offset against this loss.

The Burnet V. Logan approach furnishes a much more palatable and fair solution. Under that approach, the inventor would be entitled to treat the $40,000 royalties received by him as tax-free recovery of basis. In that way the inventor will have an unrecovered cost basis of ~~$80,000~~ $60,000 which he may not be able to utilize for tax purposes, but at least he has not paid tax on $20,000 of income when the transaction as a whole has resulted in substantial loss to him.

The Involuntary Extension of the Statute of Limitations

Prop. Sec. 453(e)(8) provides that the statute of limitations does not expire until two years after the date on which the first transferor notifies the Internal Revenue Service about the second disposition. This is a particularly unfair provision. It assumes that in all cases of related party sales there is a complete identity of interest and unlimited communication between the related parties. That simply isn't the fact.

As a result, the first transferor may find that many years after the first disposition he can be hit with a tax deficiency because of a transaction over which he had absolutely no control and of which he had no knowledge. This provision should either be eliminated or drastically changed to eliminate such an unfair result.

Special Rules on "Marketable" Securities

In the case of marketable securities, the proposed legislation would cause acceleration of realization of gain by the first transferor even where the resale occurs more than two years after the first disposition. Prop. Sec. 453(e)(2)(A). Prop Sec. 453(f)(2) defines marketable securities as securities "for which, as of the date of the disposition, there was a market on an established securities market, or otherwise." (Emphasis supplied) That is a very plastic definition and one which goes well beyond what most people would assume was meant by a marketable security. Presumably under that definition, every security is marketable since it could be sold somewhere on some terms. The definition is also unclear with respect to the situation in which a security is marketable at the time of the first disposition but not at the time of the second disposition or vice-versa. There are many situations in which a security can be non-marketable on one day and within two years become marketable, e.g. by listing on an established securities market. By the same token, a security can be listed on an established securities market one day and later be de-listed.

This definition needs to be considerably tightened.

Special Rule for "Readily Tradable" Installment Obligations

Prop. Secs. 453(f)(4) and (5) in effect treat readily tradable obligations issued by a corporation or a government (or political subdivision thereof) as the equivalent of cash. That rule is bound to lead to hardship situations and unfair results. This provision also raises a technical question whether it overrides the provisions of Code Sec. 354(a) in a reorganization in which securities are exchanged for securities.

Effective Dates

The bill provides that the legislation will in general be effective with respect to dispositions made after the date of enactment of the bill in taxable years ending after such date of enactment. That seems fair.

However, if the blank check to the Treasury to write regulations with respect to indefinite transactions remains in the bill, it would seem only right that the effective date for transactions covered by such regulations should not be earlier than the date such regulations become final. This is particularly so when the legislation puts taxpayers to an irrevocable election regarding coverage. As a minimum, the election should remain revocable until some decent interval after the regulations become final.

In the case of installment sales to related parties, the bill provides that it will become effective for dispositions made after May 14, 1980. Many persons were not aware of this

legislation until well after May 14, 1980. Certainly in the case of special rules for sale to closely related parties (Prop. Sec. 453(g)), all but a few persons were not aware of the new rules until long after May 14, 1980. In fact, there are probably many persons who are still not aware of this legislation and will not become aware of it until much later.

As presently drafted, the effective date provisions are unclear with respect to a situation in which the first disposition is to a related party and occurs after May 15, 1980, and the second disposition occurs before the enactment of this legislation.

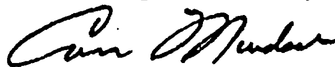
This special early effective date gives an entirely unwarranted advantage to those practitioners who in one way or another were aware of the imminence of this legislation. Such a short lead time effective date provision puts practitioners who were not privy to that information at a serious disadvantage.

I recommend that all effective dates under the new law be stated in terms of transactions occurring after the enactment of the statute except those in which regulations are to fix the law. In case of the latter, the effective date should be with respect to transactions occurring after the proposed regulations become final.

Conclusion

I believe that the now-proposed legislation is a substantial improvement over the earlier legislation about the same subjects. However, I believe that the legislation requires considerable reworking. I stand ready to assist the Subcommittee and its staff in working on the numerous technical problems facing the draftsmen of this complex legislation.

Respectfully submitted,



Converse Murdoch, Esquire
Wilmington, Delaware

EXHIBIT A

DEPUTY COMMISSIONER OF INTERNAL REVENUE
Washington, DC 20224

JUL 0 3 1980

Chester J. Salkind
Executive Director
American Society of Pension Actuaries
1700 K Street, N.W. Suite 404
Washington, D.C. 20006

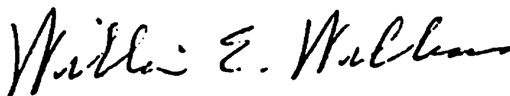
Dear Mr. Salkind:

This is in response to your letter of May 22, 1980, in which you requested under the Freedom of Information Act (FOIA) a copy of a Work Plan developed in connection with a proposed Treasury Regulation. The proposed regulation pertains to the coordination of vesting and discrimination requirements for qualified pension plans.

We are granting your request for the Work Plan. Although we are entitled to withhold portions of the Work Plan under the (b)(5) exemption of the FOIA, we are waiving that exemption in this case because we believe it is in the public interest to do so. As you have agreed, we are excluding from the scope of your request the signature line from the bottom of the first page of the Work Plan. Accordingly, that line has been removed from the copy being provided to you.

You also requested any General Counsel Memorandum that may have been prepared in connection with the proposed regulation. We have no record of any such memorandum having been prepared.

Very truly yours,



Date: JAN 2 9 1979

MEMORANDUM FOR: SECRETARY BLUMENTHAL

From: Commissioner of Internal Revenue

Subject: Regulation Work Plan for regulations under section 411 (d) (1) of the Internal Revenue Code of 1954 relating to coordination of vesting and nondiscrimination requirements for qualified plans. EE-164-78.

The Employee Plans and Exempt Organizations Division of the Office of Chief Counsel, Internal Revenue Service, has opened a regulation project, EE-164-78, on the above subject. Your approval of this regulation work plan is requested.

Regulation Work Plan

1. Description of the regulation project.

This regulation project will provide new regulations concerning the coordination of the vesting and nondiscrimination requirements for qualified plans. As a part of providing these new regulations, no existing regulation sections are expected to be revised, deleted, or struck.

2. Justification for the regulation.

This regulation project is necessary to provide regulations under section 411 (d) (1) of the Code, as added by section 1012 (a) of the Employee Retirement Income Security Act of 1974 (P.L. 93-406) ("ERISA"), relating to vesting standards.

If adopted, this regulation will provide guidance to--

a. Internal Revenue Service personnel who administer sections 401 (a) (4) and 411 of the Code, and

b. The members of the public who are subject to and must comply with these sections of the Code.

3. Statutory authority.

This regulation is authorized by section 7805 of the Code (68A Stat. 917, 26 U.S.C. 7805).

4. Knowledgeable officials.

Initiating attorney: Kirk F. Maldonado 566-3903
Reviewing attorney: Richard J. Wickersham 566-3250

5. Regulatory analysis.

This regulation project will not require a regulatory analysis because the regulations will not have major consequences for the general economy, for individual industries, geographical regions, levels of government, or specific elements of the population.

6. Policy issues.

It is believed that this regulation project will present the following policy issue:

What degree of vesting will satisfy the nondiscrimination requirements where no pattern of abuse is present.

7. Alternative approaches.

It is believed that the following alternatives should be considered for resolution of the policy issue described in item 6:

1. One approach is an objective standard, i.e., a specified degree of vesting that is a safe haven. The so-called "4-40 rule" described in the conference report on ERISA and currently followed by the Service would fit within this approach.

2. Another approach is to require whatever vesting is required by the facts and circumstances, a so-called "subjective standard." This is believed to be a preferable approach from a policy standpoint as it is more favorable to employees, though it may be the subject of criticism from plan sponsors. Also, from a strictly legal standpoint, it is arguable that the conference report does not represent a contemporaneous construction of section 411 (d) (1), which was passed by the House several months earlier without the gloss contained in the conference report.

3. Some combination of the above.

It is contemplated that the proposed regulation will reflect either alternative 2 or alternative 3.

8. Public participation.

Upon publication of a notice of proposed rulemaking in the Federal Register, the public, Congress, other Federal agencies, and the State and local governments will be given 60 days in which to submit written comments and to request a public hearing. If requested, a public hearing will be held, and any person who gives appropriate advance notice may testify at the hearing.

9. Target dates.

The following tentative schedule for completion of this regulation project takes into account the anticipated complexity, controversiality, and priority importance of the regulation.

a. Completion of initial preliminary draft of notice of proposed rulemaking for review outside Employee Plans and Exempt Organizations Division. October, 1979

b. Completion of final draft of notice of proposed rulemaking, review within Treasury, and publication in the Federal Register. 5 months after date

c. Expiration of period for written comments and completion of hearing, if any. 7 months after date

d. Completion of initial preliminary draft of Treasury decision (final rulemaking) for review outside Employee Plans and Exempt Organizations Division. 9 months after date

e. Completion of final draft of Treasury decision, review within Treasury, and publication in the Federal Register. 15 months after date

10. Significance.

This regulation is considered to be a significant regulation within the meaning of paragraph 8 of Treasury Directive that appears in the Federal Register for Wednesday, November 8, 1978 (43 F.R. 52120).

11. Recommendation.

The Internal Revenue Service recommends approval of this work plan.

Approved ______________ By direction of the Secretary

Disapproved ______________

Senator BYRD. Thank you, Mr. Murdoch.
The next witness.

STATEMENT OF GERALD W. PADWE, TOUCHE ROSS & CO.

Mr. PADWE. Mr. Chairman, my name is Gerald W. Padwe. I am associate national tax director for the public accounting firm of Touche Ross & Co.

We support strongly the installment sale bill that your committee is considering. However, I would like to concentrate my time in one particular area that has gotten very little publicity, and that we believe should be in the bill that is reported by the Finance Committee to the Senate.

There is an inequity in the present law on installment sales, and it is applicable to retailers—the technical word in the statute is "dealers," but let me use retailers here for ease of understanding—who are using the accrual method of accounting for their sales, and who wish to switch to the installment method as is permitted by statute.

If those retailers have in the past under the accrual method been permitting customers to pay using installments, the switch to the installment method, absent some statutory relief, would require the payment of a double tax on the installments that are received after that switch for sales that were made before the switch.

Senator BYRD. If you would permit me to interrupt you. The staff informs me that the Treasury has agreed to this change.

Mr. PADWE. I am delighted. The change is an excellent one, Senator. What we are trying to do is remedy an inequity that does exist that we believe is spelled out in our written statement, which I will not go into here.

The intention of the 1954 code at the time it was enacted was to give relief. Statutory draftsmanship, unfortunately, was such at that time that imperfect relief only was given. So that there still is potential for a substantial double tax.

Senator BYRD. I will ask the staff to follow up on that and see that the change is made in this legislation.

Mr. PADWE. Thank you, sir.

[Statement of Gerald W. Padwe follows:]

Touche Ross & Co.

UNITED STATES SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
HEARINGS ON INSTALLMENT SALES REVISION ACT OF 1980

STATEMENT BY GERALD W. PADWE
ASSOCIATE NATIONAL DIRECTOR - TAX SERVICES
TOUCHE ROSS & CO.
SEPTEMBER 10, 1980

Mr. Chairman, and members of this distinguished committee:

My name is Gerald W. Padwe, and I am Associate National Director - Tax Services for the international public accounting firm of Touche Ross & Co. I appreciate the opportunity to appear before you and submit the thoughts of my firm with respect to H.R. 6883, the Installment Sales Revision Act of 1980. We support strongly the provisions of that bill as passed by the House of Representatives and urge its adoption by this committee and the Senate. It is a good bill and will accomplish much in simplifying the tax rules in what is admittedly a most complex area.

We would, however, urge the inclusion of one additional change in the installment sale rules - specifically, those applicable to dealers - as the subcommittee considers these proposals. Our suggested change goes most strongly to the issue of simplification of installment reporting, and would

remove what is today either a trap for the unwary or a requirement for rather sophisticated and costly avoidance of a difficult problem.

We have reference to dealers in personal property changing from the accrual to the installment method for reporting installment payments received, an issue presently addressed by Internal Revenue Code section 453(c). Under general rules of taxation, an accrual method taxpayer receiving payments in installments will report the full amount of such payments at the time a sale is made; i.e., at the proper time for accruing the revenue. Should such a taxpayer subsequently change its method of accounting to the installment method, the installment sale rules require generally that tax be paid on all installments received following adoption of the method.

Consider a calendar year retailer qualifying for installment method treatment but presently using the accrual basis of accounting. Assume a $350 sale in December, with $100 to be paid in December and $250 to be paid in January. Under the accrual method, the seller will report the $350 sale on its tax return for the year of sale. If it changes to the installment method in the next year, it would (absent statutory relief) again have to report $250 of revenue in that next year, as an installment payment received during the year.

Prior to the 1954 Code, there was no relief possible under statute for this double taxation. Recognizing the problem, however, Congress adopted section 453(c) in 1954 to allow relief for taxpayers making such a change. In fact, the Senate Finance

Committee report on the 1954 Code spelled out the problem and its intended solution rather explicitly (83d Congress, 2d Session, Senate Report No. 1622 (1954), pg. 64):

> "Under present law a taxpayer who changes his accounting method from the accrual basis to the installment basis pays a double tax on certain income. Under the accrual method the entire profit from the sale is taken into account in the year of sale, regardless of when the collection is made. Under the installment method, the profit from a sale is recognized piecemeal as the cash is collected. In the early years following a change from the accrual to the installment method, present law taxes portions of the profit realized from all installment collections including profits and collections on sales made before the change which previously had been reported as taxable income under the accrual method.
>
> "The House and your committee's bill provide that a taxpayer shifting from the accrual to the installment method of accounting is <u>not to be taxed twice on the same income</u>. The <u>tax attributable to an amount included</u> in income for the second time is eliminated or is at least decreased to the extent of the tax attributable to its inclusion under the earlier method of accounting." (emphasis added)

Unfortunately, the statutory language drafted in section 453(c) does not accomplish the result of avoiding the double tax; under almost any circumstances, some double tax is required to be paid. Based upon the Senate Finance Committee language above, we believe the lack of complete relief is due to legislative drafting, and is actually contrary to Congressional intent.

In effect, section 453(c), and the regulations thereunder, provides that the relief granted by the subsection is the <u>lesser</u> of the tax attributable to gross profit on the installments

for the year reported under the accrual method or for the year reported a second time under the installment method. The tax for either year is computed by multiplying total tax for the year by a fraction whose numerator is the gross profit and whose denominator is gross income for that year. Unfortunately, using gross income as a measuring device does not permit the effect of deductions to be included in the computation, with a resulting distortion and, generally, incomplete relief.

Assume, for illustration, an accrual basis taxpayer has been selling on installments, and changes to the installment method for 1980.

	1979	1980
Sales	$ 500	$ 500
Cost of goods sold	(300)	(300)
Gross profit on 1979 installment sales, collected in 1980	--	50
Gross income	$ 200	$ 250
Other deductions	150	150
Taxable income	$ 50	$ 100
Tax at 46% rate	$ 23	$ 46

Under present section 453(c), the double tax relief is computed to be the lesser of:

a) 50/200 x 23 = $5.75, or

b) 50/250 x 46 = $9.20

The 1980 tax relief is limited, therefore, to $5.75, whereas the actual double tax is $23.00.

We would urge the inclusion, in H.R. 6883, of complete

relief from double taxation when changing from the accrual to the installment method. First, enacting such relief would be a matter of equity and fairness. Second, it would be an important simplification of present rules and regulations involving the installment method of accounting. Third, as discussed below, it would permit by statute what is today already available to taxpayers, but only those who have sophisticated advisers and who are willing to incur the financial costs associated with avoiding the section 453(c) partial relief rules.

To avoid the double tax requirements of section 453(c), taxpayers wishing to change from accrual to installment accounting for their installment sales have had to undertake a complete sale (usually to a financial institution) of all their installment accounts receivable at the end of a taxable year, followed by an installment election under section 453 in the next year. By actually selling the receivables at the end of the last year of accrual reporting, taxpayer reports only the accrual sales, as would have been the case in any event. However, in the next year, when the installment method is elected, the receivables which would have given rise to double taxation are no longer the property of the taxpayer: they belong to a bank or other financial institution, and the taxpayer is collecting funds as agent for the bank. Thus, those collections do not enter taxpayer's income a second time, are not subject to double tax, and only sales made in the subsequent years will be subject to the installment method election.

Because a financial institution is almost invariably the

purchaser of the installment receivables, the Internal Revenue Service looks at the sale transaction most carefully, to ascertain that a bona fide sale has occurred and not just a disguised financing transaction (in which case the taxpayer would still be the owner of the receivables and subject to the double tax). Accordingly, as part of the plan, it becomes necessary to obtain a ruling from IRS that the Service will recognize the transfer of the receivables to the bank as a genuine sale for tax purposes. Since IRS can (and has) changed its ground rules, from time to time, as to what the agreement between taxpayer and bank may or may not provide, there has not been complete uniformity among taxpayers entering into such transactions in the 25 years this technique has been available. This, we believe, is another strong argument for permitting the change to be made as a matter of statutory right, so as to avoid the necessity for the sale of receivables.

Even where the ruling is granted by IRS (and it will be where IRS terms are agreed to), the overall transaction is unnecessarily complex. It requires over a year from start to finish; inasmuch as it is necessary to plan the transaction, negotiate an agreement with a bank, request a ruling from IRS and wait the requisite time for favorable action. Then, following the sale of receivables, it is necessary to have a monthly accounting to the bank in the first year or so after such sale, in order to remit the bank's share of collections from taxpayers' customers which taxpayer has received as agent for the bank. If taxpayer is selling on revolving credit

accounts, a minimum monthly payment received from a customer must be properly allocated between this year's purchases (which belong to taxpayer) and last year's purchases (which belong to the bank). And, some physical segregation or notation must be made on customer accounts sold to a bank but physically retained by taxpayer to collect as the bank's agent.

We submit that the sale of receivables followed by subsequent election of the installment method is a highly artificial, complex, and costly method for accomplishing what we believe Congress intended to have done in 1954. Particularly since H.R. 6883 is aimed at simplifying the installment sale tax rules, it would be most appropriate to amend the language of section 453(c) in order to permit complete rather than partial relief from double taxation for those wishing to change from the accrual to the installment method.

The simplest approach to such amendment would be elimination of the word "not" in section 453(c)(1)(A), as well as the adjustment provisions of section 453(c)(1)(B) and 453(c)(2) and (3). As a result, installment payments received in the year of change and subsequent years, on account of sales previously included in income under the accrual method, would be excluded from income under the installment method. Another approach to such complete relief would be a recomputation of the tax for each of the two years excluding the gross profit subject to double taxation, and a comparison for each year of the recomputed tax with the original tax. This would give a more accurate determination of the tax for each year on that gross profit, and the lower of the two years' reductions could apply. The method would, however, be substantially more complex than the first approach. Either, though, would be preferable to the present rule.

We appreciate the opportunity to present these comments to you, and hope they will receive your favorable consideration.

STATEMENT OF JOHN P. HOLMAN, ESQ.

Mr. HOLMAN. Thank you, Mr. Chairman.

My name is John P. Holman. I would like to say, for the record that I am a practicing attorney in Washington, D.C., and that I am appearing today on behalf of Lakeside North Apartment Partnership in Atlanta, Ga.

Generally, we support the provisions of H.R. 6883. I would like to direct my remarks today specifically to certain of the effective date provisions of this bill.

As currently drafted, the provisions of the bill are effective, in general, for sales occurring after the date of enactment. Special effective date provisions in the bill, however, relate to the distribution of installment obligations in connection with a 12-month liquidation.

Senator BYRD. I did not understand what you said there.

Mr. HOLMAN. There are certain effective date provisions in the bill dealing with the distribution of installment obligations in connection with the 1-year, or 12-month, liquidation. There are also special effective date provisions with respect to related party or family sales which you have heard about earlier today.

I would like to focus your attention this morning on the effective date provisions relating to the elimination of the 30-percent rule, and the two-payment rule in the bill. We feel that, as currently drafted, the effective date provisions introduce a needless complication into the tax code.

Under the provisions of the bill as currently drafted, the following situations could occur.

First, one set of rules regarding the application of the 30-percent rule, and the two-payment rule for installment sales would apply to transactions occurring prior to the date of enactment and another set of rules would apply to transactions occurring after the date of enactment. Therefore, unless the bill happens to be enacted on the last day of a taxpayer's taxable year, two sets of installment sales rules would be applied to 1 taxable year.

Second, taxpayers who sell property in deferred payment sales during the same taxable year would be afforded different treatment under the tax code depending on whether they sell before or after the date the bill is enacted.

Third, taxpayers who have already contracted to sell property would have to gamble that the bill would be enacted prior to the settlement dates of their sales. Those who are successful in postponing their settlement dates would have the new rules apply, whereas those who cannot postpone the settlement dates of their sales would have to work under the current, and more restrictive, rules.

Senator BYRD. What effective date do you recommend?

Mr. HOLMAN. We are recommending that the effective date for the elimination of the two-payment and 30-percent rule should apply to dispositions made during any taxable year ending after the date this bill is enacted.

Senator BYRD. Any taxable year ending after the enactment of the bill?

Mr. HOLMAN. Yes. Perhaps an example would clarify this.

For a calendar year taxpayer, that is a taxpayer having a taxable year ending December 31, if the bill is enacted, let us say, October 1, any sale that he closes during his tax year ending December 31, 1980, would be subject to the new provisions, and the 30-percent rule and the two-payment rule would not be applicable.

Senator BYRD. How does the bill as it now stands——

Mr. HOLMAN. The bill as it now stands requires the 30-percent and the two-payment rule to be applied to all sales that took place prior to the date of enactment.

Senator BYRD. All sales prior to the date of enactment?

Mr. HOLMAN. Yes.

Our suggestion is simply that section 453(b)(1) of the code, which relates to the elimination of the 30-percent rule and the two-payment rule, should apply to dispositions made during any taxable year ending after the date of enactment of this bill.

We feel that the adoption of this change would have the following beneficial effects:

First, only one set of installment sales rules regarding the elimination of the 30-percent and the two-payment rules would apply to a taxpayer's entire taxable year.

Second, the 30-percent and the two-payment rules would be eliminated at an earlier date. This would have the effect of eliminating these traps for the unwary and simplifying the tax code at a somewhat earlier date.

Third, taxpayers would not, however, be permitted to file amended returns to have the provisions of this bill apply to taxable years ending prior to the date of enactment.

Fourth, all taxpayers having the same taxable year would receive equal treatment with respect to deferred payment sales occurring at any time during the year in which the bill is enacted.

Finally, taxpayers who are selling property during the current year, but who desire to have the provisions of the bill apply to their sales, would not have to defer the settlement dates of their sales until after the date of enactment.

I submit that merely amending the effective date provisions with regard to the elimination of the 30-percent rule and the two-payment rule would accomplish these objectives, and would have a further simplifying effect on this section of the tax code.

Mr. Chairman, this concludes my remarks on H.R. 6883. I appreciate the opportunity to appear here today, and ask that our written statement be made a part of the record.

[Statement of John P. Holman follows:]

SUMMARY OF COMMENTS

OF

JOHN P. HOLMAN, ESQUIRE

There is a general consensus that both the "30-percent rule" and the "two-payment rule" should be eliminated as requirements for reporting gain from the sale of property on the installment method. We suggest that the portions of the Bill that relate to the elimination of these requirements should be effective for all sales occurring during any taxable year ending after the date the Bill is enacted. We would expect this change to have the following beneficial effects:

(1) One set of rules would be applied to a taxpayer's entire taxable year (rather than one set of rules for sales completed prior to the date of enactment and a different set of rules for sales completed after the date of enactment).

(2) Taxpayers would not be permitted to file amended returns to claim the benefit of installment reporting for taxable years ending prior the date of enactment.

(3) According to the Treasury, the Bill as currently drafted is not expected to have any significant revenue effect on budget receipts. We submit that changing the effective date provisions should likewise not have a significant effect on budget receipts.

(4) The "30-percent rule" and the "two-payment rule" would be eliminated at an earlier date. This would have the effect of eliminating traps for the unwary and simplifying the tax Code for a taxpayer's entire taxable year.

(5) All taxpayers who sell property in a deferred payment sale during their taxable year which includes the date of enactment would be treated alike. Both those taxpayers who close their sales after the date of enactment and those taxpayers who are not able to defer the settlement dates of their sales until the Bill is enacted would be able to report their gain on their sales on the installment method if they choose.

MEMORANDUM

to the

Senate Subcommittee

on Taxation and Debt Management

on

H. R. 6883 and S. 2451

INSTALLMENT SALES REVISION ACT OF 1980

from

Danzansky, Dickey, Tydings, Quint & Gordon

Washington, D.C.

September 2, 1980

Our firm represents a number of clients who will be affected by S. 2451, the Installment Sales Revision Act of 1980. Some of these clients will sell parcels of real estate during 1980 and will be eligible to report the gain from these sales under the installment method of reporting even though they will receive more than 30 percent of the selling price in the year of the sale. Other clients will not be able to report the gain from their sales under the installment method simply because they were not able to defer the closing dates of their sales until after this Bill is enacted. This discrepancy in the treatment afforded taxpayers engaging in similar transactions within the same year will be caused by the effective date provisions contained in H. R. 6883 and S. 2451. As currently drafted, these provisions provide that amendments relating to the "30 percent rule" shall apply only to dispositions made after the enactment of the Act in taxable years ending after such date.

Rationale for Installment Reporting

Section 453 of the Internal Revenue Code provides a method whereby a taxpayer may elect to report the profit generated by a sale of property in those years in which the installment payments are actually received. If the installment method of reporting is elected, a proportionate amount of the gain is reportable in any tax year in which an installment payment is

received. This ratable inclusion method is logical in that it causes the seller to report the income for tax purposes as he obtains the funds to pay the tax liability so generated.

Current Restrictions on Installment Reporting

Section 453 of the Code currently requires that certain conditions be met in order to qualify for installment reporting. The requirement that the seller receive no more than 30 percent of the selling price in the year of the sale is at once probably the most commonly known and the most frequently litigated condition imposed by Section 453.

Problems have arisen, for example, where purchasers have prepaid portions of the deferred payment obligations in the year of sale, where the purchaser's note was determined to be payable on demand or tradable on an established securities market and where the seller's mortgage exceeded his basis for the property conveyed. In each of these situations it has been determined, frequently to the total surprise of the sellers, that additional income had to be treated as "received" in the year of sale and, as a result of the "30 percent rule," that the sale did not qualify for installment reporting. Somewhat similarly, problems have arisen with the "two-payment rule" where taxpayers had entered into sales where the entire purchase price was payable

in a lump sum in a taxable year subsequent to the year of sale and found that they were unable to defer their gain until the year in which they receive the sales proceeds. In short, taxpayers who have not secured competent advice and who inadvertently either exceeded the 30 percent limitation or violated the "two-payment rule" have had to recognize and pay tax on the entire gain in the year of sale even though they did not receive the entire sales proceeds in that year.

The "30 percent rule" in particular has interefered with normal business transactions and forced taxpayers into ingenious arrangements in an attempt to qualify for installment reporting. Knowledgeable sellers in certain states, for example, have succeeded in structuring "wraparound" mortgages to avoid having "year of sale payments" as a result of mortgages which exceed the bases of their properties. Less astute taxpayers, or those simply selling properties in states not permitting "wraparound" mortgages, however, have not been able to avoid this restriction.

Impetus for Change

In order to simplify the rules for installment reporting, to put taxpayers engaging in similar transactions on par with one another, and to eliminate many of the traps for the unwary, H. R. 6883 and S. 2451 would eliminate both the "30-percent rule"

and the "two-payment rule." Under H. R. 6883 and under S. 2451 as currently drafted, the income from the sale would be reportable ratably as payments are received from the purchaser, regardless of the amount of the payments received in the year of the sale. Both the American Institute of Certified Public Accountants and the American Bar Association have indicated their support for this change. We also believe that this change would strike a blow for practical, real-life tax simplification.

Equity and Simplicity and the Effective Date Provisions

Inasmuch as there is general agreement that both the "30-percent rule" and the "two-payment rule" should be eliminated, we suggest that this change should be made effective for all sales occurring during any taxable year ending after the date the Bill is adopted. By expressly providing that these rules are inapplicable to sales occurring at any time within the year, all taxpayers who sell property in deferred payment sales within the same taxable year would be on an even footing. Moreover, taxpayers who have not yet closed their sales would be able to plan their transactions without having to gamble on the precise date that the Bill will be enacted. This would cause one set of rules regarding installment sales to be applied to a taxpayer's entire taxable year rather than two sets of rules, as would be

applied as the Bill is currently drafted.

We submit that adoption of this change would have a simplifying effect on the administration of this provision of the Code. Calendar year taxpayers would all be subject to the same rules rather than one set of rules for sales occurring during 1980 but prior to the date of enactment and another set of rules for sales occurring during 1980 but after the date of enactment. This would cause the new rules, which the House of Representatives has already sanctioned, to be effective in most cases for any sale that occurs within a taxpayer's entire taxable year. Quite simply, if elimination of the "30 percent rule" and the "two-payment rule" is desirable for the sake of simplicity and to remove confusion and a trap for the unwary, it is logical that this should be done for all sales during any taxable year ending after the date the Bill is adopted. For calendar year taxpayers, this means that these rules should be eliminated for all sales occurring during 1980, regardless of whether the closing dates of the sales are before or after the date the Bill is enacted. It would not, however, permit taxpayers to file amended returns to have the rules of the Bill applied to sales that occurred during years prior to the date the Bill is adopted.

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The House Ways and Means Committee Report (96-1042) on H. R. 6883 has indicated that, on balance, the provisions of the Bill (except related party sales) should not have a significant revenue effect on budget receipts. Therefore, we submit that moving the effective date of the Bill forward should similarly not have any significant revenue effect on budget receipts. Further, this change should not prejudice any taxpayers because, under other provisions of the Bill, taxpayers may elect to have the provisions not apply to a deferred payment sale if they desire.

Recommendation

We submit that the purposes of H. R. 6883 and S. 2451 would best be served if the effective date provisions relating to the "30 percent rule" and the "two-payment rule" were amended to provide for the application of the Bill's provisions to all sales occurring during any taxable year ending after the date the Bill is adopted. This could be accomplished by renumbering subsections (2), (3), (4) and (5) of Section 5(a) of the Bill as subsections (3), (4), (5) and (6), respectively, and by inserting the following as a new subsection (2) of Section 5(a):

"(2) FOR SECTION 453(b)(1) - Section 453(b)(1)

of the Internal Revenue Code of 1954 (as amended by section 2) shall apply to dispositions made during any taxable year ending after the date of this Act."

We ask that our comments regarding the Bill be considered by the Committee and made part of the record.

We will be happy to answer any questions that members of the Committee may have.

Respectfully submitted,

LOUIS H. DIAMOND

JOHN P. HOLMAN
For the Firm

Senator BYRD. Basically what you want, if I understand it correctly, is to make the bill, in effect, retroactive for the entire year of 1980; is that it?

Mr. HOLMAN. That would be true for a calendar year taxpayer having a tax year ending December 31. For a taxpayer having fiscal year, for example, a taxpayer who has a year ending on November 30, if the bill is enacted prior to November 30 then any sale which occurs after December 1, 1979, would be included under the new rules.

Senator BYRD. Under the bill as it now stands, any transactions prior to May 14, or March 31——

Mr. HOLMAN. The two-payment rule change, Mr. Chairman, is effective only with respect to transactions closed after the date of enactment. The May 14 date that you are talking about I believe relates solely to the provisions regarding intrafamily or related party sales.

Senator BYRD. What does that mean? Does it mean that this bill does not apply to any transactions prior to May 14 insofar as intrarelated parties are concerned?

Mr. HOLMAN. That is correct. However, with regard to the general provisions of the bill, the bill would not be applied to sales occurring prior to the date of enactment, even though the sales occur during the taxpayer's taxable year which includes the date of enactment.

Senator BYRD. Thank you, gentlemen.

Next panel, Mr. Erik J. Stapper of New York, representing Galvin Associates; and Mr. Michael Layman of Harrisonburg, Va., representing Houff Davis Farm, Inc.

STATEMENT OF ERIK J. STAPPER, ESQ., REPRESENTING GALVIN ASSOCIATES

Mr. STAPPER. My name is Erik Stapper. I am a member of the law firm of Stapper & Van Doren in New York City. I represent Galvin Associates of Long Island City, N.Y.

My testimony relates solely to a proposal to amend the effective date provision of the Installment Sale Revision Act of 1980 for a new subsection (g) of section 1038 of the Internal Revenue Code.

Section 4 of the House bill H.R. 6883 proposes to amend section 1038 of the Code by adding a new subsection (g). The House Ways and Means Committee report makes it clear that this new subsection is being added to section 1038 of the Code to overcome an unfavorable interpretation by the Internal Revenue Service in Revenue Ruling 69-83.

The specific purpose of the new subsection is to entitle a decedent's estate, or other person holding a decedent's installment obligation, to the limitation on the gain to be realized by a seller following a repossession of real estate after a default by the purchaser on his installment obligations.

The addition of new subsection (g) to section 1030 is a very desirable one. The House report adequately covers the reasons for making the change. The purpose of my appearance here is to focus attention on the effective date of section 4 of the bill.

Section 5(c) of the proposed act provides the following effective date:

"The amendment made by section 4 shall apply to acquisitions of real property by the taxpayer after the date of the enactment of this act."

I believe this provision is ambiguous by referring to acquisitions instead of reacquisitions. Moreover, I respectfully submit it would be appropriate for the Senate Committee on Finance to amend this provision to read as follows:

> The amendment made by Section 4 shall apply generally to reacquisition of real property by the taxpayer after the date of enactment of this Act. Taxpayers may elect, however, to have Section 1038(g) apply to taxable years beginning in 1969, except for reacquisitions of real property in taxable years closed on the effective date of this Act by operation of any law or rule of law. The election must be made within one year after the effective date of this Act.

Senator BYRD. I must say that I am a little bit lost on this. Why do you get back to 1969? What does this have to do with 1969?

Mr. STAPPER. The significance of 1969, that is when the Treasury issued the Revenue ruling which denies to an estate or any person standing holding an installment obligation of a decedent, it denies that person, the holder of the note, the benefit of section 1038.

Senator BYRD. I am sorry, I should not have interrupted you. Go ahead.

Mr. STAPPER. This is explained in the next few words of my testimony.

At first instance a proposal to provide for an elective, retroactive effective date may appear novel and undesirable. This is not so. Congress enacted section 1038 of the Code with the very same kind of elective retroactive effective date.

Section 1038 was added to the code as a relief provision by section 2(c) of Public Law 88-570. The relief being provided for was to overcome the harsh results from the Code's installment obliga-

tions repossession provisions. Senate Report 1361 states in effect that this committee—Senator Byrd having written the report—that this committee has concluded that instead of the repossession of the real property being treated as a second sale of the property back to its original holder, it is desirable to consider instead that the first sale has been nullified.

With regard to the effective date this committee's report stated:

> The provision outlined above is to apply in the case of all repossessions of real property in the taxable years beginning after the date of enactment of this bill. However, at the election of the taxpayer, this treatmont also is to apply with respect to repossession of real property in taxable years beginning after December 31, 1957, except for those years closed by the statute of limitations on the date of enactment of this bill. An election to have this provision apply with respect to any of these past years can be made within one year after the date of enactment of this bill.

Section 1038 was added to the Code as a relief provision for certain statutory rules. The bill under consideration adds subsection (g) to section 1038 as a relief provision from an adverse Internal Revenue Service interpretation.

If it was appropriate to provide an elective retroactive effective date to overcome the harsh results of a code provision, I submit it is even more appropriate to provide similar for new subsection (g) of section 1038 since it will provide relief not from a statutory provision but from an administrative interpretation.

[Statement of Erik J. Stapper follows:]

PREPARED STATEMENT OF ERIK J. STAPPER

My name is Erik J. Stapper. I am a member of the law firm of Stapper & Van Doren in New York City. I represent Galvin Associates of Long Island City, New York. My testimony relates solely to a proposal to amend the effective date provision in the Installment Sales Revision Act of 1980 for new subsection (g) of Section 1038 of the Internal Revenue Code.

Section 4 of House bill H.R. 6883 proposes to amend Section 1038 of the Code by adding a new subsection (g). The House Ways and Means Committee Report makes it clear that this new subsection is being added to Section 1038 of the Code to overcome an unfavorable interpretation by the Internal Revenue Service in Revenue Ruling 69-83, 1969-1 Cum. Bull. 202. The specific purpose of the new subsection is to entitle a decedent's estate (or other person holding a decedent's installment obligation) to the limitation on the gain to be realized by a seller following a repossession of real estate after a default by the purchaser on his installment obligations.

The addition of new subsection (g) to Section 1038 is a very desirable amendment. The House Report adequately covers the reasons for making the change. The purpose of my appearance here is to focus attention on the effective date of Section 4 of the Bill. Section 5(c) of the proposed Act provides the following effective date:

"The amendment made by section 4 shall apply to acquisitions of real property by the taxpayer after the date of the enactment of this Act."

I believe this provision is ambiguous by referring to acquisitions instead of reacquisitions. Moreover, I respectfully submit it would be appropriate for the Senate Committee on Finance to amend this provision to read as follows:

"The amendment made by section 4 shall apply generally to reacquisitions of real property by the taxpayer after the date of enactment of this Act. Taxpayers may elect, however, to have Sec. 1038(g) apply to taxable years beginning after 1969, except for reacquisitions of real property in taxable years closed on the effective date of this Act by operation of any law or rule of law. The election must be made within one year after the effective date of this Act."

At first instance a proposal to provide for an elective, retroactive effective date may appear novel and undesirable. This is not so. Congress enacted Section 1038 of the Code with the very same kind of elective, retroactive effective date.

Section 1038 was added to the Code as a relief provision by § 2(c) of Public Law 88-570. The relief being provided for was to overcome the harsh results from the

Code's installment obligations repossession provisions. Senate Report No. 1361, states in effect that this Committee:

"* * * has concluded that instead of the repossession of the [real] property being treated as a second sale of the property back to its original holder, it is desirable to consider instead that the first sale has been nullified."

With regard to the effective date this Committee's report stated:

"The provision outlined above is to apply in the case of all repossessions of real property in the taxable years beginning after the date of enactment of this bill. However, at the election of the taxpayer, this treatment also is to apply with respect to repossession of real property in taxable years beginning after December 31, 1957, except for those years closed by the statute of limitations on the date of enactment of the bill. An election to have this provision apply with respect to any of these past years can be made within 1 year after the date of enactment of this bill." (1964-2 Cum. Bull. at 832).

Section 1038 was added to the Code as a relief provision from certain statutory rules. The bill under consideration adds subsection (g) to Section 1038 as a relief provision from an adverse Internal Revenue Service interpretation. If it was appropriate to provide an elective retroactive effective date to overcome the harsh results of a Code provision, I submit it is even more appropriate to provide similarly for new subsection (g) of Section 1038 since it will provide relief not from a statutory provision but from an administrative interpretation.

Senator BYRD. You are talking about 1969 and 1956, then the taxpayer could elect whether he wanted to make it retroactive to such dates as that?

Mr. STAPPER. When section 1038 was added to the Code, this committee, which added that section to the Code by addition to an existing bill from the House, provided for an identical type of a provision. It said: "This section of the code will be applicable to 1964. However, taxpayers may elect to apply that section to all years that are still open after 1957." That is in the law, and that I believe is the same kind of election provision that would be appropriate here.

Senator BYRD. Thank you, sir.

Mr. Layman, good morning, sir. Did you bring the Daily News Record with you?

Mr. LAYMAN. Not this morning. I left before it arrived at my front door, sir. [General laughter.]

STATEMENT OF MICHAEL LAYMAN, ESQ., REPRESENTING HOUFF DAIRY FARMS, INC.

Mr. LAYMAN. I am from Harrisonburg, Va. I am an attorney and I practice law there. I am here on behalf of Houff Dairy Farms, Inc. These are several elderly gentlemen who have retired from farming in the last couple of years, and their tax situation is, I am afraid, similar to what other farmers will face in our area, as well as other areas across the country in years to come.

Basically, I commend those who have written H.R. 6883 but I believe there is one small area that they did not focus on, and after talking with these gentlemen I believe that they don't disagree with the tax consequences that are proposed, but they don't want to change the bill at this point because it may affect its chance of passage. Over all, it is a good bill.

What I am referring to are subchapter S corporations. These are corporations, as you know, that are taxed at the shareholder level. Many small farms, and small businessmen use this election.

Let me give you an example whereby an incorporated farm family sells one tract of land in year No. 1 in order to raise capital that is needed because of unusually high interest rates and other

financial problems. Let's say weather caused them adverse financial problems and they need to come up with some cash over the next couple of years, so they sell one of their tracts of land on an installment sale basis.

As subchapter S shareholders they expect to be taxed at the shareholder level on this note as it is paid. Let's say that a couple of years go by, and because of age, because again of unusual financial problems, or because of disability, they are forced to go out of farming. They now need to sell their entire farm.

The proposed legislation will allow for the first time their sub S corporation to sell assets to a third party, receive an installment note, and this second installment note can be distributed down to the shareholders and it will be taxed as it is received over a period of years.

What about this first installment note, where again if they had remained a sub S corporation, it would have been taxed at the shareholder level. The law now provides that when that note is distributed down in complete liquidation, or distributed in any sense, it will cause immediate taxation. It will not be taxed as it is paid.

There are three basic principles, I believe, that have been involved in this part of H.R. 6883. One is that a person be taxed as they expect to be taxed. Another is taxation based on ability to pay. The third is that there be flexibility in one's ability to sell a corporation, that is, the tax result from the sale of corporate stock should be somewhat similar to the sale of corporate assets to the extent possible, and vice versa.

If they do not accept my proposition or request, then I think we will violate all three principles. In my case, the taxpayer will not be taxed as expected. This note will suddenly be taxed, and the taxpayer will not have the cash at that point to pay. This also then violates the principle of the ability to pay. Also, we will not be treating the sale of assets the same as the sale of stock because if they had been able to sell stock, then they could have included in the value of the second note the value of the first note that the buyers would then collect.

Why do I think that this is important? I do think, because of the uncertainties that we now find ourselves in in terms of inflation and high interest rates, unusual weather patterns, many of the small taxpayers in the sub S corporation status will be hurt harshly by not being able to distribute out these earlier notes.

The only objections I have heard from officials in Treasury, and others who have been involved, is that "H.R. 6883 is a good bill." "Let's not make changes because it will delay its passage," or "What about the 333 liquidation, or partial liquidations, why shouldn't we do it here?"

In those situations you would be changing the law in the sense that you would create tax consequences not provided before, but in what I propose our shareholders would all along have been taxed at the shareholder level, and on an as paid basis.

I don't feel there is any tax abuse that would be possible under my suggestion, especially if you limit it to installment obligations that arose while taxpayers were in fact sub S corporations.

I would like to submit my statement to be reproduced in the record, and I appreciate the opportunity to be heard, sir.

[Statement of Michael Layman follows:]

SENATE FINANCE SUBCOMMITTEE

Hearing on S 2451
Revision of Installment Sales Reporting
August 29, 1980
Statement of Michael L. Layman, Attorney/CPA
Clark, Bradshaw, Harrison & Layman, P.C.
92 North Liberty Street
Harrisonburg, Virginia 22801
1-703-433-2601

APPEARING ON BEHALF OF: Houff Dairy Farm, Inc.

The proposed legislation is generally very good, but it fails to address the particular problems of subchapter S corporations (corporations taxed at the shareholder level) which hold installment sale notes of prior years and are required to be liquidated (sold) due to the disability, retirement, or financial problems of its owner(s).

S 2451 as proposed will:

Allow any corporation, regular or subchapter S, to now sell its assets at the corporate level for an installment note and distribute the note in complete liquidation to its shareholder(s) whereby the shareholders will pay tax on any gain as they are paid.

S 2451 as proposed unfortunately will <u>not</u>:

Allow that same corporation to distribute an installment sales note created in any earlier year to its shareholder(s) in connection with the same liquidation without causing full taxation even though (i) the note is an installment note and (ii) the note would have been taxed at the shareholder level as paid absent the liquidation.

S 2451 as proposed should be amended:

To allow a subchapter S corporation to distribute all of its installment notes to its shareholder(s) in complete liquidation so that the gain, if any, is taxed as the notes are paid.

This legislative amendment to S 2451 that I propose promotes further simplification as well as a taxing concept based on the ability to pay, and will correct an existing tax rule that often causes very harsh and unexpected tax consequences to taxpayers operating small businesses. The following fact situation illustrates my point: A subchapter S corporation which operates a dairy farm decides to sell some of its less productive land in 1980 due to financial problems caused by high interest rates and dry weather conditions. The land is sold on an installment sales basis so that the five-year note ($50,000 gain) is taxed at the shareholder level as it is paid. In 1981, continued financial problems or bad health forces the farmer to retire and the entire farm is sold for a ten-year note. The gain on the second sale is two hundred thousand dollars ($200,000.00), representing many years of hard work and the effects of inflation on land values. The shareholders, as subchapter S shareholders, have always reported all corporate income at the shareholder level, and they assume that the gain from both installment notes payable to their corporation when distributed to them in liquidation of the corporation will be taxed to them individually as collected under the subchapter S rules and the installment sales rules. However, the taxpayers are advised by their tax counsel that (i) the first installment note with a fifty thousand dollar ($50,000.00) gain, payable to their corporation, cannot be distributed to them individually in liquidation of the business as they had expected without disastrous tax consequences, but that (ii) S 2451 if passed would allow the second note with a two hundred thousand dollar ($200,000.00) gain to be distributed so that it would be taxed as collected. It does not make sense to them why both notes should not be taxed as collected since the notes were to be

taxed at the shareholder level any way under the subchapter S rules if they were able to continue the farm operation. They ask their tax counsel if they can just continue their corporate subchapter S existence and report the gain as the notes are collected by the corporation, but they are told that their corporation will soon not qualify as a "subchapter S corporation" if it does not distribute the notes since it will not be operating an active trade or business, i.e. more than twenty percent (20%) of its gross receipts are from interest, which is prohibited by the subchapter S statutes. They are told that if they are not a subchapter S corporation, they will be a regular (or subchapter C) corporation and all of the income (both capital gain and interest) will be taxed at the corporate level. Any money distributed to them as individual shareholders will be treated as ordinary dividends and, therefore, the income will be taxed twice, once at the corporate level (since the corporation gets no tax deduction for dividends paid) and again at the shareholder level. They next ask whether they can leave the money in the corporation to avoid this double taxation, and they learn that this would be even worse because their corporation is now a personal holding company since sixty percent (60%) or more of its "adjusted ordinary gross income" is from interest, and if the interest received by their corporation is not distributed, the interest income will be hit with a seventy percent (70%) personal holding company tax under Section 541 in addition to the regular corporate income tax.

Our taxpayer is in a no win position and even the best tax advice will not allow the first note to be taxed as collected. Yet, there is no logical reason to allow one note to be taxed as collected and not the other.

My proposed solution would be a simple one and a help for the many taxpayers who are caught in this trap. My proposal would allow a subchapter S corporation which is in the process of complete liquidation to distribute installment sale notes to its shareholders and have the notes taxed as paid instead of when distributed.

As mentioned already, subsection (g) of S 2541 takes one step toward my proposal. S 2541 as proposed for the first time allows a corporation in a section 337 liquidation to distribute to its shareholders an installment sale note payable to it without requiring gain to be recognized by the shareholders until the note is actually paid. This would apply to both regular and subchapter S corporations. The basic tax consequences of a section 337 liquidation election is, therefore, to produce a tax at the shareholder level on an ability to pay basis and not at the corporate level when the note is distributed. Existing subchapter S law imposes taxation at the shareholder level in all situations except in a liquidation, i.e. existing law does not allow any corporation (regular or sub S) to distribute an installment note without immediate tax recognition. S 2541 would make it much easier for businesses to negotiate the sale of their assets in complete liquidation at the corporate level because a corporate liquidation 337 would avoid immediate taxation on installments notes distributed. My proposal would extend this right to subchapter S corporations with respect to all installment sale obligations. Since subchapter S corporation tax law is intended to create tax consequences at the shareholder level, I believe the regulations to Section 453 requiring a subchapter S corporation to recognize this gain immediately have created all along an unintended result. Should not a subchapter S corporation which liquidates farm A on an installment

sale basis in year 1, and farm B on an installment sale basis in year 2, be allowed to distribute both installment notes to its shareholders without immediate tax consequences? Why continue a concept that violates this fundamental principal of taxation? Those proposing HR 6883 and S 2451 to date have overlooked its specific application to subchapter S corporations and instead have written with only regular corporations in mind. In speaking with various representatives of the AICPA and the ABA, they have admitted such. I support S 2451 but let's take a few more minutes to perfect it. I'm from the Shenandoah Valley where we have hundreds of small farmers. There are many farmers who are operating as subchapter S corporations who may be forced to sell a portion of their farm with the hard times facing them today. They will probably sell on an installment sale basis. If they are then forced by high interest rates, crop failures, etc. to sell their remaining acreage at a later date, they will be in the same disastrous consequences that my example illustrates with no way out. My proposal does not open the door to tax abuse. Subchapter S corporations are limited to corporations with 15 or fewer shareholders. Subchapter S tax laws are in existence to cause taxation at the shareholder level. The installment sales rules should not change this result but should promote it. The installment sale note distributed from a subchapter S corporation should be taxed as paid at the shareholder level for four basic reasons:

(1) Taxing concepts should be tied to the ability to pay;

(2) Taxing concepts should promote consistency within the subchapter S rules, i.e. no surprises and especially no harsh surprises;

(3) Taxing concepts should promote tax simplification; and

(4) Taxing concepts should not create an opportunity for tax avoidance.

My proposal is consistent with all of the above.

The specific statutory construction I propose would read as follows:

"(h) USE OF INSTALLMENT METHOD BY SHAREHOLDERS OF ELECTING SMALL BUSINESS CORPORATION IN SECTION 337 LIQUIDATIONS.-

(1) RECEIPT OF OBLIGATIONS NOT TREATED AS RECEIPT OF PAYMENT.-

(A) IN GENERAL.-If, in connection with the complete liquidation of an electing small business corporation to which section 337 applies, the shareholder in a transaction to which section 331 applies receives (in exchange for the shareholder's stock) an installment obligation acquired with respect to a sale or exchange by the corporation which would be taxed at the shareholder level if electing small business corporation status had been maintained, then, for purposes of this section, the receipt of payments under such obligation (but not the receipt of such obligation) by the shareholder shall be treated as the receipt of payment for the stock.

(B) OBLIGATIONS ATTRIBUTABLE TO SALE OF INVENTORY MUST RESULT FROM BULK SALE.-Subparagraph (A) shall not apply to an installment obligation described in section 337(b)(1)(B) unless such obligation is also described in section 337(b)(2)(B)."

Thank you for the opportunity to appear today before you, and I welcome the opportunity to answer any questions you might have.

Respectfully submitted,

Michael L. Layman

Senator BYRD. Thank you, Mr. Layman.
As I understand, or did I understand you correctly that you feel that if changing this bill as recommended would delay its passage, you don't want it changed at this time.

Mr. LAYMAN. That is correct. But I don't see where our adding this one provision would bog it down so greatly. It does not affect revenue. There is no area of abuse that I see. It is totally in line with the thinking behind the other parts of the statute.

Senator BYRD. Thank you, gentlemen.

The next panel, Mr. James Powell, chairman, Tax Committee, National Cattlemen's Association; Mr. Herbert J. Lerner, Federal Tax Division, AICPA; and Mr. Martin D. Ginsburg, Tax Section, New York State Bar Association Committee on Taxation, New York City Bar Association, Committee on Simplification, Tax Section, American Bar Association.

Welcome, gentlemen.

STATEMENT OF JAMES POWELL, CHAIRMAN, TAX COMMITTEE, NATIONAL CATTLEMEN'S ASSOCIATION

Mr. POWELL. Senator Byrd, the National Cattlemen's Association supports H.R. 6883 and urges its early passage. It would provide needed simplification of existing tax law dealing with installment sales, and would aid in both compliance and administration of these laws.

We specifically endorse the provisions of H.R. 6883 which would eliminate the requirements under present law of not more than 30 percent of the selling price to be received in any taxable year of sale, and a deferred payment sale be for two or more payments, and that the selling price for casual sales of personal property must exceed $1,000 and that the installment method must be elected.

Additionally, the association supports the provision of the bill which states that the receipt of like-kind property, in connection with a disposition, will not be taken into account in determining gain recognized for installment sale reporting purposes.

The NCA also strongly favors the provisions that gain will not be recognized by a shareholder who receives installment obligations as a liquidating distribution from a corporation which liquidates within 12 months of adoption of a plan of complete liquidation.

Of great importance to farmers and ranchers using the cash method of accounting is the ability to use the installment method of reporting gains from the sale of livestock and crops. The report of the House Committee on Ways and Means accompanying H.R. 6883 contains the following statement:

> For purposes of the bill, it is intended that gain from the sale of property which is not required to be inventoried by a farmer under his method of accounting will be eligible for installment method reporting as gain from casual sale of personal property.

The Ways and Means Committee statement is a vital part of H.R. 6883, and the association urges that it be incorporated in the Senate report of the bill. Such legislative history will make clear the application of installment method to deferred sales of livestock and crops by cash method ranchers and farmers.

In general, NCA agrees with the statement of related party sales as provided in H.R. 6883. Specifically, the association endorses the provision that an involuntary conversion of property after a related party sale does not accelerate recognition of the installment gain to the initial seller. Also, NCA supports the exception with regard to disposition which occur after the death of the first seller or the death of the person acquiring the property in the first disposition, or where it is established to the satisfaction of the Internal Revenue Service that neither the initial sale nor the resale has, as one of its principal purposes, the avoidance of Federal income taxes.

In this regard, NCA agrees with the language contained in the report of the House Committee on Ways and Means accompanying H.R. 6883. The report states that regulations and rulings under the nontax avoidance exception will deal with certain tax-free transfers which normally would not be treated as a second disposition of the property, such as charitable transfers, gift transfers, and transfers to a controlled corporation or a partnership.

The Ways and Means Committee report also says it is intended that the second disposition will qualify under the nontax avoidance exception when it is of an involuntary nature, other than by reason of an involuntary conversion such as a casualty or condemnation. For example, in cases of foreclosure upon the property by a judgment lien creditor of the related purchaser, or bankruptcy of the related purchaser.

The association strongly favors these report statements and urges that the legislative history covering H.R. 6883 also make it clear that tax-free exchanges of property under section 1031 of the Internal Revenue Code would not be considered dispositions which trigger recognition of gain to the initial seller.

Let me comment on 2916. NCA strongly supports 2916 which would make investment tax credit available in situations where the alternative minimum tax applies. Under existing law, a farmer or rancher can incur large capital gains in a given year due to the sale of breeding stock, or the sale of farm or ranch property.

Frequently such sales, especially those relating to breeding stock, are conducted in the regular course of business, and may provide only marginal profit to the farmer or the rancher.

With the advent of the alternative minimum tax, some ranchers have incurred additional tax in situations where the alternative minimum applied because of such sales of breeding livestock and land. In a number of these situations, the investment tax credit, which would otherwise be available, could not be claimed because of the prohibitions contained in present law.

As a result, these farmers and ranchers have incurred income tax liability in years of no income, or actual loss, from farm or ranch operations per se. This has forced them to use funds received from sales of breeding livestock and/or land to pay taxes which otherwise could have been utilized for operating revenues or for needed capital improvements.

As soon as this problem came to the attention of NCA, the association took steps to encourage the introduction of corrective legislation such as S. 2916 which would make investment tax credit available as an offset against the alternative minimum tax. Said

amendment would provide much needed relief and is justified on the grounds of equitable treatment of the taxpayer.

NCA generally supports and urges immediate passage of H.R. 6883. The bill would bring about a number of beneficial and needed changes in the installment sales provisions of existing law, and would be a significant step forward in the simplification of the income tax laws.

NCA strongly endorses the provision of S. 2916, which would permit investment tax credit to be applied against the alternative minimum tax.

Thank you, Senator, for allowing me to appear before this subcommittee.

[Statement of James Powell follows:]

NATIONAL CATTLEMEN'S ASSOCIATION
P O. Box 569 1?01 Lincoln St
?enver, Colorado 80201

STATEMENT

of the

NATIONAL CATTLEMEN'S ASSOCIATION

to the

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

Relative to
H.R. 6883
Installment Sales Revision Act of 1980

and

S. 2916
Concerning Application of Investment Tax
Credit to Alternative Minimum Tax

Submitted by
James L. Powell, Chairman
Tax Committee

September 10, 1980

The National Cattlemen's Association is the national spokesman for all segments of the nation's beef cattle industry--including cattle breeders, producers, and feeders. NCA represents approximately 280,000 professional cattlemen throughout the country. Membership inculdes individual members as well as 51 affiliated state cattle associations and 15 affiliated national breed organizations.

SUMMARY OF STATEMENT

on

H.R. 6883 - Installment Sales Revision Act of 1980 and

S. 2916 - Concerning Application of Investment Tax Credit to Alternative Minimum Tax

The National Cattlemen's Association strongly supports the immediate passage of both H.R. 6883 and S. 2916.

H.R. 6883 would make a number of beneficial and needed changes in the installment sales provisions of existing law, and would be a significant step toward simplification of the income tax laws.

The NCA specifically endorses elimination of the provisions requiring not more than 30% of the selling price be received in the taxable year of sale, two or more payments to be considered a deferred sale, casual sales of personal property to exceed $1,000, and election of the installment method.

The Association also supports the provisions of the bill covering the receipt of like-kind property in connection with a disposition, installment obligations as a liquidating distribution from a corporation which liquidates within 12 months, and the use of the installment method of reporting gain from the sale of livestock and crops.

With respect to the deferred sale of livestock and crops, the NCA urges that the language contained in the House Committee Report be included in the Senate Report as well. The same request is made with respect to the House Report language which addresses the nontax-avoidance exception with respect to related party sales.

The Association also urges that the legislative history make it clear that tax-free exchanges of property under Section 1031 of the Tax Code would not be considered dispositions which trigger recognition of gain to the initial seller.

The NCA strongly supports the provisions of S. 2916. The alternative minimum tax has proved to be a serious burden for certain farmers and ranchers who must sell breeding livestock and land. Present law has forced these operators to incur income tax liability in years of no income, or actual loss, from the farm or ranch operation, per se. Allowing investment tax credit to be applied against the alternative minimum tax would provide much needed relief and is justified on the grounds of equitable treatment of the taxpayer.

STATEMENT

Comments on H.R. 6883

The National Cattlemen's Association supports H.R. 6883 and urges early passage. In general, the bill is one of the most important pieces of income tax legislation to be considered in a number of years. It would provide needed simplification of existing income tax laws dealing with installment sales, and would aid in both compliance and administration of these laws.

NCA specifically endorses the provisions of H.R. 6883 which would eliminate the requirements under present law that not more than 30% of the selling price be received in the taxable year of sale; that a deferred payment sale be for two or more payments; that the selling price for casual sales of personal property must exceed $1,000; and that the installment method must be elected.

Additionally, the Association supports the provision of the bill which states that the receipt of like-kind property, in connection with a disposition, will not be taken into account in determining gain recognized for installment sale reporting purposes. The NCA also strongly favors the provision that gain will not be recognized by a shareholder who receives installment obligations as a liquidating distribution from a corporation which liquidates within 12 months of adoption of a plan of complete liquidation.

Of great importance to farmers and ranchers using the cash method of accounting is the ability to use the installment method of reporting gain from the sale of livestock and crops. The report of the House Committee on Ways and Means accompanying H.R. 6883 contains the following statement:

> "For purposes of the bill, it is intended that gain from the sale of property which is not required to be inventoried by a farmer under his method of accounting will be eligible for installment method reporting as gain from casual sale of personal property."

The Ways and Means Committee statement is a vital part of H.R. 6883, and the Association urges that it be incorporated in the Senate Report on the bill. Such legislative history will make clear the application of the installment method to deferred sales of livestock and crops by cash-method ranchers and farmers.

NCA understands the concern expressed regarding abuses in which there is an installment sale between related parties, followed soon thereafter by a sale to a third party. This procedure obviously can result in substantial tax benefits, since the related parties may have the use of the entire sales proceeds and yet pay the tax liability over a period of years.

In general, NCA agrees with the treatment of related party sales as provided in H.R. 6883. Specifically, the Association endorses the provision that an involuntary conversion of property after a related party sale does not accelerate recognition of the installment gain to the initial seller. Also, NCA supports the exception with regard to dispositions which occur after the death of the first seller or the death of the person acquiring the property in the first disposition.

Further, the Association supports the provision of H.R. 6883 which prohibits acceleration or recognition of taxable gain to the initial seller in any case where it is established, to the satisfaction of the Internal Revenue Service, that neither the initial sale nor the resale has, as one of its principal purposes, the avoidance of Federal income taxes.

In this regard, NCA agrees with the language contained in the Report of the House Committee on Ways and Means accompanying H.R. 6883. The Report states that regulations and rulings under the nontax-avoidance exception will deal with certain tax-free transfers which normally would not be treated as a second disposition of the property, such as charitable transfers, gift transfers, and transfers to a controlled corporation or a partnership.

The Ways and Means Committee Report also says it is intended that a second disposition will qualify under the nontax-avoidance exception when it is of an involuntary nature, other than by reason of an involuntary conversion such as a casualty or condemnation-- for example, in cases of foreclosure upon the property by a judgment lien creditor of the related purchaser, or bankruptcy of the related purchaser.

The Association strongly favors these Report statements and, further, urges that the legislative history covering H.R. 6883 also make it clear that tax-free exchanges of property under Section 1031 of the Internal Revenue Code would not be considered dispositions which trigger recognition of gain to the initial seller.

Special rules are contained in the House version of H.R. 6883 regarding sales of depreciable property between certain closely related parties, such as a husband and wife, a taxpayer and a trust treated as owned by the taxpayer or the taxpayer's spouse, a taxpayer and a partnership or corporation which is 80% owned by the taxpayer and/or the taxpayer's spouse, or partnerships and corporations which are 80% owned by the taxpayer and/or the taxpayer's spouse.

NCA accepted this provision in the House version in the interest of expediting passage of the bill. To the knowledge of the Association,

such transactions are not common or of frequent occurance in connection with agricultural operations. It has been reported that such installment sales between closely related parties have created tax-avoidance problems in other areas of the economy, and the NCA understands this is the reason for including said restriction in H.R. 6883.

Comments on S. 2916

NCA strongly supports S. 2916, which would make investment tax credit available in situations where the alternative minimum tax applies.

Under existing law, a farmer or rancher can incur large capital gains in a given year due to the sale of breeding livestock or the sale of part of the farm or ranch property. Frequently, such sales, especially those relating to breeding livestock, are conducted in the regular course of business and may provide the only profit margin to the farmer or rancher.

With the advent of the alternative minimum tax, some farmers and ranchers have incurred additional tax in situations where the alternative minimum tax applied because of such sales of breeding livestock and land. In a number of these situations, the investment tax credit, which would otherwise be available, could not be claimed because of the prohibitions contained in present law. As a result, these farmers and ranchers have incurred income tax liability in years of no income, or actual loss, from farm or ranch operation, per se. This has forced them to use funds received from sales of breeding livestock and/or land to pay taxes which otherwise could have been utilized for operating revenues or for needed capital improvements.

As soon as this problem came to the attention of NCA, the Association undertook steps to encourage the introduction of corrective legislation

such as S. 2916, which would make investment tax credit available as an offset against the alternative minimum tax. Said amendment would provide much needed relief and is justified on the grounds of equitable treatment of the taxpayer.

Conclusion

NCA generally supports and urges immediate passage of H.R. 6883. The bill would bring about a number of beneficial and needed changes in the installment sales provisions of existing law, and would be a significant step forward in the simplification of the income tax laws.

NCA strongly endorses the provisions of S. 2916, which would permit investment tax credit to be applied against the alternative minimum tax.

Senator BYRD. Thank you, Mr. Powell.

The next witness will be Mr. Herbert J. Lerner, Federal Tax Division, AICPA.

Meanwhile, the committee will take a 1-minute recess.

[Recess.]

Senator BYRD. The committee will be in order.

Mr. Lerner.

STATEMENT OF HERBERT J. LERNER, FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CPA'S

Mr. LERNER. My name is Herbert J. Lerner. I appear today on behalf of the Federal Tax Division of the American Institute of CPA's, in my capacity as chairman of its Tax Accounting Subcommittee.

The Federal Tax Division is pleased to have the opportunity to testify on H.R. 6883. We have submitted a detailed statement of our position, and that has been submitted for the record.

Senator BYRD. It will be inserted in the record.

Mr. LERNER. Thank you.

This current proposal is an outgrowth of hearings held last year in which we participated very actively. We also participated in other meetings and discussions with staff members at the Senate and House level, the joint committee staff, members of organized bar groups, the Treasury Department, in an attempt to develop consensus positions on a number of controversial problems regarding installment sale treatment.

We believe that the distillation process has produced an excellent bill. It is one which we wholeheartedly support. In addition to simplifying a number of unnecessarily complicated provisions in current law, the act also substantially improves the tax treatment, of related party transactions so as to reduce the prospect for continued abusive use of those provisions. It also makes a number of other desirable substantive changes.

We think that it does so in a very tempered manner, so that many related party transactions will not be denied installment treatment if they otherwise have a justifiable purpose.

As a result of this distillation process for purposes of this hearing we have relatively few comments to make on H.R. 6883. Most of our suggestions, we either have been talked out of in this distillation process, or we have been successful in convincing others as to the appropriateness of certain provisions.

Of the three provisions that we comment upon in our detailed statement, there are only two that I would like to mention here today.

One is the section 453(c) proposal, on which we appreciate your earlier comment, Mr. Chairman, that the Treasury has supported that change so as to eliminate the potential for duplicate taxation of installment sale treatment for a dealer who changes from the accrual method to the installment method. This has been a very longstanding proposal of our organization, and we are pleased to see that all parties seem to have embraced the appropriateness of it. I will not dwell on that point further.

In the area of interspousal transactions, and sales to related businesses, the current proposal would require that in the case of an installment of depreciable property, only depreciable property, between spouses, or between the taxpayer and an 80 percent or more corporation or partnership, or between two such 80 percent or more owned entities, that the installment privilege is denied and the taxpayer must use the functional equivalent of the accrual method. It is not stated as the accrual method statutorily, but that is the purpose of that provision.

This is a rather simple proposal, but it can be viewed as a harsh rule. We believe that it is necessary due to the high probability that interspousal transactions of this type are typically not commercially motivated, and the tax benefits of stepped-up basis for future depreciation is too great a temptation not to restrict the transaction from the outset.

The same reason can be said to apply in the case of such sales of depreciable property to or from such an 80-percent-owned entity.

I would like at this point to clarify a point that was raised earlier today. In a long-term installment sale transaction, the interest element on that installment transaction would not be required to be accelerated, not be required to be picked up in the year of sale under the accrual method. It would only be the selling price.

We suggest, as others have, that a safe harbor rule be inserted in 453(g) to exclude from that strict accrual rule those installment sales of depreciable property which are established to the satisfaction of the Secretary of the Treasury as not having as one of their principal purposes the avoidance of Federal income tax.

This would correspond to a similar provision contained in the 2-year triggering rule of section 453(e)(7). It would avoid the undue result; that is, the accrual basis acceleration of income, on an installment sale which is motivated primarily by non-Federal income tax avoidance purpose, such as the avoidance of foreign tax considerations, or State tax considerations.

It would also presumably apply where there is no significant acceleration of increased depreciation to the buyer, as compared with the recognition of income to the installment seller.

I think the concern here may be best illustrated by the extreme situation if you did not have a provision requiring this treatment, a wife could sell to husband, or vice versa, on a 20-year payout, no payments until the 20th year, increased depreciation by the purchasing party reflected through current deductions with no income until the 20th year picked up by the related party, but they file joint returns.

There is the clear opportunity for achieving early depreciation deductions through that transaction before the installment gain is reportable. This all occurs in a setting which we believe is not commercially motivated. Barring some very unusual circumstances—perhaps the family separation circumstance may be an appropriate one—I think that that is certainly consistent with the proposed delegation of authority to the Secretary of the Treasury to deal with a situation which can be justified on its facts—on the surface that kind of transaction in our judgment does not deserve the installment sale treatment, and not to restrict it in this legislation I think would encourage transactions of that type.

I might also add that from an experience standpoint, we tried to poll some people within our firm as to transactions between husband and wife, and other than those which were incident to divorce and separation, or some foreign tax consideration, and we are only aware of one instance that was where there was a commercially motivated installment between husband and wife. Even in that transaction, if you had this provision whereby increased depreciation to the buyer would not be accelerated, as compared to the pickup of income by the installment seller, the transaction would have satisfied that rule.

Mr. Chairman, we appreciate the opportunity to have testified today, and to be a party to this development of what we consider to be highly desirable legislation. We urge enactment of it on a prompt basis.

[Statement of Herbert J. Lerner follows:]

STATEMENT OF

HERBERT J. LERNER, CPA -- CHAIRMAN,
TAX ACCOUNTING SUBCOMMITTEE

OF THE

FEDERAL TAX DIVISION

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

SENATE FINANCE COMMITTEE

CONCERNING

H. R. 6883, THE "INSTALLMENT SALES REVISION ACT OF 1980"

SEPTEMBER 10, 1980

INTRODUCTION

The Federal Tax Division of the American Institute of Certified Public Accountants is pleased to have the opportunity to submit this statement and offer testimony on H. R. 6883, the "Installment Sales Revision Act of 1980" which would amend §453(b) of the Internal Revenue Code of 1954 to simplify and revise the tax rules for reporting the gain under the installment method for sales of real property and casual sales of personal property.

This Act is an outgrowth of the hearings held last year on earlier versions of companion proposals (H.R. 3899 and S. 1063), and consideration this year of the current bill. The Federal Tax Division has been privileged to participate with representatives of several organized bar groups, the Treasury Department and congressional staff personnel in the development of consensus positions on this proposed legislation. This distillation process has resulted in a House-passed Act which we believe is truly responsive to the need for simplification in this important area. In addition to simplifying a number of unnecessarily complicated and troublesome aspects of current law (commented upon below), the Act also eliminates the prospect for continued abusive use of installment sales involving certain related-party transactions and makes other desirable substantive changes.

In short, we wholeheartedly support the prompt enactment of H.R. 6883. Set forth below are our detailed comments as well as specific suggestions for changes in H.R. 6883 which we believe would improve and further simplify installment sale reporting.

SIMPLIFYING CHANGES UNDER §453(b)

H. R. 6883 already reflects many of the specific legislative recommendations previously made by the Federal Tax Division, some of which are contained in our current "Recommended Tax Law Changes" booklet:

(1) Single deferred payment sales would qualify for installment treatment. Whereas under current law, the Internal Revenue Service has ruled /1/ (and courts have agreed /2/) that a taxpayer may not elect to report income from the sale of real property on the installment method where the total purchase price is payable as a single sum in a year subsequent to the year of sale, the Act would eliminate the formalistic requirement that a sales agreement must provide for two or more payments to qualify for installment reporting.

(2) Elimination of the 30-percent rule. The Act also would eliminate the 30-percent initial payment limitation for reporting gain on the installment method from the disposition of real property or a casual sale of personal property by a nondealer. We believe that elimination of the 30-percent

/1/ Rev. Rul. 69-462, 1969-2 CB 107, amplified by Rev. Rul. 71-595, 1971-2 CB 223.
/2/ Baltimore Baseball Club, Inc. v. U.S., 481 F. 2d 1283 (Ct. Cl. 1973); 10-42 Corp., 55 TC 593 (1971).

limitation will remove a trap for the unwary taxpayer and thus result in simplification. In addition, it will obviate the need for arranging transactions in less than their most desirable form from a business standpoint simply to satisfy an arbitrary limitation.

(3) Installment reporting should be permitted in contingent or open-end sales. Under current law, it has been held that to qualify for installment sale reporting, a fixed and determinable selling price must exist at the time of the sale./3/ The Act would change this result and permit installment sales reporting for a sale which includes a contingent element for all or part of the contract price.

We strongly support this desirable change. We feel that it will not only provide sellers an opportunity to consummate such sales with assurance about the resulting tax treatment, but also will eliminate much of the controversy that arises from the alternative use of the "deferred payment method" of reporting.

We agree with the approach of leaving to regulations the formulation of the precise details of how ratable basis recovery for contingent payment sales will work. We believe

/3/ See e.g., Gralapp v. United States, 458 F. 2d 1158 (10th Cir. 1972); and In re Steen, 509 F. 2d 1398 (9th Cir. 1975).

that the House Ways and Means Committee Report provides adequate direction to the Treasury Department regarding the reasonableness of future regulations to provide for fair and equitable recovery of basis to avoid, whenever possible, leaving a seller with an unrecovered basis in the installment obligation.

(4) Installment reporting should be permitted for installment obligations received in a §337 liquidation. Under present law, a shareholder is denied installment sale treatment when the corporation adopts a plan of complete liquidation under §337, sells its property for installment notes, and distributes those notes to the shareholders. While a special rule generally protects the corporation from gain recognition upon the distribution of the installment obligations, under present law the shareholders have to take the fair market value of those notes into account for determining currently taxable gain on the liquidation.

The Act would permit the deferral of gain recognition when a shareholder receives installment obligations in a liquidation of the corporation which were received by the corporation from a sale of its assets during the twelve-month liquidation period. The shareholder may report gain from the liquidation on the installment method as payments are received on the installment obligations. Installment obligations attributable

to the sale of inventory by the liquidating corporation would not be eligible for this treatment unless they are the result of a bulk-sale of the inventory of a particular trade or business. While this recommendation of the Federal Tax Division was based primarily on tax equity and ability-to-pay considerations, it avoids the need for taxpayers to engage in elaborate transactions to achieve installment reporting benefits and thereby enhances overall tax simplification. Permitting the shareholder-recipient of an installment obligation to report his liquidation gain attributable to such obligation under the installment method alleviates the need for the use of a related-party sale of stock on the installment basis as was used in Rushing./4/

The Act deals with the problem of liquidating distributions received in two taxable years by requiring an amended return for the first year. We support that approach, although we would prefer a "catch-up" rule, if a simple one could be developed. We realize that a catch-up provision which takes into account the difference in marginal tax rates between years and the value of a one year deferral of tax liability probably would be complex both from a statutory drafting standpoint and from a taxpayer computation standpoint.

/4/ Rushing v. Commissioner, 441 F. 2d 593 (5th Cir. 1971) aff'g 52 TC 888 (1969).

In addition to the foregoing simplifying changes, the Act also would:

(1) Eliminate the $1,000 sales-price floor for qualification for installment reporting of casual sales of personal property. In our previous testimony before this Subcommittee on S. 1063, we suggested that simplification would be better served by eliminating the $1,000 threshold amount. We are pleased to see that the current Act has taken that approach.

(2) Restrict related-party sales. The Act takes what we consider to be a very reasonable approach to dealing with "Rushing-type"/5/ transactions. These transactions often involve installment sales wherein the initial seller has long-term deferral of gain and the property is shortly thereafter sold by the related purchaser so that the related group, considered

/5/ Footnote 4, supra. While Rushing did not involve an immediate sale for cash outside of the related group (the corporation adopted a plan of liquidation and sold its assets to an unrelated buyer for notes and cash before Rushing sold his stock to the trust for his children, and then liquidated by distributing the buyer's notes to the trust), subsequent cases have involved immediate sales for cash to unrelated third parties or sales of corporate assets for cash followed immediately by liquidation of the corporation. See for example, William D. Pityo, 70 TC 225 (1978); Clair E. Roberts, 71 TC 311 (1978); and Carl E. Weaver, 71 TC 443 (1978).

as one economic unit, has cash in hand but no current reporting of the resulting gain. Rather than generally prohibiting outright installment reporting for related-party sales, the Act causes an acceleration of income to the original seller when, and if, the related-party buyer makes a disposition of the property too soon after its purchase.

In applying the new related-party rules, the Act uses the attribution rules of §318(a). This accords with our recommendation made during testimony before this Subcommittee on S. 1063 as well as our testimony before the Select Revenue Measures Subcommittee of the House Ways and Means Committee on the current bill.

Under H.R. 6883, when there is a second disposition of property sold to a related-party purchaser, the amount realized on that disposition by the related buyer (or the fair market value of the property disposed of if the second disposition is not a sale or exchange) is treated as received at that time by the initial seller, but only to the extent that it exceeds actual payments made under the installment sale before the end of the taxable year. In addition, if a second disposition results in the recognition of gain to the original seller under the Act, subsequent payments to the seller would be recovered tax free until they equal the amount

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realized from the disposition which results in acceleration of gain recognition.

In the case of property other than marketable securities, the resale rule generally would apply only for dispositions occurring within two years of the initial sale. However, the running of the two-year period is suspended if, and while, the related buyer's risk of loss with respect to the property is substantially diminished through a short sale, a put, or the granting of an option to acquire the property.

If the property sold to the related buyer is marketable securities, the two-year resale rule does not apply. Instead, gain recognition can be accelerated if there is a second disposition at any time before the installment obligation is satisfied.

The Act provides several desirable exceptions to the application of the related-party rules. First, the Act exempts any sales of stock to the issuing corporation from the related-party rules altogether. This is in recognition of the fact that there is no abuse potential if a corporation acquires its stock from a shareholder and then resells it, since there is no gain from the sale of a corporation's

treasury stock in any event, and therefore the related party group does not benefit from a step-up in basis from the original transaction. Second, the Act excepts from the early disposition triggering rules any disposition by the related-party purchaser that arises from a compulsory or involuntary coversion so long as the initial sale occurred before the threat or imminence of the conversion. Third, if either the original seller or the related purchaser dies, a subsequent disposition of the property is not subject to the early disposition triggering rules. Finally, if it is established to the satisfaction of the Commissioner that neither the original sale nor the early disposition by the related party had as one of its principal purposes the avoidance of Federal income tax, gain is not triggered to the original seller upon the second disposition. The accompanying House Ways and Means Committee Report appropriately notes that this mechanism may be utilized to permit certain tax-free transfers of the purchased property, e.g., charitable contributions or gifts, not to be treated as early dispositions.

To protect the interests of the Treasury, under the Act, the period for assessing a deficiency in tax attributable to a disposition by the related-party purchaser will not expire before the day which is two years after the date the original seller furnishes a certificate that there was a second disposition of the property.

We strongly support the Act's approach to dealing with potential abuses resulting from related-party installment sales, while at the same time permitting a great many nontax-motivated sales to be consummated. We do, however, have technical comments insofar as the proposal deals with husband-wife sales and certain corporate liquidations. These are set forth in the last section of this statement.

In addition, we suggest that the "second disposition" triggering exception in the event of death be clarified so that the exception will be operative in the event of the death of either 1) the seller, 2) the buyer, or 3) the spouse of the seller or the buyer, if the spouse has or had an interest in the property which is substantially equal to that of his or her spouse. This rule would avoid partial triggering problems where the property sold or purchased is owned as community property or where the property is owned jointly and one of the spouses dies during the two-year period.

(3) Extend installment treatment to future payment obligations received in like-kind exchanges or corporate reorganizations. The Act provides that the receipt of like-kind property will not be taken into account in determining gain recognized for installment sale reporting purposes. In addition, the Act provides that rules similar to the like-kind exchange rules will apply to an exchange which is described in §356(a) and is not treated as a dividend.

We support both of these proposed changes on the basis of ability-to-pay considerations as well as on the basis of sound tax policy. There is no logical basis for disparate treatment of installment obligations in these situations than in the case of a traditional installment sale under the proposed new rules.

(4) Permit §1038 treatment to estate of a deceased taxpayer who sold real property on the installment method. The Act provides that an executor or beneficiary who receives an installment obligation from a decedent will succeed the decedent for purposes of qualifying for nonrecognition treatment if the property is reacquired in satisfaction of the obligation. Under present law, the Internal Revenue Service has ruled that §1038 does not apply to a reconveyance to the estate of a deceased taxpayer who made the original sale./6/

We support this change because it provides certainty and because we believe it reflects sound tax policy.

(5) Deal with special disposition problems. The Act would make it clear that the cancellation of an installment obligation or permitting it to become unenforceable because of lapse of time will be treated as a disposition of the obligation which will trigger deferred gain to the holder. If the holder and the

/6/ Rev. Rul. 69-83, 1969-1 CB 202.

obligor are related parties, the fair market value of the obligation will be treated as not less than face value. The Act also provides that the installment obligation disposition rules cannot be avoided by bequeathing the obligation to the obligor. The Act amends §691(a)(2) to make it clear that a testamentary transfer to the obligor is a taxable event.

We support these changes from a tax-equity standpoint and because we believe they also reflect sound tax policy.

(6) Automatic election of installment reporting. A further simplification of our tax law would occur by virtue of the automatic election of installment reporting provided by the Act. By making installment treatment the norm with an election out of installment treatment when that would be desirable, *e.g.*, where the seller has an expiring net operating loss, the Act removes a trap for the unwary taxpayer who will no longer be hurt by an error of omission.

Under the Act, generally, an election not to have installment sale reporting apply to a deferred payment sale must be made in the manner to be prescribed by regulations on or before the due date (including extensions of time for filing) for filing the income tax return for the year in which the sale occurs. However, late elections may be allowed pursuant to regulations. It is our hope that these regulations will permit late

elections when reasonable cause exists for the failure to make a timely election-out.

Once an election out of installment sales treatment is made, it generally will be irrevocable. However, the Secretary is given the authority to consent to a revocation. We hope that consent to a revocation will be permitted when it does not have as one of its principal purposes the avoidance of income taxes.

We feel that the election out procedure provides an appropriate limitation on the use of cost recovery reporting and will also put the Service on notice that such reporting method is being used. Assuming that a given transaction may properly qualify for recovery of cost under existing law, we believe it is appropriate that the Service be put on notice of that fact through the election-out procedure.

ADDITIONAL RECOMMENDED MODIFICATIONS TO THE PRESENT ACT

Due to the unusual deliberative process whereby organized professional groups, including the AICPA, were able to have input in both the tax policy formulation as well as the technical structure of provisions reflected in the House-passed version of the "Installment Sales Revision Act of 1980," we have only three additional recommendations for your consideration at this time:

(1) Repeal the provisions of existing Code §453(c) in the case of dealers who change to the installment method. We urge that the current proposal be modified to reflect the Federal Tax Division's long-standing recommendation concerning changes from the accrual to the installment method of reporting sales of property by dealers. (See Attachment A for a reprint of our recommendation.) We believe this is a noncontroversial related problem area that calls for swift consideration.

Under present law, a dealer in property is subject to the possibility of double taxation for all or a portion of the gross profit on installment payments received during the year of adoption of the installment method (and subsequent years), which receipts are attributable to installment sales arising from pre-adoption years. This can occur by virtue of the provisions of present §453(c) which are not changed under H.R. 6883. (See proposed Section 453A(b).)

To deal with this problem under present law, knowledgeable taxpayers either (1) "sell" their installment receivables on the last day of the taxable year before the year of adoption of the installment method, or (2) transfer the installment receivables to an affiliate (e.g., a wholly-owned subsidiary). Thus, collections on the receivables are not made by the dealer, in its own right, during any year when it uses the installment method of reporting income from dealer installment sales. In this connection, it should be noted that the

Internal Revenue Service has regularly issued private letter rulings confirming such favorable treatment.

The unadvised taxpayer, however, may suffer the illogical consequences of double taxation for having failed to solve the problem of §453(c) by such a form-oriented transaction which serves no other business purpose.

The problem under present law can be remedied only by legislative action. We suggest that the cure be a simple provision that collections on preadoption year installment obligations of an accrual-basis taxpayer be excluded from the computation of gross income for a dealer in property who adopts the installment method with respect to such sales.

At a time when this committee is considering the simplification and revision of §453 to eliminate unnecessary complexities and improve the tax logic underlying its provisions, we urge that you address this problem in the manner described above. We have considered the proposal from the standpoint of legislative transitional rules and have concluded that no such legislative rules are necessary or desirable. It is assumed that Treasury Regulations would provide a basis for segregating current year collections of preadoption-year installment receivables in a manner similar to the provisions of present Regs. §1.453-7, so that there

would be no duplication of income attributable to such collections consistent with the repeal of §453(c).

(2) Technical changes in the treatment of interspousal transactions and sales to related businesses. The current proposal would require (under §453(g)) that in the case of an installment sale of depreciable property between spouses or between the taxpayer and an 80%-or-more owned corporation or partnership, or between two such 80%-or-more owned entities, that the installment privilege is denied and the taxpayer must use the accrual method. This simple, but harsh, rule is necessary due to the high probability that interspousal transactions of this type are not commercially motivated and the tax benefits of stepped-up basis for future depreciation is too great a temptation not to restrict the transaction from the outset. The same reason may be said to apply in the case of such sales of depreciable property to or from such an 80% owned entity.

We suggest, nevertheless, that a safe harbor rule be inserted in §453(g) to exclude from the strict accrual rule such installment sales of depreciable property which are established to the satisfaction of the Secretary of the Treasury as not having as one of their principal purposes the avoidance of Federal income tax. This exception would correspond to the similar provision of proposed §453(e)(7). It would avoid the undue result in a case such as where the

installment sale is motivated primarily by foreign or state tax considerations, or where there is no significant acceleration of increased depreciation to the buyer as compared with the recognition of income to the installment seller.

To provide a greater degree of consistency and logic, we suggest that proposed §453(h)(1)(C) be modified so that it embraces only installment obligations related to the sale of depreciable property consistent with the rule in subsection (g).

(3) Technical change desirable for basis recovery regulations provision. Proposed §453(i)(2) should be modified by inserting "not less than" before the words "ratable basis" appearing therein. Consistent with the acknowledgement that there are circumstances wherein basis recovery should be computed on an income forecast or similar method, whereby such recovery may be more than ratable for certain years, this clarifying change appears desirable.

ATTACHMENT

SECTION 453 - ELIMINATION OF DOUBLE TAXATION UPON CHANGE FROM ACCRUAL TO INSTALLMENT BASIS

Upon a change from the accrual to the installment basis of reporting taxable income from installment sales by dealers in personal property, installment payments actually received during the year on account of sales made in a taxable year before the year of change should be excluded in computing taxable income for such year of change and for subsequent years [section 453(c)].

Under the Internal Revenue Code of 1939 a taxpayer changing from the accrual method to the intallment method was not permitted to exclude from gross income for the year of change and subsequent years the gross profit which had been included in income and taxed in an earlier year when the taxpayer was on the accrual basis. The result was that such taxpayer was taxed twice on the same income.

The Committee Reports accompanying the Internal Revenue Act of 1954 state that with the intention of eliminating this double taxation, Congress enacted section 453(c) of the Internal Revenue Code. Unfortunately, that section does not go far enough, for it still requires that the gross profit from installment payments received after the change to the installment method be included in gross income in the year of receipt even though it had previously been taxed under the accrual method.

Actually, section 453(c) does not accomplish its intended purpose. Only limited relief is provided from the double tax penalty. Even if it is assumed that the tax rate and gross income are the same for the earlier year and the year of change, the net income and the final tax in the earlier year would probably have been smaller because the expenses of sale would have been deducted in the earlier year under the accrual method. Thus, the section 453(c) adjustment will not eliminate all the tax in the second year resulting from the inclusion of the gross profit. The double tax of section 453(c), however, can be avoided by selling the receivables prior to the election to report on the installment basis. Although this technique does provide relief from the double tax, it adds to the incongruity of section 453(c).

In order to accomplish equity among taxpayers who change from the accrual to the installment method of accounting for installment sales, taxpayers who adopted the installment method originally, and taxpayers who sell their receivables prior to changing to the installment method, and, in order to follow the expressed intent of the Congress, section 453(c) should be amended to permit a changeover to the installment method without double taxation.

Senator BYRD. Thank you, Mr. Lerner.
Mr. Ginsburg, nice to see you again.

STATEMENT OF MARTIN D. GINSBURG, TAX SECTION, NEW YORK STATE BAR ASSOCIATION, COMMITTEE ON TAXATION, NEW YORK CITY BAR ASSOCIATION, COMMITTEE ON SIMPLIFICATION, TAX SECTION, AMERICAN BAR ASSOCIATION

Mr. GINSBURG. I am very happy to be here again, Mr. Chairman. You have been kind enough to catalog all those organizations I have the privilege of representing this morning, so I will not do it again. I will just say that the three bar association groups I do represent this morning have adopted the lengthy report commenting on H.R. 6883 with vast approval, for submission to this hearing, and it extends my testimony today.

With your permission, I ask that the joint report and the three page summary of it that has been submitted to the hearing be included in the record.

Senator BYRD. That will be included in the hearing.

[Report follows:]

Committee on Simplification
Section of Taxation
American Bar Association

Committee on Taxation
Association of the Bar
of the City of New York

Tax Section
New York State Bar Association

JOINT REPORT

ON

H.R. 6883

INSTALLMENT SALES REVISION ACT OF 1980

Submitted to the Subcommittee on
Taxation and Debt Management Generally,
Senate Finance Committee
September 10, 1980

Committee on Simplification
Section of Taxation
American Bar Association

Committee on Taxation
Association of the Bar
of the City of New York

Tax Section
New York State Bar Association

H.R. 6883

INSTALLMENT SALES REVISION ACT OF 1980

Report Submitted to the Subcommittee on
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September 10, 1980

On March 19, 1980, representatives Ullman, Conable, Rostenkowski, and Duncan of the House Ways and Means Committee, and Senators Long and Dole of the Senate Finance Committee, introduced through companion bills (H.R. 6883, S.2451) the Installment Sales Revision Act of 1980, legislation to revise, reform, and simplify many of the rules governing dispositions of property for future payment. This legislation is the healthy offspring of Subcommittee hearings held last summer on a narrowly focused installment sale bill introduced May 2, 1979 (H.R. 3899, S.1063).

We submitted to the summer 1979 hearings an extensive Joint Bar Report commending the announced congressional intention to

simplify selected areas of substantive tax law and commending in particular the choice of the installment sale provision as an initial focus of this ongoing legislative project. Our 1979 report, however, criticized the earlier bill in two major respects. First, we found the treatment of related party installment sales, then proposed, to be misdirected and excessively penal. Second, we believed misguided the bill's narrow concentration on a very few specific installment sale rules. In our view sensible simplifying legislation required a broader focus, an attention to and revision of all elements that contribute importantly to the inordinate complexity of present tax law's treatment of property dispositions when payment is deferred. At the hearings the Treasury Department and the Federal Tax Division of the AICPA announced positions essentially similar.

Stimulated by the Subcommittees' response, a unique, lengthy collegial effort to simplify and reform this important, complex area of tax law then was undertaken. Participants included representatives of the congressional staffs, Treasury Department, bar association tax sections and the Federal Tax Division of the AICPA. Valuable comments were furnished by other concerned private sector groups. As refined at and after the April 17, 1980 hearing before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, the product is the proposed Installment Sales Revision Act of 1980.

The bill comports with the recommendations unanimously made last summer, by the Treasury Department and the institutional tax

groups, that Congress should react to major contributors to the field's complexity. The bill does not deal with every element in exactly the manner we recommended in our Joint Bar Report last summer, or in exactly the manner the Treasury Department or the AICPA then recommended. That would not have been possible since the various recommendations were not identical in every detail. More importantly, in working together the participants uncovered technical problems not earlier perceived and gained appreciation of and a willingness to accommodate the special concerns of other participants. The process of identification, reasonable discourse, and fair accommodation has yielded what in our view is a signal achievement, a truly effective tax simplification and reform bill. We urge its prompt enactment.

I. The Philosophy of the Bill

The overarching defect in present law's treatment of sales for future payment is the lack of a unified statutory approach. Section 453, the installment sale provision allowing deferral of gain and requiring ratable recovery of basis, is unavailable if any part of the selling price is contingent in amount, if personal property is sold and the selling price is small, if the sale agreement calls for only a single payment, if the ill-advised seller fails affirmatively to elect installment treatment, or if, in the year of sale, "payment" -- including an otherwise nontaxable receipt of like-kind property -- exceeds 30% of the total selling price. If statutory installment treatment is unavailable or not elected, the seller in some circumstances is currently

taxed on money he or she does not have, in others will avoid current gain recognition and obtain an even lengthier tax postponement under the nonstatutory method of cost recovery reporting.

Unbalanced tax consequences characterize present law beyond the election threshold. Installment treatment is available when the shareholder sells the corporation's stock; it is not available to the shareholder when the corporation sells its assets and liquidates. Gift of an installment obligation to any donee, including the maker, triggers the donor's previously deferred gain; there is authority, albeit slender, for the proposition that writing "cancelled" across the face of the note permanently avoids recognition of that gain, and at least an argument that bequest of the note to the maker achieves a similar result.

Present law's discordant taxing scheme places too great a premium on the sophistication of the accountant or lawyer. It entraps the ill-advised, usually less affluent seller while affording the wealthy and well-advised undue advantage. This reality defines the simplification objective. Both the opportunity to blunder and the opportunity of undue advantage should be circumscribed. When the commercial context calls for deferral of payment, liability to the fisc also should be deferred. When payment is in hand, an appropriate portion of the seller's gain should be recognized. The design of the transaction, straightforward and unadorned or sophisticated and byzantine, ought not

mandate inappropriate acceleration or inappropriate deferral of tax.

The Installment Sales Revision Act embraces this tax simplification concept. In origin, development and coverage, the bill is commendable tax legislation.

It has been pointed out on more than one occasion that tax simplification is a very complicated business. The pending bill offers proof. Although exemplary in concept and coverage and the product of extensive effort, goodwill and accommodation, as introduced on May 2, 1980 the bill in our view was incomplete or technically flawed in a very few respects. Almost all of the perceived defects were corrected by the Ways and Means Committee, either by amendment to the bill or, where appropriate, committee report clarification. In the balance of this report, we first (Part II) review the bill's major achievements, next (Part III) furnish our few technical comments on the present form of the bill, and finally (Part IV) suggest some additional deferred payment sale matters for Committee consideration.

II. Coverage of the Bill

The Installment Sales Revision Act of 1980 covers and sensibly resolves a host of primary and secondary simplification and reform issues that currently plague the tax treatment of future payment sales.

A. Extension of the Installment Sale Concept.

Without any justification in sensible tax policy, present section 453(b) does not provide tax deferral when the

deferred payment sale fails to fit the lexicographer's notion of an installment arrangement. In the dictionary sense an installment is one of two or more payments. A sale today calling for a single full payment five years hence does not fit. The seller is denied statutory relief. 1/ Had the seller, better advised, required and obtained a small down payment the problem would have been avoided. Further, without regard to the number of payments called for under the sale agreement, if total sale price is not fixed and determinable by the close of the sale year, so that the percentage of that total which each separate payment represents initially cannot be known, statutory relief again isunavail- able. 2/ The bill properly resolves both problems.

1. Two Payment Rule. The requirement of two or more payments is eliminated. 3/

2. Contingent Payments. The term "installment sale" is defined in the bill to encompass any property disposition in which a payment is to be received in a subsequent taxable year. 4/ New section 453 thus will afford statutory deferral of tax liability to sales and exchanges in which part or even all of the future payment obligation is contingent in amount. The ratable recovery of basis concept, central to installment reporting under the new law as now, will be extended to contingent payment transactions. As summarized by Chairman Ullman in introducing the proposed legislation: 5/

> The bill would also permit installment sale reporting for sales for a contingent selling price. Under present

> law, these sales are not eligible for installment reporting. In extending eligibility, the bill does not prescribe specific rules which would apply to every conceivable transaction. Rather, the bill provides that the specific rules will be prescribed under regulations.
>
> However, it is intended that, for sales under which there is a stated maximum selling price, the regulations will permit basis recovery on the basis of a gross profit ratio determined in reference to the stated maximum selling price. In cases where the sales price is indefinite but payable over a fixed period of time, it is generally intended that basis of the property sold would be recovered ratably over that fixed period. In cases where the selling price and payment period are both indefinite, it is intended that the regulations would permit ratable basis recovery over some reasonable period of time. Also, in appropriate cases, it is intended that basis recovery would be permitted under an income forecast type method.

We endorse both the substantive approach to basis recovery and the decision to remit to the regulations articulation of the precise and detailed rules. 6/

B. Eligibility.

A principal defect of present section 453(b) is the number and nature of substantive and practical threshold impediments to obtaining installment treatment. The two payment and fixed selling price requirements are examples. Others that deserve and receive proper attention in the bill include the 30% initial payment limitation, the minimum selling price requirement when personal property is sold, and the requirement that the

deferred payment seller affirmatively elect installment treatment.

1. <u>30% Limitation</u>. Whatever justifications have been advanced in its behalf, and over time they have been many and varied, <u>7</u>/ the initial payment limitation has functioned in practice as little more than a trap for the unwary, an avoidable nuisance for the well-advised. The bill's elimination of the initial payment limitation strikes a major blow for tax simplification.

2. <u>Minimum Selling Price</u>. Present section 453(b)(1)(B), applicable to a casual sale or other casual disposition of personal property but not to real property, denies installment treatment unless the selling price exceeds $1,000. The bill introduced last year would have increased this floor amount to $3,000, inappropriately burdening the small taxpayer who, rather than his wealthier neighbor, is more likely to engage in transactions of this magnitude. The new bill sensibly reverses field and eliminates the minimum sale price floor.

3. <u>Automatic Installment Election</u>. Well-advised sellers are well aware of present law's requirement that installment treatment must be elected in the tax return filed for the year of sale. Well-advised sellers make that election when it is to their advantage. Others, less affluent and less well-advised or not professionally advised at all, too often fail timely to elect and inadvertently forego the tax deferral benefit Congress has proffered. This has particularly proved the case when the

sale agreement calls for no down payment. The bill advances the simplification cause in a major way by declaring installment treatment the automatic norm, 8/ allowing a timely filed election out of installment treatment 9/ to the seller who, possessing for example an expiring loss carryover, 10/ would be disadvantaged by deferred reporting of gain.

A nonresident alien who sells property (normally foreign situs property sold abroad) and subsequently takes up residence in the United States is, of course, not subject to federal income taxation on that transaction. Under present law this is true whether the sale is for cash or installment payments; the alien makes no present law installment election. As the House Ways and Means Committee Report notes, the statutory shift to an automatic installment election (unless the seller affirmatively elects out of installment treatment) is not intended to change this result. The Senate Finance Committee Report, we hope, also will confirm the continuation of present law's treatment of the nonresident alien.

C. Section 337 and Related Party Sales.

Present law denies a shareholder installment treatment when the corporation, adopting a plan of complete liquidation that comports with section 337, sells its property for installment notes and distributes those notes to the shareholder. 11/ A direct sale of the corporation's shares to the same purchaser for identical notes, however, permits installment reporting. When the installment purchaser refuses to buy corporate stock, present law

forcefully encourages the shareholder first to sell his stock for installment notes to a family trust or other related party intermediary; benefitted by its high purchase price basis, that related buyer without tax disadvantage can cause the corporation to follow the section 337 asset sale and liquidation route.

This exercise in self-help was the orgin of the so-called Rushing related party installment sale transaction. 12/ Sophisticated taxpayers, however, quickly perceived an opportunity of special advantage. If the related buyer promptly resells for cash, the family group has received the funds but has deferred a decade or more payment of the associated tax liability. In the main, the courts have approved carefully designed schemes of this sort. 13/

The installment sale bill introduced last year did not tender an appropriate response. It condemned all related party installment sales, failing to recognize that, in all but a narrow class of cases, the tax avoidance potential resides, not in that initial transaction, but rather in the early and voluntary resale for cash. More broadly, the original legislative proposal concentrated solely on tax avoidance potential and did not propose to cure, indeed would have worsened, the section 337 installment sale problem that Mr. Rushing had faced and resolved through self-help. But the two, inappropriate tax deferral when cash is in hand and inappropriate tax acceleration when cash is not in hand, are opposed faces of a single issue. The proper resolution of either requires the proper resolution of both.

The Installment Sales Revision Act comprehends this relationship and sensibly resolves both problems.

1. Section 337. Subject to the appropriate inventory sales exception and to a narrowly crafted related party rule, the bill declares eligible for shareholder installment treatment debt obligations issued to and distributed by a corporation incident to a section 337 liquidation. 14/ If the liquidating corporation has a subsidiary which also sells property and liquidates within recently enacted section 337(c)(3), debt obligations generated in that transaction qualify for installment treatment when redistributed to the parent corporation's shareholders. 15/ Consistent with the policy of section 337 itself, the bill provides that to qualify for shareholder installment treatment debt obligations attributable to inventory must arise from a bulk sale of the inventory of the particular trade or business. 16/

The bill's approach is at once consonant with the tax simplification objective and a sensible extension of the law beyond the confines of that objective. The bill simplifies in curing in a direct way Mr. Rushing's problem, equating the installment sale of a corporation's assets to the installment sale of corporate stock. The bill goes further, to the particular advantage of shareholders of closely held corporations, in allowing installment treatment when, for example, a division or the properties of a subsidiary are sold to one buyer, another division is sold to a second buyer, and a building or other

investment asset is sold to a third buyer. 17/ In the practical world an installment sale dispersal of that sort cannot ordinarily be accomplished by selling the corporation's shares.

2. Related Party Transactions. Certain interspousal and self-dealing transactions to one side, an installment sale to a related party automatically receives installment treatment. To identify and discourage tax avoidance, the bill correctly focuses on a "second disposition" by the related buyer. Reasonably balancing considerations of simplicity, equity, and revenue protection, the bill establishes these ground rules: 18/

-- If there is an inappropriate "second disposition" -- in general, a voluntary and too early resale or other disposition of the property by the related buyer -- the amount realized on that transaction by the related buyer (or the value of the property disposed of if the second disposition is not a sale or exchange) is treated as received at that time by the original seller.

-- If the property sold is other than marketable securities, a resale or other transfer by the related buyer can constitute a triggering second disposition if it is made within two years of the initial related party installment sale. If the related buyer holds subject to the normal risks of ownership for two years, the taint is off. Subsequent resale triggers no gain to the original seller. This safe harbor is eroded and the two year term extended if and while the related buyer avoids normal

risks of ownership through, for example, a short sale or put or commercially equivalent arrangement. 19/

-- If the property sold to a related buyer is marketable securities, the two year safe harbor does not apply.

-- Without regard to the pace of events, various transactions are exempted from the triggering rule. If the property transferred in the original installment sale is corporate stock and the related buyer is the issuer, the triggering rule is inapplicable. 20/ If either the original seller or the related purchaser dies, a subsequent transfer of the property triggers no acceleration of gain, either to the original seller if alive or to the estate if dead. 21/ If the related buyer's too early transfer is the product of a compulsory or involuntary conversion, section 1033, no gain is triggered to the original seller. 22/ Finally, if no specific exemption is available but it is established to the satisfaction of the Commissioner that neither the related party sale nor the subsequent untimely redisposition had as one of its principal purposes the avoidance of federal income tax, gain is not triggered to the original seller. 23/ Thus, the statute affords a mechanism through which the special case, from illness or economic misfortune to involuntary corporate freezeout merger, may be accommodated.

-- And, if all else has failed and a second disposition is too early made, the bill affords additional measures of relief. If the related buyer sells a portion of the property to generate funds with which to make an installment

payment to the original seller, there is no double counting. The actual payment absorbs the second disposition's deemed payment. If actual payment precedes second disposition, the same favorable result obtains even though the events occur in different taxable years. 24/ And if the triggering second disposition occurs first, and no installment payment is made until a subsequent year, the earlier event in effect again absorbs the later and the original seller owes no additional tax unless and until payments received exceed the second disposition proceeds he has earlier taken into account. 25/

3. Interspousal and Self-Dealing Transactions.

A sale of depreciable property between related taxpayers offers the special tax planning advantage of a stepped up basis for future depreciation. Congress long ago circumscribed that special advantage, when the parties are married or stand in an 80% control relationship one to the other, by characterizing the seller's gain as ordinary income in sections 1239 (spouse or controlled corporation) and 707(b)(2) (controlled partnership). When the sale calls for immediate recognition of gain, the ordinary income policeman adequately performs its function under current law.

But if the seller may use the installment method to defer recognition, the ordinary income sanction may not be adequate. Particularly when the buyer elects to depreciate the used property on the component method, the present value of the augmented depreciation benefit may exceed substantially the present value of the future ordinary income detriment. Extending installment

treatment to the shareholder in a section 337 liquidation measurably compounds the problem. The section 1239 policeman performs no safeguarding function since section 337 expunges the corporate level gain to which section 1239 would otherwise apply. The need to pay adequate interest in the deferred payment transaction is of little moment in the tax planning equation: In the joint federal income tax return filed by husband and wife, interest expense and interest income wash.

The bill attempts to respond to these concerns. Proposed section 453(g) denies installment treatment and in effect requires accrual accounting when depreciable property is sold and the parties stand in a marital or self-dealing (80% controlled entity) relationship. If the installment sale is not direct but rather is through a section 337 liquidating corporation, e.g., husband is shareholder and wife purchases corporate assets for installment obligations, proposed section 453(h)(1)(C) denies installment treatment when the obligation is distributed to the shareholder. Treatment of direct sales and section 337 transactions is not wholly parallel, however, since the section 337 provision neither requires accrual accounting nor limits installment method disallowance to sales of depreciable property.

We believe the concern which the described self-dealing provisions address merits consideration. Also, it may well be that the concern is not necessarily limited to transactions involving depreciable property. When one spouse sells to another a capital gain asset, for example a tract of appreciated land, which the buyer will subdivide and sell after two years, the joint return wash of interest income and deductions encourages the setting of a

high interspousal price and thereby the transmutation of subdivision ordinary income into deferred payment capital gain. But the bill reacts to nondepreciable property only in the section 337 context, and the bill's accrual mandate, applicable in the case of direct depreciable property sales between closely related persons, does not apply when section 337 is in point.

Thus, the present form of the bill is discordant. A spectrum of harmonizing responses may be envisioned.

At one end of the spectrum, it is arguable that the installment sale advantage, present under current law, is adequately balanced by the loss of the income tax-free basis step up at death which attends an installment sale, section 1014(c), and thus that the problem is not of a magnitude sufficient to demand a special solution. In part offsetting this view, however, is the anticipation that Congress near term likely will liberalize depreciation and thereby unbalance the equation.

Some who agree that a tailored legislative solution is warranted would focus tightly on the depreciation deduction itself. They would allow installment treatment but defer the augmented depreciation flow until the seller's gain has been equivalently recognized. Perhaps a sounder and less complex rule, embracing a concept now embodied in the consolidated return regulations, would allow installment treatment but trigger gain to the deferred payment seller as, when, and to the extent augmented depreciation deductions exceed gain to that time reported by the seller. Still others will embrace forced accrual as the general rule, but would provide for one or a variety of "no

tax avoidance" exceptions, or for an option in the parties to obtain installment treatment but defer or even forego augmented depreciation, or to accelerate gain recognition to match depreciation, or for some combination of these safety valves.

At the other end of the spectrum, there are those who support a simple closed door. Forced accrual, never installment treatment, on any deferred payment sale of property, depreciable or not, in the self-dealing context.

Each of these views, and others along the spectrum, has its partisans among our bar association tax groups. But, while we may differ among ourselves as to the significance of the self-dealing concern and the importance of a legislative solution, and the harmonizing specifications that should underlie any legislative solution, we are of one mind on the larger issue. All of our organizations have supported the bill from its inception. However much we might prefer an approach more harmonious than the present form of the bill supplies, we view its treatment of the self-dealing problem as secondary to the many excellent clarifications and simplifications embodied in the bill. Whatever approach to the self-dealing problem Congress ultimately may adopt (and one is suggested in part III B below), we will continue unreservedly to support the bill.

D. Otherwise Tax Free Exchanges.

Under section 1031(b), when like-kind property is exchanged, gain is recognized only if and only to the extent "boot" -- cash, debt obligations, and other nonqualifying property -- is received. Under section 356(a)(1), in a corporate reorganization gain is recognized only if and only to the extent boot is received. Differing from the like-kind exchange, in a reorganiza-

tion recognized gain in some circumstances may be taxed as dividend income and not as the proceeds of a property dispostion.

Under section 1038, an installment seller of real property, forced to repossess that property which has stood as security for the notes, recognizes gain only if and only to the extent payments previously received were offset against basis and not included in income.

When the boot received in a section 1031(b) like-kind exchange or in a section 356(a)(1) non-dividend reorganization exchange is installment paper, present tax law affords senseless treatment in the former case, 26/ uncertain treatment in the latter. 27/ Section 1038, as it applies to realty transactions, works appropriately when the seller repossesses, uncertainly or not at all if the seller has died and the estate or beneficiary repossesses. 28/ The bill attempts reasonable clarification and reform.

1. Section 1031(b) Debt Boot. The bill appropriately provides that the term "payment" does not include qualifying (like-kind) property received. Installment obligations are not taxed in the year of receipt. In determining year of sale gain, the taxpayer's basis is first allocated to the qualifying property received up to its fair market value; excess basis if any is ratably allocated to the installment debt and against any cash or other boot received. 29/

2. Section 356(a)(1) Debt Boot. The bill attends to this case in a desirably simple way, stating that rules similar to the like-kind exchange rules shall apply to an exchange which is described in section 356(a) and is not treated as a dividend. 30/

3. Section 1038. The bill confirms the application of section 1038 to the estate or beneficiary of a deceased seller. 31/ This provides desirable certainty where the law currently is unclear, and it does so in a manner consistent with rational tax policy. The mechanics are uncomplicated. Section 1038 encompasses the successor; in the hands of the repossessing successor the real property has an adjusted basis equal to the basis the realty would have had if the original seller were the repossessing party, increased by an amount equal to the section 691(c) deduction foregone. 32/

E. Special Disposition Problems.

The bill identifies and reacts appropriately to three avoidance cases that may inhere in present law. Each will arise, ordinarily, when buyer and seller were related.

1. Cancellation. Father sells appreciated property to Daughter for a long-term installment note. Daughter enjoys the benefit of her high purchase price basis. Years later Father writes "cancelled" across the face of the note. Reversing the extraordinary result reached in one decided case, 33/ the bill declares the event a disposition taxable to Father. 34/

2. Lapse. Father does not cancel the note. Instead, he takes no action to collect and, under state law and in the fullness of time, the obligation becomes unenforceable. Under the bill, Father's previously deferred gain is recognized. 35/

3. Bequest. The note is still valid and enforceable when Father dies. The note passes to Father's estate, a nontaxable disposition under section 691(a)(2). Subsequently, the

estate distributes the note to Daughter, the obligor, who is an estate beneficiary. The bill amends section 691(a)(2) to make it clear that testamentary transfer to the obliger, yet another form of cancellation, is a taxable event. 36/

III. Comments on the Present Form of the Bill

Attesting to the care with which it was formulated, the Installment Sales Revision Act, in the form passed by the House of Representatives, raises in our view only a few concerns.

A. Technical Problem in Certain Section 337 Liquidations.

The technical problem in issue focuses on proposed section 453(h)(2) and seems best explainted by illustration.

> Example. Mr. A owns all of the stock of X corporation at an adjusted basis of $300,000. He is on the calendar year. X owns two investment properties. On July 1, 1980 X adopts a plan of complete liquidation (comporting with section 337), promptly sells one investment property for $400,000 cash, and distributes the cash to A before year end. On February 1, 1981 X sells its other property for $600,000 in long term installment notes (bearing adequate interest) and distributes the notes to A in completion of its liquidation.

Under present law and under the bill, in 1980 (year-1) A offsets his entire $300,000 basis in the X shares against the $400,000 cash distributed to him in that year. He thus reports 1980 capital gain of $100,000. Receipt of $600,000 of installment notes in 1981 (year-2), however, requires an adjustment. The informing notion is this: Had A received the total distribution of cash and notes in a single taxable year he would have been required ratably to allocate his $300,000 basis 40% ($120,000) to

the cash and 60% ($180,000) to the notes and thus would have been required to recognize immediate gain of $280,000 (cash of $400,000 less $120,000 basis allocated to the cash). Since A recouped his entire $300,000 basis in year-1 and recognized in that year only $100,000 of gain, he now is obliged to recognize an additional $180,000 of capital gain and will hold the installment notes at a basis of $180,000.

The single issue is one of timing. Is A to recognize the additional $180,000 gain in year-2 (1981), the year in which the liquidation is completed and all facts are known (a catch-up approach)? Or is A to recognize the additional gain in year-1 (1980), the year in which the excess cash was in fact received, in which event A must be required to file an amended return for that taxable year? 37/

The bill's proposed section 453(h)(2) adopts the amended return approach. This is a "pure" solution in that it essentially deprives Mr. A of the financial advantage inherent in even a one year postponement of gain recognition. It is, nonetheless, a troubling solution in that it produces one of the very rare cases in which the tax law requires the filing of an amended return to change prior year reporting to reflect events occurring after the close of that prior year. 38/

The catch-up approach, under which Mr. A would first calculate his year-2 tax results as if all distributions were made in that year and then would subtract the gain recognized and reported in year-1, lacks the conceptual purity of the amended return solu-

tion. But it is, in our view, a simpler and thus a preferable solution. The X corporation of the example may be widely held and Mr. A's basis $300, not $300,000, his proceeds $400 cash and $600 notes, not $1 million. This Mr. A has difficulty enough filing one tax return each year. He is unlikely to view an amended return directive as the triumph of tax simplification.

While we believe the catch-up solution preferable, we are not militant in our objection to the bill's amended return requirement. It is our understanding that the Federal Tax Division of the AICPA and the Treasury Department currently view the matter as we do, prefering the catch-up solution but quite prepared to follow the amended return route should Congress find that "pure" solution the better solution.

If, however, our recommendation in favor of catch-up is adopted, proposed section 453(h)(2) must be redrafted. We suggest the following language (new material underlined):

> (2) Distributions received in more than 1 taxable year of shareholder. -- If --
>
> (A) paragraph (1) applies with respect to any installment obligation received by a shareholder from a corporation, and
>
> (B) by reason of the liquidation such shareholder <u>or his successor</u> receives property in more than 1 taxable year,
>
> then, on completion of the liquidation, basis previously allocated to property so received shall be reallocated <u>between such</u> taxable years so that the shareholder's basis in the stock of the corporation is properly allocated among all property received in such liquidation by such

shareholder or any successor. If by reason of such reallocation recognized gain, in excess of gain previously recognized, shall be attributable to an earlier taxable year, such additional gain shall be treated as recognized at the time such liquidation is completed. 39/

B. Interspousal and Self-Dealing Transactions.

Proposed sections 453(g) denies installment treatment, and in effect forces accrual, when depreciable property is sold to spouse, 80% controlled corporation, or 80% controlled partnership. In the analogous section 337 context, proposed section 453(h)(1)(C) denies installment treatment (but does not require accrual) when a shareholder receives the debt obligation of purchasing spouse, 80% controlled corporation, or 80% controlled partnership. As proposed in the bill, in the section 337 context installment treatment is disallowed whether the property purchased is depreciable or nondepreciable. As discussed in Part II C 3 of this report, these rules are uncomfortably disparate and the concern engendering them might well attract any of a number of other, better coordinated responses.

Our strong support of the bill in no way is contingent upon the retention or the revision of the proposed self-dealing provisions. Nonetheless, because the disparate tax treatment embodied in these provisions does not well conform to the bill's overriding simplification objective, if self-dealing rules are to be maintained in the bill we prefer a set of rules under which the tax results are the same whether the particular self-dealing transaction is a direct sale or is a section 337 sale.

One method of achieving this simplifying objective would tie proposed section 453(g), the direct sale provision, to the Code's present self-dealing provisions, sections 707(b)(2) and 1239, but limiting attribution to spousal attribution only. A direct sale falling within the ambit of either of these provisions will be denied installment treatment and subjected to mandatory accrual. At a minimum, revised section 453(g) should grant an exception, identical to one currently in the bill, when it is established to the satisfaction of the Secretary that the sale did not have as one of its principal purposes the avoidance of federal income tax. Other exceptions of the no tax avoidance sort, by statute or committee report, should cover transactions incident to legal separation or divorce and cases in which under the installment method the seller's gain will not be deferred significantly beyond the time the related buyer enjoys augmented depreciation deductions. The section 337 provision, proposed section 453(h)(1)(C), then would call into play the new section 453(g) rule, treating the shareholder as if that taxpayer had sold the corporate property directly to the issuer of the installment obligation.

C. Certain Related Party Sales: Death of Spouse.

Reactive to the *Rushing* problem, proposed section 453(e) permits installment reporting when the sale is to a related party (but is not a self-dealing transaction), but accelerates recognition of the otherwise deferred gain if the buyer voluntarily and too quickly undertakes a "second disposition" of the property. As an exception, proposed section 453(e)(6)(C) sensibly provides that

a transfer subsequent to the death of either the related seller or the related buyer shall not be treated as a "second disposition." The bill does not in terms advert to the not unusual case in which, by community property or by deed, the "seller" or the "buyer" is husband and wife owning the property jointly or in common. We believe considerations of tax simplification and tax equity support extending the present death-cleansing exception to cover fully the usual husband-wife cases. If Mother and Father, joint owners of a parcel of real property, sell on the installment method to Child and Child's spouse and, within two years, any of these four individuals dies, a subsequent transfer of the property should not accelerate any of the deferred installment gain. To prevent tax avoidance planning, however, we recommend expansion of the bill's current exception to cover only the normal case in which the spouses hold their interests as community property or, in non-community property jurisdictions, hold equal undivided interests in the property.

IV. Additional Issues for Committee Consideration

The bill does not attempt to resolve every anomaly in the taxation of future payment sales. In particular, the bill excludes from its coverage a series of conceptually connected issues relating to payment. While we find the bill's focussed approach sensible, we believe there is at least one installment sale issue, highlighted in very recent litigation, that merits prompt Congressional response. In addition, we note below two other installment sale concerns for the attention of the Com-

mittee. One, a provision of the current statute that has attracted nearly universal disapprobation, could easily be attended to in the present bill. The other, relating to collection gain, raises issues of policy unrelated to normal installment sales; we do not urge that it be treated in the pending legislation but do recommend that, near term, the Committee reexamine and appropriately react to this area of disparate tax treatment.

A. Certain Secured Obligations of Future Payment.

The February 28, 1980 decision of the Tax Court in J. K. Griffith, 73 T.C. 933 strongly suggests that the definition of "payment" in proposed section 453(f)(3) merits clarifying expansion.

In Griffith, Farmer sold a cotton crop to an unrelated purchaser under a deferred payment contract. The purchaser's obligation under the contract was secured by a standby letter of credit (Farmer could not draw upon the letter of credit unless the purchaser first defaulted in payment). Farmer's rights under the deferred payment contract were explicitly designated non-negotiable and nontransferable. The standby letter of credit also was explicitly nontransferable. Over four dissents, a majority of the Tax Court concluded that, by reason of the standby letter of credit, Farmer had received full payment in the year of sale and could not report the transaction on the installment method. Since Farmer would in fact receive cash only over a period of five years commencing two years following the sale, the burden placed on him by the Tax Court's determination was severe.

The decision in Griffith is particularly troubling because it came as an almost complete surprise. Less than five months earlier the Tax Court, in C. J. Porterfield, 73 T.C. 91 (1979) on far less compelling facts (a bank certificate of deposit had been escrowed as collateral security for the purchaser's note) found no "payment" and validated installment reporting. In so doing the court narrowly distinguished on grounds of intent its prior contrary holding in J. Earl Oden, 56 T.C. 1165 (1971).

Dissenting in Griffith, Judge Sterrett made the essential point: -

> "Installment sales are not narrowly, or even primarily, the province of wealthy individuals, large corporations, and their sophisticated tax advisers. Sales for future payment are made by persons at virtually all economic levels -- by individuals who are not wealthy, by small corporations, by persons lacking access to the most sophisticated tax advice. . . . [Due to its complexity section 453 often] imposes an undue and never intended burden on taxpayers who, through inability, inadvertence, or inadequate advice, fail to take steps that are now necessary to qualify their deferred payment sales for deferral of tax liability" [quoting testimony given at last summer's hearing on S.1063]. The instant case and the majority position thereunder exemplify the harrowing aspects of the foregoing testimony.
>
> . . . In Oden the petitioner looked to and actually received payment from the escrow account, and accordingly we found that the escrow was not intended as security for the buyer's obligation. In the recent case of Porterfield . . . even though the escrow agreement . . . provided that the escrow funds were to be paid to petitioner, we found that the

parties' actions and intentions were to the contrary, and that the escrow served as security for the buyer's obligation. Therefore, we held that the petitioner was entitled to report the sale on the installment method.

The actions and intentions of petitioner in the instant case are clear. Petitioner received a nontransferable letter of credit. The agreement provided that the letter of credit was to serve as security and could only be collected in the event of default by the buyer. Further, as in Porterfield, there never was a default; petitioner looked to and received all payments from the buyer. . . .

In the instant case the majority looked not at the language of the agreement or the actions of the parties as provided in Oden and Porterfield but instead to law review articles to find that petitioner was in constructive receipt of the proceeds under the letter of credit. I do not challenge the majority's analysis of the U.C.P. but only the necessity thereof. It implicitly asks too much of the taxpayer and his counsel. The issue is whether the letter of credit was security. . . . Petitioner has satisfied the test as set out in Oden and applied in Porterfield. Accordingly, he should be entitled to rely on our decisions therein and report the sale under the installment method.

When this Court demands certain taxpayers obtain a legal opinion letter on the transferability of proceeds under a non-transferable letter of credit while excusing other taxpayers for their failure to read or understand documents executed by them (as we did in Porterfield), we are creating the type of confusion and complexity about which [the witness at the hearings on S. 1063] testified. Effectively, section 453 is no longer a relief provision allowing the taxpayer to defer taxation until receipt of the proceeds, but instead a tax trap for the ill advised. The line between Oden, Porterfield and the instant case has become so convoluted as to create a web. Unfortunately, and unintentionally, only

> the wealthy individual or corporation with the "most sophisticated tax advice" will be able to avoid entanglement.

The escrowing against an installment obligation of cash or its equivalent (such as a certificate of deposit) seems to us a matter quite different from the posting of security in the form of a nontransferable standby letter of credit upon which the seller may draw only after the purchaser has defaulted. Uncertain of the purchaser's long-term financial strength, the seller seeks assurance of ultimate payment. The purchaser able to obtain a standby letter of credit finds it an attractive device. Current bank borrowing would inflict on the purchaser an annual interest charge of 12% or more; the letter of credit will cost the purchaser annually in the neighborhood of 1% of the drawable amount. If, as was the case in Griffith and is often the case, the interest rate on the purchaser's installment obligation to the seller is substantially less than 12%, it is the purchaser and not the seller who derives significant economic benefit from the arrangement.

Were Griffith the only very recent court decision to intimate disaster when letter of credit security is used, we might be slower to urge immediate Congressional response. But Griffith does not stand alone. On March 14, 1980 the Court of Appeals for the Fifth Circuit decided Watson v. Commissioner, 40/ once again involving a farmer selling a cotton crop for a deferred payment agreement secured by a letter of credit. While technically distinguishable from Griffith in that Mr. Watson, naively having contracted for but a single payment, could not and did not elect

the installment method of reporting, the case is on target as regards letter of credit security:

> The Watson's second contention is that the letter of credit was not assignable. . . . The Watsons overlook [Tex. Bus. & Com. Code] section 5.116(b). Subsection (b) provides that a beneficiary may assign the right to proceeds, even though the credit expressly states that it is non-transferable or nonassignable . . . . Given Section 5.116(b), we are unable to agree with the Watsons' argument that this letter of credit was not assignable. . . .
>
> The Watsons final point of error is based upon lack of a familiarity with letters of credit. Appellants point to the trial testimony, which shows that Sonny Watson did not know what a letter of credit was; did not know he would receive a letter of credit from Security Bank; and did not know he could use the letter of credit as collateral for a loan. The record reveals that all the Watsons wanted to do was defer their income from the sale of their 1973 crop until the following year. [The Watsons had been unable to sell part of their 1972 crop until 1973, and sought to avoid a doubling up of income in that year.]
>
> While this Court might be sympathetic to the plight of the Watsons, the invitation to apply a subjective standard when assessing tax liability must be rejected.

In sum, a near perfect disaster. Commercially naive and wholly unrepresented, farmer sold his crop for deferred payment, and was handed as security a nontransferable and nonassignable letter of credit which he did not request, did not understand, and did not make any use of during the taxable year. Had farmer retained a lawyer of great commercial acumen, farmer would have learned not only what a letter of credit is, but also that under Texas law

proceeds of a letter of credit are assignable though the letter itself is not. Consulting a skillful tax lawyer, farmer then would have learned that the mere ability to assign proceeds might subject farmer to immediate tax liability on the proceeds he would not until later receive. Armed with all of this sophistication, farmer who never asked for the letter of credit in the first place would have refused to accept it, thereby avoiding a tax problem (unless the Commissioner were to assert the very rejection constituted constructive receipt), but obligating himself to pay two hefty legal fees. His entire cotton crop was worth approximately $42,000.

Surely the tax law can do better than this. 41/

Reactive to the current entagled state of the case law, we urge that Congress furnish at least minimal clarification by revising proposed section 453(f)(3) along the following lines (new language underlined):

> (3) Payment. -- Except as provided in paragraph (4), the term "payment" does not include the receipt of evidences of indebtedness of the person acquiring the property, without regard to whether such evidences of indebtedness are guaranteed by any other person or are secured by a standby letter of credit.

Our recommendation is designed to be conservative. The reference to another's guarantee makes explicit what is understood to be current law. Like the standby letter of credit, the guarantee is commercially distinguishable from the cash or cash equivalent escrow. We do not urge a statutory reaction to the escrow

arrangement, believing there are factual situations in which it may be appropriate and others in which it is not. 42/ We do suggest that the Committee Report state that no inference regarding such arrangements be drawn from the absence of explicit reference to them in new section 453(f)(3), and that no inference as to prior law be drawn from the new statutory treatment of guarantees and standby letters of credit.

B. Change From Accrual to Installment Basis.

A retailer or other dealer in personal property, historically accounting for tax purposes on the accrual method, is permitted to change to the installment method. Present section 453(c), applicable in this circumstance, contains unusually complex adjustment rules. Because of the complexity and, in some cases, the perceived unfairness of these rules, dealers normally avoid their application by selling to a third party all of the uncollected accounts receivable then in-house. Section 453(c) thus fosters sale transactions which, other than in tax consequence, are economically undesirable.

The Federal Tax Division of the AICPA has recommended to the Committee that section 453(c) be amended to obviate the need to dispose of receivables in-house. We believe this recommendation to be soundly based and noncontroversial, and endorse the Division's proposal.

C. Collection Gain.

The character of collection gain in a qualifying installment sale is determined by the character and holding period

of the property sold. This is appropriate. However, outside the installment sale area, it is an unfortunate anomaly of current law that collection gain can qualify as long-term capital gain if the obligor is a corporation or governmental entity, but cannot qualify for capital gain treatment if the obligor is neither. 43/ The divergent tax treatment is senseless. A seller's tax ought not depend upon the identity of an unrelated buyer. At the hearings held last summer it was the generally expressed view that this anomaly in present law ought to be expunged. But, the problem arising only outside the installment sale arena, it is one to be resolved on another day.

V. Conclusion

The proposed Installment Sales Revision Act of 1980 is commendable tax legislation. It is our earnest hope that Congress will move swiftly to enact this bill, and that the bill's adoption and the careful collegial process through which it was formulated will furnish the encouragement and the blueprint for future legislation designed to simplify and improve our inordinately complex tax law.

Respectfully submitted,

Committee on Simplification
Section of Taxation
American Bar Association

Committee on Taxation
Association of the Bar
of the City of New York

Tax Section
New York State Bar Association

FOOTNOTES

1. Rev. Rul. 69-462, 1969-2 C.B. 107, amplified by Rev. Rul. 71-595, 1971-2 C.B. 223; Baltimore Baseball Club, Inc. v. United States, 481 F.2d 1283 (Ct. Cl. 1973); 10-42 Corp., 55 T.C. 593 (1971).

2. This problem, a severe one when the sale agreement calls for both fixed future payments and contingent future payments, is generically known as the Gralapp problem. See Gralapp v. United States, 319 F.Supp. 265 (D.Kan. 1970), aff'd, 458 F.2d 1158 (10th Cir. 1972); In re Steen, 509 F.2d 1398 (9th Cir. 1975). But cf. National Farmers Union Service Corp. v. United States, 67-1 U.S.T.C. ¶9234 (D.Colo. 1967), aff'd on other grounds, 400 F.2d 483 (10th Cir. 1968).

3. Proposed §453(b)(1).

4. Ibid.

5. Congressional Record, March 19, 1980, H 2004. See also, to the same effect, H.R. Rep. No. 96-1042, 96th Cong. 2d Sess. 4, 20-21 (1980).

6. Statutory authority for development of the necessary or appropriate regulations is provided by proposed §453(i).

7. The first statutory installment sale provision, §212(d) of the Revenue Act of 1926, contained a 25% initial payment limitation justified as a means of resolving a question of valuation of the property sold on the assumption that property thereafter served as security for the debt. S. Rep. No. 52, 69th Cong., 1st Sess. 20 (1926). In the Revenue Act of 1928 the limitation was raised to 40%, justified as a dividing line between cases in which the seller has and does not have "a substantial assurance of the actual payment of the full amount of the deferred purchase price." H.R. Rep. No. 2, 70th Cong., 1st Sess. 14 (1928). The Revenue Act of 1934 introduced the 30% limitation and yet a different justification, the presumed ability of the seller who has received more than 30% to pay the entire tax. H.R. Rep. No. 704, 73d Cong., 2d Sess. 24 (1934). Two decades later the Tax Court conjured up a fourth justification, administrative convenience. Ivan Irwin, Jr., 45 T.C. 544, 550 (1966), rev'd on another point, 390 F.2d 91 (5th Cir. 1968).

8. Proposed §453(a).

9. Proposed §453(d).

10. See Congressional Record, March 19, 1980, H. 2004 (floor statement of Chairman Ullman).

11. See, *e.g.*, *Mercedes Frances Freeman Trust v. Commissioner*, 303 F.2d 580 (8th Cir. 1962); *West Shore Fuel, Inc. v. United States*, 598 F.2d 1236 (2d Cir. 1979); Rev. Rul. 73-500, 1973-2 C.B. 113.

12. *W.B. Rushing*, 52 T.C. 888, 896 (1969), *aff'd*, 441 F.2d 593 (5th Cir. 1971).

13. See *Nye v. United States*, 407 F.Supp. 1345 (M.D.N.C. 1975); *William D. Pityo*, 70 T.C. 225 (1978); *Clair E. Roberts*, 71 T.C. 311 (1978); *Carl E. Weaver*, 71 T.C. 443 (1978). *Cf.* *Philip W. Wrenn*, 67 T.C. 576 (1976); *Paul G. Lustgarten*, 71 T.C. 303 (1978); Rev. Rul. 73-157, 1973-1 C.B. 213; Rev. Rul. 73-536, 1973-2 C.B. 158; Rev. Rul. 77-414, 1977-2 C.B. 299.

14. Proposed §453(h).

15. Proposed §453(h)(1)(E).

16. Proposed §453(h)(1)(B), cross referencing to §337(b)(2)(B).

17. Proposed §453(h)(1), which establishes the described rules, by disassociating (with the single exception of piecemeal sales of inventory) corporate level and shareholder level tax consequences, is excellently designed to avoid the intractable shareholder reporting and IRS audit problems that would be presented if, for example, installment reporting eligibility at the shareholder level were tied to nonrecognition at the corporate level A separate technical problem is, however, presented by the bill's treatment of distributions received by a shareholder in more than one taxable year. Proposed §453(h)(2). That separate technical problem and a recommended solution are discussed in part III of this report.

18. Proposed §453(e).

19. Proposed §453(e)(2)(B). Although not specifically cataloged in the proposed statute, we assume that the reference there to "a short sale or any other transaction" would encompass the related buyer's borrowing (within the two years) nonrecourse against the property, at least if the amount borrowed represents a significant percentage of the property's value.

20. Proposed §453(e)(6)(A). A subsequent resale of its own shares by the issuer presents no installment sale qualification problem since, under §1032, an issuer is not taxed on

the sale of its own shares. Thus, the initial installment purchase furnished no tax avoiding basis advantage.

21. Proposed §453(e)(6)(C).

22. Proposed §453(e)(6)(B).

23. Proposed §453(e)(7). This provision is modeled on §302(c)(2), which cuts off family attribution in certain corporate stock redemptions. §302(c)(2) provides an advantageous reference. The Commissioner is generally perceived to have exercised his authority under that provision in a fair and balanced manner. See, e.g., Rev. Rul. 77-293, 1977-2 C.B. 91. Like the proposed statute, §302(c)(2) focuses exclusively on the avoidance of federal income tax. Related party installment sales, particularly with respect to farm properties and closely held businesses, more often are motivated by considerations of estate planning than with income tax avoidance in view.

24. Proposed §453(e)(3).

25. Proposed §453(e)(5).

26. Receipt of like-kind property, although otherwise nontaxable, under present law is treated as a payment with respect to the installment debt portion of the exchange consideration. See Rev. Rul. 65-155, 1965-1 C.B. 356; Clinton H. Mitchell, 42 T.C. 953 (1964); C. W.Yeager, 18 T.C.M. 192 (1959).

27. Under present law it is unclear if installment debt boot, received in exchange for shares under §356(a)(1), may be reported on the installment method. Compare Frances M. Avrill, 37 B.T.A. 485 (1938), rev'd on other grounds, 101 F.2d 644 (1st Cir. 1938)(holding no), with LTR 7941022 (ruling 18)(holding yes).

28. It is the position of the Internal Revenue Service, Rev. Rul. 69-83, 1969-1 C.B. 202, that §1038 treatment is unavailable to a repossessing estate or beneficiary of a deceased seller. On this theory the repossessing successor recognizes previously deferred installment gain offset, to the extent appropriate, by the deduction afforded under §691(c). The Service's position seems devoid of a sound basis in tax policy and has not been tested in court.

29. Proposed §453(f)(6).

30. Ibid.

31. Proposed §1038(g).

32. The concept of treating as basis to a successor what would have been an exclusion (or deduction) to a predecessor was employed by the Tax Court in Ridge Realization Corp., 45 T.C. 508 (1966)(§111 case).

33. Miller v. Usry, 160 F.Supp. 368 (W.D.La. 1958).

34. Proposed §453B(f)(1). Because buyer and seller were related, the installment obligation is treated as worth not less than its face amount. Proposed §453B(f)(2).

35. Proposed §453B(f)(1), (2).

36. Proposed §691(a)(5).

37. In the example case all cash was received in year-1 and thus all immediately recognizable gain can be attributed to that year. There can of course be cases in which cash is received in both taxable years in which event gain may be attributed to each, and cases in which the installment notes are distributed in year-1 and the cash is distributed in year-2. The latter case presents no amended return problem, and the former is analytically indistinguishable from the example case.

38. Other cases are exemplified by the failure timely to reinvest in a new principal residence the proceeds of sale of a prior principal residence. See §1034(j).

39. The inserted references to the shareholder's "successor" are to take account of the case, for example, in which the shareholder dies after the first liquidating distribution and before the second.

40. Watson v. Commissioner, 693 F.2d 594 (5th Cir. 1980) (not a §453 case).

41. In fact, the tax law very recently has done much better. On April 14, 1980, the Court of Appeals for the Tenth Circuit, in Sprague v. United States, Civil No. 76-0263-B, reversing 78-2 U.S.T.C. ¶9650 (W.D. Okla. 1978), held receipt of buyer's note secured by a standby letter of credit did not constitute year-of-sale payment and thus did not prevent installment reporting of the sale. Thus, the tax law again is in a muddle of uncertainty and a Congressional directive sorely needed.

42. For valid business reasons, an installment obligor who originally furnished as security the property purchased may offer to substitute a cash escrow in order to free the purchased property from pledge. In 1968 the Internal Revenue Service

published a favorable ruling validating this arrangement. Rev. Rul. 68-246, 1968-1 C.B. 198. Nine years later the Service revoked (prospectively) that ruling. Rev. Rul. 77-294, 1977-2 C.B. 173. Thus, for nearly a decade the Service publicly recognized, as the courts continue to recognize, that there are situations in which even an escrow of cash may qualify as security and not as actual or constructive payment.

43. See §1232(a).

Committee on Simplification
Section of Taxation
American Bar Association

Committee on Taxation
Association of the Bar
of the City of New York

Tax Section
New York State Bar Association

H.R.6883

INSTALLMENT SALES REVISION ACT OF 1980

Summary of

Report Submitted to the Subcommittee on
Taxation and Debt Management Generally,
Senate Finance Committee
September 10, 1980

We highly commend both the process of substantive tax simplification exemplified by H.R.6883 and the tax simplifying and rationalizing provisions of the bill itself. The following briefly summarizes the detailed Joint Bar Report we have submitted for inclusion in the record.

A. Coverage of the Bill

1. We approve elimination of the two payment rule.

2. We approve extension of installment treatment to sales for contingent payments.

3. We approve elimination of the 30% initial payment limitation.

4. We approve elimination of the current $1,000 floor amount qualifying installment sales of personal property.

5. We approve the automatic granting of installment treatment to all deferred payment realty sales and casual sales of personal property, and the provisions for a timely election out of installment treatment.

6. We approve extending installment treatment to shareholders of a corporation which, in process of liquidation under section 337, sells its assets for deferred payment obligations and distributes those obligations to the shareholders.

7. We approve the carefully tailored provisions covering the installment sale to a related party other than spouse or 80% controlled corporation or partnership; under these provisions, installment method deferral is allowed but gain, previously deferred, is triggered if and to the extent the related purchaser voluntarily retransfers the property too early.

8. We approve the sensible extension of installment treatment to future payment obligations received incident to an otherwise tax free like-kind exchange or corporate reorganization exchange.

9. We approve the extension of section 1038 nonrecognition benefits to the repossessing estate or beneficiary of a deceased installment seller of real property.

10. We approve the clarification of the installment obligation disposition rules as they relate to the various forms of cancellation.

B. Comments and Suggestions

H.R.6883, although covering a number of related and highly technical subjects and thus vulnerable to technical error, is extremely well drawn. We have only three comments or suggestions on the present form of the bill.

1. The proposed treatment of shareholders receiving installment obligations incident to a section 337 corporate liquidation is, in general, excellent. Our only technical comment relates to the treatment of liquidating distributions received by a shareholder in two consecutive taxable years of the shareholder. Properly to allocate stock basis between first and second year distributions, the bill requires that the shareholder file an amended return for year-1. An alternative course, and one we believe preferable because simplifying, is adoption of a "Catch-up" approach under which the shareholder reflects all appropriate adjustments in the tax return filed for year-2.

2. The bill denies installment treatment when the deferred payment sale, whether direct or through a corporation liquidating under section 337, is to a "closely related" purchaser (spouse or 80% controlled corporation or partnership). The rules promulgated by the bill are somewhat discordant. On a direct sale they apply only if the property sold is depreciable; in the section 337 context the rules apply whether the property is depreciable or not. Accrual accounting is mandated on a direct sale; the taxpayer's normal method of accounting applies in a section 337 transaction. Our bar association tax groups are not of one mind as to the significance or breadth of the issue addressed in these rules, but we collegially favor a harmonizing revision that would attract the same tax treatment whether the sale is direct or through a corporation liquidating under section 337. However, our strong support of H.R.6883 is in no way contingent upon the revision or retention of the provisions now in the bill.

3. When property is sold to a related party (other than spouse or controlled entity), the risk that previously deferred installment gain will be accelerated by the

purchaser's too early second disposition is eliminated if either purchaser or seller has died. The bill does not specifically advert to property owned by husband and wife in joint tenancy or as community property. We recommend the exception now contained in the bill be expanded to encompass the death of either spouse, whether co-ownership is on the seller side, the related purchaser side, or both.

C. Additional Issues for Committee Consideration

Sensibly, the bill does not attempt to resolve every anomaly in the taxation of future payment sales. We support the focused approach taken in the bill but believe there are two issues, not controversial but of special significance, that deserve the Committee's attention at this time.

1. Three very recent court decisions, inconsistently decided, make it wholly unclear whether installment reporting is available when the deferred payment obligation is secured by a standby letter of credit. The taxpayers who to date have been held taxable on payments not received have been cotton farmers at least one of whom was not even aware the buyer's obligation was secured. We urge that the bill's definition of "payment" be amended to make it clear that installment reporting will not be unavailable merely because the buyer's future payment obligation is guaranteed by a third person or is secured by a standby letter of credit.

2. Present section 453(c), in point when a retailer or other dealer in personal property changes from the accrual method to the installment method of tax accounting, is unusually complex and, in application, often unfair. Well advised dealers avoid the provision by selling to a third party all uncollected accounts receivable then in-house. Taxpayers less well advised, often smaller retailers, risk entrapment. We endorse the recommendation of the Federal Tax Division of the AICPA to simplify and rationalize the present provision.

Mr. GINSBURG. Mr. Chairman, I also have prepared a very lengthy written statement of my own. The subcommittee's patience is legion, but I suspect that it is not without limits. I would like to deliver this morning a much shorter discussion.

Senator BYRD. That, too, will be inserted in the record.

Mr. GINSBURG. Thank you.

I will follow Senator Dole's suggestion of concentrating only on problems. Therefore, with respect to the bill itself, I will simply say that we think this is a super bill.

There are a couple of issues in the background, and a couple of questions that were raised this morning. I will focus on these.

The proposed treatment in the bill of shareholders receiving installment obligations incident to a section 337 corporate liquidation is in general excellent. The only technical suggestion relates to the treatment of liquidating distributions received by a shareholder in two consecutive taxable years.

Properly to allocate stock basis between first and second year distributions, the bill requires that the shareholder file an amended return for year one. An alternative course, and one we believe preferable because it is simplifying, is the adoption of a catch-up approach under which the shareholder elects all appropriate adjustments in the tax return to be filed for year two.

We are frank to admit that there are good arguments for the amended return approach that is now in the bill, just as we believe there are good arguments supporting the catch-up approach we prefer. Either one will work.

We prefer the year-two catch-up simply because taxpayers have enough difficulty filing one tax return each year. We do not think that most taxpayers will view an amended return directive as the triumph of tax simplification. But we are not militant about this, and we believe that either way will work.

The second point I would like to discuss is a bit of an added starter, we hope, to the bill. Three very recent court decisions inconsistently decided make it entirely unclear whether installment reporting currently is available when a deferred payment obligation issued by an unrelated purchaser is secured by a standby letter of credit.

The taxpayers who to date have been held taxable on payments they have not received have been cotton farmers, at least one of whom was not even aware the buyer's obligation was secured by anything.

We urge that the bill's definition of payment be amended to make clear that installment reporting will not be unavailable merely because the buyer's future payment obligation is guaranteed by a third party, or secured by a standby letter of credit.

We are delighted to discover that on page 4 of the Treasury's statement submitted this morning, the Treasury does not object to this.

That, I think, brings me to the hotter item of the day, related party sales. I think two things have been focused in the discussion this morning. One is the ultimate exemption: If all else has failed you get out of problems if you can show to the satisfaction of the Secretary that tax avoidance was not in the picture.

It has been suggested that the Treasury Department once again has come in with a notion to excessively restrict taxpayers. In fact, the history is somewhat different.

The proposal came out of the institutional tax groups, and not out of the Treasury Department. Perhaps a moment of history is worthwhile here.

Senator, you will I think recall that last year when the windfall profit tax bill was being debated, the business community, small business and large business, more than adequately represented by lawyers and accountants came down to the Senate and asked for a few additional amendments that were perhaps not 100 percent germane to the crude oil profit tax.

One of those had to do with the problem of invasion of LIFO inventory layers. It was presented to the Senate in this way:

Some terrible cosmic international event occurs. There is a boycott, or an interruption of foreign trade, and the business people who are on LIFO discover that they must invade their inventory, sell off LIFO layers. This is disadvantageous because one suddenly pays a lot of previous deferred tax.

It was urged that in that sort of situation taxpayers should be allowed to replenish their inventory and get back the tax that they paid during the bad year.

This was a sympathetic position but it raised a problem. If a cosmic event occurs, how do you know whether the particular taxpayer has sold off all that back inventory at an awfully high price because the taxpayer really had no choice, it was forced on him by the event, or whether it is simply a case of the taxpayer saying: "What a good price I can get for these goods, which by definition are in short supply."

We had no trouble, then, suggesting how to work this out. The Senate proposed, and Congress enacted a new section 473. Section 473(c)(1)(B) says it very nicely. You are OK if the taxpayer establishes to the satisfaction of the Secretary that such a decrease in inventory was properly motivated, properly attributable to the cosmic event.

We thought that was a fine idea last year. We were entirely happy to go on the basis of satisfying the Secretary. Mr. Chairman, it was good last year. It is good this year. It is the same kind of a problem.

The other issue that has been focused this morning has to do with the husband and wife matter, the closely related taxpayer problem in which the House bill takes a restrictive position.

In our joint report we spend a lot of time, a lot of pages, on this because people do have different views as to whether this is a problem, how big a problem it is, and how it ought to be resolved.

Some people think—the people I am referring to are my people, the Bar Association groups—that the provision in the House bill is too tight. Some think it is too loose, and it should be tightened some more. Some people have intermediate positions on it.

There has been an awful lot of discussion with the staffs, and with the Treasury. It has been suggested that the real problem, to the extent that there is a real problem, with the provision is that as it stands it affords disparate treatment to essentially similar situations.

In some types of sales it applies only to depreciable property. In certain other situations it applies to any property. In some circumstances it applies an accrual rule. In some it does not.

What we think is needed, and I believe there is general agreement on this, is a harmonizing change, so that the tax results will be the same whatever type of sale it is, a direct sale, a sale through a liquidating corporation, and so forth.

We have a suggestion for that in our report. Essentially we understand that it is technically acceptable to the various participants.

How will it all work? What about the small parade of horribles that we heard this morning. If husband and wife own the home in which they live full time, and one of them makes an installment sale to the other, under the proposal there is no problem. It is not depreciable property. They are free to do so.

Perhaps the more interesting example this morning focused on a vacation home. They live in it part time, and they lease it out for the rest of the time. We have a second wife, and a little real estate planning going on, and we are going to have husband sell the thing to second wife for a long deferred payment.

As a technical matter, it was suggested that if the bill applied to this case, the husband would have to accrue not only the selling price but also all future interest. I believe that is technically incorrect. Only the sale price, and not the future interest, would be accrued. But in fact, on the example given, nothing should be accrued.

As the written testimony that was submitted this morning points out, section 280A of the code would apply in this case, and would limit and actually probably eliminate a depreciation deduction. The property might have been depreciable, but there is no depreciation advantage. Under the bill, if there is no tax advantage accruing to the husband and wife transaction, there is nothing to be triggered off by the bill. So that one, I think, also would be exempt.

I would close with two comments, both of which amuse me. The first is, I think the taxpayer in that case does have a cause of action against the lawyer for malpractice, since what has happened in the case is a gain that either would have been exempt from taxes by virtue of death stepped-up basis, or ultimately what would have been capital gain, has been converted to ordinary income under current section 1239. I think that that is rather bad advice.

The other point relates to the comment that was made that, if you have a low rate of interest on the note and the noteholder dies, it will be valued in the estate at a lower than face amount value. I think that is correct under present law.

The difficulty with that example I think is, first, in husband and wife transactions, in my experience, the sale is made for a full, fair, high rate of interest because the interest expense and the interest income wash out in the joint return.

Much more significantly, Mr. Chairman, if there is a problem, the solution is obvious. It is to have the estate take over the basis the decedent had in the note.

I did not think that I would ever come to this committee and hear a proposal for carryover basis again. Because that is what this

is. While it is the rare case in which carryover basis would help the taxpayer, there is an old story about the camel's nose being in the tent. Experience tells us that the camel is rarely far beyond its nose. I really don't think the committee would want to do this.

Thank you.

[Statement of Martin D. Ginsburg follows:]

STATEMENT OF MARTIN D. GINSBURG
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE
ON H.R. 6883

SEPTEMBER 10, 1980

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

MY NAME IS MARTIN D. GINSBURG. I AM A PROFESSOR OF LAW AT GEORGETOWN UNIVERSITY LAW CENTER TEACHING VARIOUS SUBJECTS IN THE FIELD OF FEDERAL TAXATION. WHEN I LAST HAD THE PRIVILEGE OF ADDRESSING THE SUBCOMMITTEE, I WAS A PROFESSOR OF LAW AT COLUMBIA UNIVERSITY, WHICH ONLY PROVES THAT EVEN ACADEMICS MOVE ABOUT. FOR SOME TWENTY YEARS PRIOR TO JOINING THE ACADEMIC COMMUNITY, AND WITH A MORE MODEST COMMITMENT OF TIME SINCE JOINING THE COLUMBIA AND MORE RECENTLY THE GEORGETOWN FACULTY, I HAVE PRACTICED LAW IN NEW YORK CITY AND IN WASHINGTON, PRIMARILY IN THE FEDERAL TAX FIELD.

I AM VERY PLEASED TO TESTIFY THIS MORNING WITH RESPECT TO HOUSE BILL 6883, LEGISLATION INTENDED TO CLARIFY, SIMPLIFY, AND VASTLY IMPROVE THE FEDERAL INCOME TAX TREATMENT OF INSTALLMENT SALES AND OTHER DEFERRED PAYMENT SALES. I APPEAR TODAY IN VARIOUS CAPACITIES: OFFICIALLY, ON BEHALF OF COMMITTEE ON TAXATION OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK AND ON BEHALF OF THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION, OF BOTH OF WHICH ORGANIZATIONS

I AM PAST CHAIRMAN, AND, INDIVIDUALLY -- RATHER THAN INSTITUTIONALLY -- ON BEHALF OF THE COMMITTEE ON SIMPLIFICATION OF THE SECTION OF TAXATION OF THE AMERICAN BAR ASSOCIATION, OF WHICH COMMITTEE I AM CURRENTLY CHAIRMAN.

THE THREE BAR ASSOCIATION GROUPS I REPRESENT THIS MORNING JOINTLY HAVE ADOPTED A REPORT, ANALYZING AND COMMENTING ON H.R. 6383, FOR SUBMISSION TO THIS HEARING. THE JOINT REPORT EXTENDS MY TESTIMONY TODAY ON BEHALF OF THESE GROUPS. WITH THE CHAIRMAN'S PERMISSION, I ASK THAT THE JOINT REPORT, AND THE SEPARATE THREE-PAGE SUMMARY OF IT WHICH HAS ALSO BEEN DISTRIBUTED THIS MORNING, BE INCLUDED IN THE RECORD OF THIS HEARING.

I ALSO HAVE PREPARED A FAIRLY LENGTHY WRITTEN STATEMENT. THE SUBCOMMITTEE'S PATIENCE IS LEGION BUT I SUSPECT IT IS NOT WITHOUT LIMITS. I SHOULD LIKE TO DELIVER THIS MORNING A MUCH SHORTENED ORAL VERSION AND, AGAIN WITH THE CHAIRMAN'S PERMISSION, ASK THAT THE WRITTEN VERSION BE INCLUDED IN THE RECORD.

IN GENERAL

MY YOUNGER CHILD IS ADDICTED TO CLEAR STATEMENT OF A FORCEFUL SORT. IF HE WERE TESTIFYING THIS MORNING HE WOULD ANNOUNCE, "THIS IS A SUPER BILL!" AND THEN WOULD SIT DOWN. I FOLLOW HIS LEAD IN THE FIRST -- THIS IS INDEED A SUPER BILL -- BUT WILL POSTPONE MY DEPARTURE LONG ENOUGH TO EXPLAIN, BRIEFLY, WHY IT IS A SUPER BILL AND WHY WE URGE ITS PROMPT ENACTMENT.

QUITE SIMPLY, THE PRESENT TAX LAW GOVERNING SALES FOR FUTURE PAYMENT IS A MESS, A SNAKE'S NEST OF COMPLEXITY, A TRAP FOR THE UNWARY, AN OPPORTUNITY TO TAKE UNDUE ADVANTAGE ON THE

PART OF THE WEALTHY AND WELL-ADVISED.

COVERAGE OF THE BILL

ON OUR COUNT, THE BILL MAKES TEN SIGNIFICANT CHANGES IN PRESENT LAW. EVERY ONE IS AN IMPROVEMENT AND WE UNRESERVEDLY APPLAUD THEM ALL.

1. THE TWO PAYMENT REQUIREMENT IN INSTALLMENT SALES IS ELIMINATED.

2. INSTALLMENT TREATMENT IS EXTENDED TO SALES FOR PAYMENTS THAT ARE WHOLLY OR PARTLY CONTINGENT.

3. THE 30% INITIAL PAYMENT LIMITATION IS ELIMINATED.

4. THE $1,000 FLOOR AMOUNT FOR QUALIFYING INSTALLMENT SALES OF PERSONAL PROPERTY BY NON-DEALERS IS ELIMINATED.

5. INSTALLMENT TREATMENT IS AUTOMATIC ON SALES OF REALTY AND CASUAL SALES OF PERSONALTY. THE RARE TAXPAYER WHO DOES NOT WISH INSTALLMENT TREATMENT MAY TIMELY FILE AN ELECTION OUT.

6. IF A CORPORATION ADOPTS A PLAN OF COMPLETE LIQUIDATION COMPORTING WITH SECTION 337, SELLS ASSETS FOR INSTALLMENT OBLIGATIONS AND DISTRIBUTES THOSE OBLIGATIONS, THE SHAREHOLDERS ARE AFFORDED INSTALLMENT TREATMENT.

7. SUBJECT ONLY TO A SPECIAL "SELF-DEALING" -- PRIMARILY, "HUSBAND AND WIFE" -- EXCEPTION, THE BILL ALLOWS INSTALLMENT TREATMENT ON SALE TO A RELATED PARTY AND TRIGGERS THE DEFERRED GAIN ONLY IF AND ONLY TO THE EXTENT THE RELATED BUYER VOLUNTARILY RE-TRANSFERS THE PROPERTY TOO QUICKLY. IN GENERAL, TOO QUICKLY IS WITHIN TWO YEARS IF THE PROPERTY IS OTHER THAN MARKETABLE SECURITIES. I SHOULD LIKE TO RETURN TO THIS PROVISION, AND TO THE "SELF-DEALING"

EXCEPTION, LATER IN MY TESTIMONY.

8. INSTALLMENT TREATMENT IS EXTENDED TO DEBT OBLIGATIONS RECEIVED INCIDENT TO AN OTHERWISE TAX-FREE LIKE-KIND EXCHANGE OF PROPERTY AND RECEIVED INCIDENT TO CERTAIN OTHERWISE TAX-FREE CORPORATE REORGANIZATIONS. MR. CHAIRMAN, WHEN I TESTIFIED BEFORE THIS SUBCOMMITTEE ON JUNE 22, 1979, ON A PREDECESSOR BILL, S. 1063, YOU INTERROGATED ME AS TO THE SENSIBLE TAX TREATMENT OF INSTALLMENT OBLIGATIONS RECEIVED INCIDENT TO AN OTHERWISE TAX-FREE, LIKE-KIND EXCHANGE. CURRENT LAW IS DISASTROUS HERE, AND THE EARLIER BILL AFFORDED NO RELIEF. IN OUR DISCUSSION WE AGREED, I BELIEVE, ON WHAT THE SENSIBLE TAX TREATMENT OUGHT TO BE. I AM DELIGHTED TO CONFIRM THAT THE BILL NOW BEFORE YOU AFFORDS THAT SENSIBLE TAX TREATMENT.

9. SECTION 1038, WHICH GRANTS NON-RECOGNITION BENEFITS TO A REPOSSESSING INSTALLMENT SELLER OF REAL PROPERTY, IS EXTENDED TO THE ESTATE OR BENEFICIARY OF A DECEASED SELLER.

10. FINALLY, THE INSTALLMENT OBLIGATION DISPOSITION RULES AS THEY RELATE TO VARIOUS FORMS OF CANCELLATION ARE SENSIBLY CLARIFIED.

TECHNICAL COMMENTS AND SUGGESTIONS

EXPERIENCE TEACHES THAT A BILL DEALING WITH A 50 YEAR HISTORY OF UNMITIGATED COMPLEXITY IS BOUND TO BE REPLETE WITH TECHNICAL PROBLEMS. EXPERIENCE, IN THIS CASE, IS NOT A GOOD TEACHER. THE BILL IS VERY WELL DRAWN. WE HAVF ONLY THREE RECOMMENDATIONS DIRECTED TO WHAT IS NOW IN THE BILL.

1. THE PROPOSED TREATMENT OF SHAREHOLDERS RECEIVING INSTALLMENT OBLIGATIONS INCIDENT TO A SECTION 337 CORPORATE

LIQUIDATION IS, IN GENERAL, EXCELLENT. OUR ONLY TECHNICAL SUGGESTION RELATES TO THE TREATMENT OF LIQUIDATING DISTRIBUTIONS RECEIVED BY A SHAREHOLDER IN TWO CONSECUTIVE TAXABLE YEARS. PROPERLY TO ALLOCATE STOCK BASIS BETWEEN FIRST AND SECOND YEAR DISTRIBUTIONS, THE BILL REGUIRES THAT THE SHAREHOLDER FILE AN AMENDED RETURN FOR YEAR-1. AN ALTERNATIVE COURSE, AND ONE WE BELIEVE WE PREFERABLE BECAUSE SIMPLIFYING, IS ADOPTION OF A "CATCH-UP" APPROACH UNDER WHICH THE SHAREHOLDER REFLECTS ALL APPROPRIATE ADJUSTMENTS IN THE TAX RETURN TO BE FILED FOR YEAR-2. WE ARE FRANK TO ADMIT THERE ARE GOOD ARGUMENTS FOR THE AMENDED RETURN APPROACH CURRENTLY REFLECTED IN THE BILL, JUST AS WE BELIEVE THERE ARE GOOD ARGUMENTS SUPPORTING THE CATCH-UP APPROACH WE PREFER. EITHER APPROACH WILL WORK. WE PREFER THE YEAR-2 CATCH-UP SIMPLY BECAUSE TAXPAYERS HAVE ENOUGH DIFFICULTY FILING ONE RETURN EACH YEAR. WE DO NOT THINK THE GENERALITY OF TAXPAYERS WILL VIEW AN AMENDED RETURN DIRECTIVE AS THE TRIUMPH OF TAX SIMPLIFICATION.

2. ON A DEFERRED PAYMENT SALE TO A RELATED PARTY, OTHER THAN THE SELLER'S SPOUSE OR 80% CONTROLLED ENTITY, THE BILL AFFORDS INSTALLMENT TREATMENT AND PRESERVES THAT TAX DEFERRAL BENEFIT UNLESS THE RELATED BUYER VOLUNTARILY DISPOSES OF THE PROPERTY TOO QUICKLY. IN GENERAL, TOO QUICKLY IS WITHIN TWO YEARS. AND, IF A DISPOSITION IS MADE SO QUICKLY THAT THE AUTOMATIC EXEMPTION IS LOST, ANY OF A NUMBER OF OTHER EXEMPTIVE PROVISIONS MAY APPLY TO AVOID ACCELERATION OF GAIN. THE PAMPHLET PREPARED FOR THIS HEARING BY THE STAFF OF THE JOINT COMMITTEE ON TAXATION SUPPLIES A DETAILED CATALOGUE OF THESE EXEMPTIVE PROVISIONS. I SHOULD LIKE TO DWELL FOR A MOMENT ON JUST ONE.

THE BILL SANITIZES A TOO EARLY DISPOSITION OF THE PROPERTY IF IT IS ESTABLISHED TO THE SATISFACTION OF THE SECRETARY -- THAT IS, TO THE SATISFACTION OF THE COMMISSIONER -- THAT NEITHER THE ORIGINAL RELATED PARTY SALE NOR THE TOO EARLY SECOND DISPOSITION HAD AS ONE OF ITS PRINCIPAL PURPOSES THE AVOIDANCE OF FEDERAL INCOME TAX. THUS, UNDER THE BILL AS WRITTEN THE INSTALLMENT SELLER SHOULDERS THE BURDEN OF DEMONSTRATING ABUSE OF DISCRETION BY THE COMMISSIONER. THE BILL COULD HAVE BEEN WRITTEN DIFFERENTLY. IT COULD HAVE SAID NOTHING ABOUT THE METHOD OF DETERMINATION, THEREBY ALLOWING THE ORIGINAL INSTALLMENT SELLER TO GO TO COURT AND ATTEMPT TO SHOULDER THE NORMAL BURDEN OF PROVING ERRONEOUS THE COMMISSIONER'S FINDING OF INCOME TAX AVOIDANCE PURPOSE.

THE INSTITUTIONAL TAX GROUPS -- THE BAR ASSOCIATIONS AND THE AICPA -- THAT HAVE WORKED EXTENSIVELY WITH THE CONGRESSIONAL STAFFS AND THE TREASURY ON THIS LEGISLATION, DID NOT SEEK THAT MODEST LITIGATION ADVANTAGE. TO THE CONTRARY, THE INSTITUTIONAL GROUPS OF TAXPAYER REPRESENTATIVES RECOMMENDED THE PROCEDURE EMBODIED IN THE BILL AS PART OF THE PACKAGE SOLUTION THAT INCLUDES THE TWO YEAR SAFE HARBOR AND THE MANY OTHER EXEMPTIVE PROVISIONS. NEITHER THE BAR ASSOCIATIONS NOR THE AICPA IS FAMOUS FOR IMPLACABLE HOSTILITY TO TAXPAYER INTERESTS. WE SOUGHT NO IMPROVED LITIGATION OPPORTUNITY RECOGNIZING THAT, REALISTICALLY, IT IS AN OPPORTUNITY TO DO MORE. IT IS AN OPPORTUNITY TO PLAY THE AUDIT LOTTERY, TO GIVE NO NOTICE OF THE TOO EARLY SECOND DISPOSITION, TO CONTEST AND ULTIMATELY COMPROMISE IF AND ONLY IF AN AUDITING REVENUE AGENT STUMBLES UPON THAT SECOND DISPOSITION AND ASKS THE RIGHT QUESTIONS.

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WE ARE AT ONE WITH THE TREASURY IN CONCLUDING THAT THERE HAS BEEN ENOUGH OF THIS. THE BILL IS GENEROUS IN ITS APPROACH TO RELATED PARTY INSTALLMENT SALES. TO ACCOMPLISH ITS OBJECTIVE, IT SHOULD HAVE THIS TOOTH.

THERE IS ONE CLASS OF INSTALLMENT SALES, THE "SELF-DEALING" SALE TO SPOUSE OR 80% CONTROLLED CORPORATION OR PARTNERSHIP, THAT IS NOT GRANTED INSTALLMENT TREATMENT UNDER THE BILL. IN THE JOINT BAR REPORT SUBMITTED TO THIS HEARING MUCH IS WRITTEN ABOUT THIS RESTRICTIVE APPROACH. THE VARIOUS BAR ASSOCIATION GROUPS AND THEIR MEMBERS ARE NOT OF ONE MIND ON IT. SOME THINK IT TOO RESTRICTIVE AND QUESTION THE NEED FOR IT. OTHERS FIND IT TOO LIBERAL AND WOULD FURTHER TIGHTEN THE PROPOSED RULES. A VARIETY OF INTERMEDIATE SOLUTIONS TO THE "SELF-DEALING" PROBLEM HAVE BEEN SUGGESTED BY OTHERS.

ALTHOUGH THERE IS NO UNANIMITY, THERE IS SUBSTANTIAL SYMPATHY FOR A "SELF-DEALING" PROVISION. DEFERRED PAYMENT SALE TO A SPOUSE, FOR EXAMPLE, IS SIGNIFICANTLY DIFFERENT FROM SALE TO A CHILD OR OTHER RELATIVE BECAUSE, WHEN HUSBAND AND WIFE TRANSACT, THE BUYER'S INTEREST EXPENSE AND THE SELLER'S INTEREST INCOME WASH OUT, ONE AGAINST THE OTHER, IN THE SPOUSES' JOINT INCOME TAX RETURN. THUS, THE SPOUSES CAN AND WILL AGREE ON A HIGH, FULL AND FAIR RATE OF INTEREST ON THE DEFERRED PAYMENT OBLIGATION. WHEN WEALTHY PARENT SELLS TO LESS WEALTHY CHILD, FULL AND FAIR INTEREST ATTRACTS A FULL AND FAIR BURDEN OF ANNUAL INCOME TAX LIABILITY.

WHILE THERE MAY BE DIVERGENT VIEWS IN OTHER RESPECTS, I BELIEVE THERE IS UNANIMITY AMONG THE BAR ASSOCIATION TAX GROUPS ON ONE ASPECT OF THE PROVISION NOW IN THE BILL. THE RULES THAT

EMERGE FROM THAT PROVISION ARE, WE BELIEVE, DISCORDANT. TO NO OBVIOUS PURPOSE, DIRECT SALES BETWEEN CLOSELY RELATED TAXPAYERS AND SALES MADE INDIRECTLY THROUGH A CORPORATION LIQUIDATING UNDER SECTION 337 ARE NOT TREATED THE SAME WAY. WE FAVOR A HARMONIZING REVISION AND, IN THE JOINT BAR REPORT, SUPPORT AN APPROACH THAT WOULD MORE CLOSELY TIE THIS "SELF-DEALING" PROVISION TO A SENSIBLY-AMENDED SECTION 1239 AND SECTION 707(B)(2), THE CODE'S PRESENT SELF-DEALING PROVISIONS.

3. OUR FINAL TECHNICAL COMMENT RELATES TO ANOTHER ASPECT OF THE BILL'S GENERAL RELATED PARTY INSTALLMENT SALE PROVISION. PROPERLY, THE BILL NOW PROVIDES THAT IF EITHER RELATED SELLER OR RELATED BUYER DIES, NO SUBSEQUENT DISPOSITION OF THE PROPERTY WILL ACCELERATE THE ORIGINAL SELLER'S PREVIOUSLY DEFERRED GAIN. IN REAL LIFE THE SELLER, OR THE BUYER, MAY BE HUSBAND AND WIFE AS JOINT TENANTS OR COMMUNITY PROPERTY OWNERS. WE BELIEVE THE BILL'S EXEMPTIVE PROVISION SHOULD BE EXPANDED TO PROVIDE THAT, IN THIS SITUATION, IF EITHER PAST OR CURRENT HALF-OWNER DIES, THE EXEMPTION WILL APPLY TO THE ENTIRE PROPERTY.

ADDITIONAL ISSUES FOR COMMITTEE CONSIDERATION

AS DETAILED MORE FULLY IN THE JOINT BAR REPORT, THERE ARE TWO ISSUES, NOT ATTENDED IN THE PRESENT FORM OF THE BILL, WHICH WE BELIEVE DESERVE COVERAGE.

1. THREE VERY RECENT COURT DECISIONS, INCONSISTENTLY DECIDED, MAKE IT WHOLLY UNCLEAR WHETHER INSTALLMENT REPORTING IS AVAILABLE WHEN THE DEFERRED PAYMENT OBLIGATION ISSUED BY AN UNRELATED BUYER IS SECURED BY A STANDBY LETTER OF CREDIT. THE TAXPAYERS WHO TO DATE HAVE BEEN HELD TAXABLE ON PAYMENTS NOT

RECEIVED HAVE BEEN COTTON FARMERS, AT LEAST ONE OF WHOM WAS NOT EVEN AWARE THE BUYER'S OBLIGATION WAS SECURED BY ANYTHING. WE URGE THAT THE BILL'S DEFINITION OF "PAYMENT" BE AMENDED TO MAKE IT CLEAR THAT INSTALLMENT REPORTING WILL NOT BE UN-AVAILABLE MERELY BECAUSE THE BUYER'S FUTURE PAYMENT OBLIGATION IS GUARANTEED BY A THIRD PARTY OR IS SECURED BY A STANDBY LETTER OF CREDIT.

2. PRESENT SECTION 453(C), IN POINT WHEN A RETAILER OR OTHER DEALER IN PERSONAL PROPERTY CHANGES FROM THE ACCRUAL METHOD TO THE INSTALLMENT METHOD OF TAX ACCOUNTING, IS UNUSUALLY COMPLEX AND, IN APPLICATION, OFTEN UNFAIR. WELL-ADVISED DEALERS AVOID THE PROVISION BY SELLING TO A THIRD PARTY ALL UNCOLLECTED ACCOUNTS RECEIVABLE THEN IN-HOUSE. TAXPAYERS LESS WELL-ADVISED, OFTEN SMALLER RETAILERS, RISK ENTRAPMENT. WE ENDORSE THE RECOMMENDATION OF THE FEDERAL TAX DIVISION OF THE AICPA TO SIMPLIFY AND RATIONALIZE THE PRESENT PROVISION.

CONCLUSION

MR. CHAIRMAN, WE SEEM TO BE WELL EMBARKED ON A WELCOME PROCESS OF TAX SIMPLIFYING LEGISLATION. THE BAR ASSOCIATION TAX GROUPS WISH TO EXPRESS THEIR GREAT APPRECIATION TO THE SUBCOMMITTEE FOR ITS WILLINGNESS TO CONSIDER THIS LEGISLATION TWICE, LAST JUNE AS S. 1063 IN A TOO NARROW AND TOO DRACONIAN FORM, AS THE SUBCOMMITTEE THEN RIGHTLY PERCEIVED, AND AGAIN TODAY WHEN THERE IS AT HAND A PRODUCE OF TRUE VALUE.

THANK YOU.

Senator BYRD. Thank you, Mr. Ginsburg.

Having worked on a number of matters with you, and with the New York State Bar Association's Committee on Taxation, and the New York City Bar Association, and the Tax Section of the American Bar Association, I have a great deal of confidence in you and these three groups which you represent.

Apparently, and I was not aware of it until I started working on this bill, there has been a great deal of abuse in the installment sale area, particularly in regard to related parties. I think that if there is abuse, the law should be changed to prevent something like that.

The only thing that concerns me about this is that in trying to eliminate abuse, are we then being unfair and inequitable to individuals in denying them their just rights? I don't say that we are, but I am trying to understand whether we are, or whether we are not.

Are you well satisfied with the bill as it is written in regard to related parties?

Mr. GINSBURG. Yes, Mr. Chairman. With the addendum that I noted about cleaning up husband and wife, so that the rules are harmonized rather than disparate, personally I am very satisfied. I think the groups that I represent are also satisfied.

I think it is pretty well known that neither the Bar Associations, nor the AICPA, nor the Cattlemen, nor the American Bankers are implacably hostile to taxpayer interests. We have been, I think, very careful here to try to carve out a rule that narrowly describes the sort of abuse situations that exist or that become obvious under the bill.

It was suggested this morning that we are opening no new loopholes, or no potential new loopholes. I wish that were true, it never is, of course. We have already identified at least one clear one, which if not dealt with would be rather a bonanza to the people who picked it up.

We are satisfied, and we very much hope that the bill will be enacted.

Senator BYRD. Let me say that I received a letter from Congressman John H. Rousselot of California, in which he encloses a statement by Mr. John D. Tapp, a certified public accountant in San Gabriel, Calif.

I will insert at this point in the record Mr. Tapp's statement.

[Statement follows:]

Tapp & Tapp
An Accountancy Corporation
1720 South San Gabriel Boulevard, Suite 212
San Gabriel, California 91776

John D. Tapp, CPA
Lynda C. Tapp, CPA

Telephone
(213) 280-8971

September 8, 1980

The Honorable Senator Harry F. Byrd, Jr.
Committee on Finance
United States Senate Subcommittee on
 Taxation and Debt Management
Senate Office Building
2227 Dirksen
Washington, D.C. 20510

Re: Written Testimony Concerning S 2451/H.R. 6883
 Installment Sales Revision Act of 1980

Dear Senator Byrd:

Complements must be given on the passage of the Installment Sales Revision act of 1980, H.R. 6883 (Ullman), and the adoption of the Senate version of S. 2451 (Long/Dole). The IRS Code Section which this legislation deals with has been in need of revision for some time. However, it is apparent that the authors and staff persons involved in the writing and passage of this legislation have been over zealous in changing the provisions of the Code dealing with "related party" transactions.

Under the 1980 Act, amounts realized on certain resales by a related party installment purchaser, would trigger recognition of immediate gain by the initial seller without the benefits of the Installment Sale Provisions of the Code. The elimination of the favorable tax deferral treatment of sales between related parties is attacking the deferral concept of the code. Parties entering into transactions with family members under present law, which have been fully condoned in the courts, is not concerned with tax avoidance but rather only the deferral of taxes. In addition to the elimination of this deferral mechanism, the revision of Code Sec. 453(e) will retroactively effect family transactions back to 3/31/80. This legislation will cause developers to accelerate the recognition of taxes which directly cause new housing prices to increase. These increases will ultimately be absorbed by American family units. Family units will no longer enjoy the full benefits of the Installment Sale Provision of the Code, and also the '80 Act becomes retroactively effective for taxpayers in this group back to 3/31/80. It is common knowledge that the IRS Code in its present form gives favorable tax treatment to single individuals, this Act in its present form, would further erode the family structure in American society.

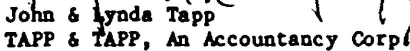
One must firmly question the motives of the authors of this Act when attacking the family unit. You can be effective in preventing this discriminatory section of the 1980 Act by taking the following course of action:

1. Oppose the passage of S. 2451 until the section dealing with related party transactions is eliminated.

2 Oppose the passage of S. 2451 until the section dealing with related party transactions can be enacted in a non-discriminatory manner.

Section 453(e) is detrimental to family units in its present form in both H.R. 6883 and S. 2451.

Very truly yours,



John & Lynda Tapp
TAPP & TAPP, An Accountancy Corp.

Enclosures: Letters of Endorsement

1. John W. Dickson
   Second Vice President
   Service Station Dealers Association

2. Jim Blakely, President
   Tow Recovery Assoiciation of America

3. Rich Chappel, Association Director
   California Tow Truck Association

4. Myron Kerbajian, Businessman

5. Howard E. Welch, Businessman

6. Harold Ekmanian, Businessman

7. Guy J. Hocker, Councilman
   City of Hawthorne, California

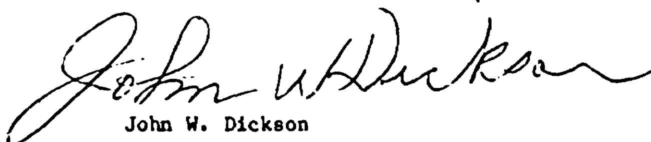
8. Marion Hurley, Director
   United Republicans of California

9. Clayton Hurley
   Attorney at Law

The Honorable Senator Harry F. Byrd, Jr.
Committee on Finance
United States Senate
Subcommittee on Taxation and
Debt Management
2227 Dirksen
Senate Office Building
Washington, D. C.

The present form of S. 2451 is discriminatory to family groups. I, as a member of the Service Station Dealers of America, agree with the written testimony attached to this letter and believe your Subcommittee should delete that section of the legislation which revises Code Sec. 453 (e).

Very truly yours,

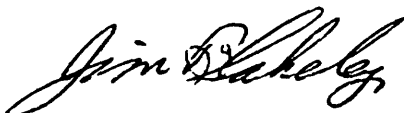


John W. Dickson
2nd V.P., S.S.D.A.
Dickson Mobil
73-220 Highway 111
Palm Desert
California 92260

The Honorable Senator Harry F. Byrd, Jr.
Committee on Finance
United States Senate
Subcommittee on Taxation and
Debt Management
2227 Dirksen Senate Office Building
Washington, D. C.

The present form of S. 2451 is discriminatory to family groups. I, as a member of the Tow Recovery Association of America, agree with the written testimony attached to this letter and believe your Subcommittee should delete that section of the legislation which revises Code Sec. 453 (e).

Very truly yours,



Jim Blakeley
Allied Gardens Towing
4334 Sheridan Lane
San Diego, Ca. 92120

The Honorable Senator Harry F. Byrd, Jr.
Committee on Finance
United States Senate
Subcommittee on Taxation and
Debt Management
2227 Dirksen Senate Office Building
Washington, D. C.

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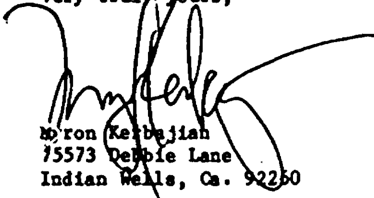

Myron Kerbajian
75573 Debbie Lane
Indian Wells, Ca. 92260

The Honorable Senator Harry F. Byrd, Jr.
Committee on Finance
United States Senate
Subcommittee on Taxation and
Debt Management
2227 Dirksen Senate Office Building
Washington, D. C.

The present form of S. 2451 is discriminatory to family groups. The California Tow Truck Association agrees with the written testimony attached to this letter and believe your Subcommittee should delete that section of the legislation which revises Code Sec. 453 (e).

Very truly yours,

Rich Chappel
California Tow Truck Association
4121 Redwood Ave., Suite 203
Los Angeles, Ca. 90066

The Honorable Senator Harry F. Byrd, Jr.
Committee on Finance
United States Senate
Subcommittee on Taxation and
Debt Management
2227 Dirksen Senate Office Building
Washington, D. C.

The present form of S. 2451 is discriminatory to family groups. I agree with the written testimony attached to this letter and believe your Subcommittee should delete that section of the legislation which revises Code Sec. 453 (e).

Very truly yours,

Howard E. Welch
Haddick's Towing, Inc.
15120 E. Valley
City of Industry, Ca. 91744

The Honorable Senator Harry F. Byrd, Jr.
Committee on Finance
United States Senate
Subcommittee on Taxation and
Debt Management
2227 Dirksen Senate Office Building
Washington, D. C.

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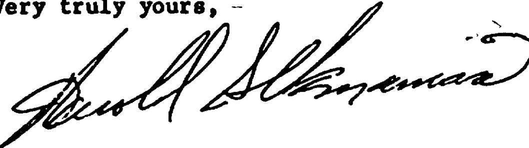

Harold Ekmanian
c/o B & H Inglewood Tow
150 W. Ivy
Inglewood, Ca. 90302

The Honorable Senator Harry F. Byrd, Jr.
Committee on Finance
United States Senate
Subcommittee on Taxation and
Debt Management
2227 Dirksen
Senate Office Building
Washington, D. C.

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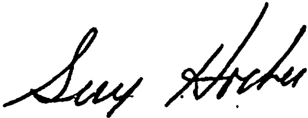
Very truly yours,



Guy Hocker
14101 Hawthorne Blvd.
Hawthorne, CA 90250

The Honorable Senator Harry F. Byrd, Jr.

Committee on Finance

United States Senate

Subcommittee on Taxation and

Debt Management

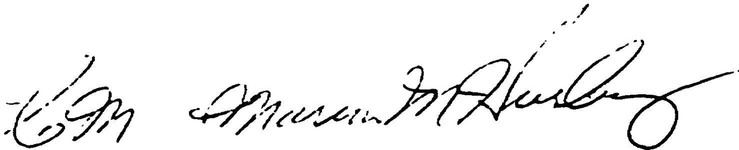
2227 Dirksen

Senate Office Building

Washington, D. C.

The present form of S. 2451 is discriminatory to family groups. We, as members of the United Republicans of California, agree with the written testimony attached to this letter and believe your Subcommittee should delete that section of the legislation which revises Code Sec. 453 (e).

Very truly yours,



Clayton & Marion Hurley

649 Vallombrosa

Pasadena, Ca. 91107

Senator BYRD. In his statement he says this: "Retroactively effective for family transactions back to 3-31-80. Also the 1980 Act becomes retroactively effective for taxpayers." It is not retroactive, is it?

Mr. GINSBURG. No, sir. I think the date to which the writer was referring was actually changed in the House bill, as it finally came out, to a May 14, 1980, effective date. That is, if there is a related party sale for installment paper quickly followed by a giant cash resale, and the first transaction occurs before May 14, it may be abusive, but it is a winner. The bill does not apply to it.

If the first transaction takes place after May 14, 1980, the present bill would apply to it, but only if there is a cash resale within 2 years afterward. I am considering here the normal related party situation, and assuming none of the awesome laundry list of exceptions that is in the bill applies.

It would be a fairly egregious case that would be caught. It is difficult to believe that by May 14 anybody interested in this transaction was not aware that legislation had been under consideration for almost a year.

Senator BYRD. What about the effective dates, you feel that the effective dates as indicated in the bill are appropriate?

Mr. GINSBURG. That is a good question, sir.

We have a retroactive effective date in the bill on section 337 transactions, back in effect to transactions entered into on or after April 1, 1980. The only thing I can say is that it seems to me generous, since it is a very pro-taxpayer provision.

The Bar Association groups did not request that beneficence since we are on long record in opposing retroactive provisions in the code, whether they help taxpayers or hurt them. With some reasonable exceptions, that is our general position.

We would not request retroactivity on the other provisions, even though we recognize that it would be a nice thing for individual taxpayers. We think that in general the country would be better off if we made all new changes in the tax law prospective only.

Senator BYRD. I rather think so, too.

As I understand it, then, the new installment sale provisions would affect only those sales that occur after May 14?

Mr. GINSBURG. That is in the related party situation. The normal case where I sell my business to a stranger——

Senator BYRD. That would be March 31.

Mr. GINSBURG. No, sir. That would be the date of enactment of the bill. If I close the sale after date of enactment, the new rules apply. If I close the sale before the date of enactment, the old rules apply. The only exception to that is the section 337 situation in which a date prior to today applies.

If it is a section 337 sale, as I understand the bill, the benefits of it will accrue even though it is closed before the effective date.

Senator BYRD. Senator Dole.

Senator DOLE. I have no questions.

I was listening to Mr. Murdoch before I left, and I felt sorry for that poor fellow who maybe would have a cause of action against a lawyer, but that would not be much solace to the taxpayer.

I have read the statements, and I appreciate Mr. Powell's reference to 2916, which we will hear testimony on later. As I understand it, nearly all, with some exception, areas of concern have been either worked out or are in the process of refinement or modification by the staff working with the Treasury. So there may even be additional minor modifications to take care of some of the objections that others have raised this morning. We want to cooperate with that.

Senator BYRD. Thank you, Senator Dole.

Thank you, gentlemen.

Mr. GINSBURG. Thank you, Mr. Chairman.

Senator BYRD. Next will be a panel of four, Ms. Brenda R. Viehe-Naess, tax counsel of the American Insurance Institute; J. Sprigg Duvall, president, Victor O. Schinnerer & Co.; Mr. Charles E. Schwing, president, American Institute of Architects, and Mr. William R. Ratliff, president-elect, American Consulting Engineers Council, accompanied by Mr. Robert Warden of Peabody, Rivlin, Lambert & Meyers.

Welcome.

STATEMENT OF BRENDA R. VIEHE-NAESS, TAX COUNSEL, AMERICAN INSURANCE ASSOCIATION

Ms. VIEHE-NAESS. Mr. Chairman, I am Brenda R. Viehe-Naess, tax counsel of the American Insurance Association. We are a trade association representing 150 stock property-casualty insurance companies, whose combined premium for the year 1979 represented more than one-third of the property-casualty insurance premiums in the United States.

I ask that a complete copy of my written testimony be included in the record, and I will present only a brief oral summary for you today.

Senator BYRD. Very well, it will be done.

Ms. VIEHE-NAESS. The question whether to grant a deduction for amounts set aside for self-insurance of professional liability was considered at length by the 95th Congress. The proposal had been one of several recommendations made by the Interagency Task Force on Product Liability, a study headed by the Department of Commerce.

After further consideration, Commerce Secretary Juanita Kreps announced on July 20, 1978, that the administration had decided not to endorse the proposal for reasons similar to those reviewed by the Treasury today.

We believe considerations of tax and public policy which led to the rejection of the proposal in 1978 apply with equal force today, and that they require that the legislation proposing the special deduction for architects and engineers should be rejected as well.

It is a long established principle in the tax law that amounts are not deductible under the accrual method of accounting until all events have occurred which established the fact of a liability giving rise to the deduction, and the amount of the deduction can be determined with reasonable accuracy.

There are no compelling policy reasons which would justify departing from this well-established principle. The availability of coverage is no longer a problem.

The number of carriers writing architects and engineers professional liability insurance has increased since the underwriting crisis of 1974 and 1975. It is difficult to imagine that a design firm would be unable to obtain one or more quotes for coverage.

In the current market, the more reasonable explanation for firms "going bare"—operating without insurance—is a conscious decision to risk an adverse judgment rather than pay the cost of insurance.

The cost of liability insurance, which we understand to be the principal concern of architects and engineers, increased steadily during the early 1970's and peaked in 1974-75. These increases were the product of changes in the tort law which led to a substantial increase in the size of court awards as well as an increase in the number of claims.

As the size of the claims and the trends changed, underwriters were forced to raise premiums to meet these rising costs. Yet, because the increase in premiums is attributable to changes which occurred in the tort law and the pattern of judgments, it is hard to accept the contentions of supporters of the legislation that the

premiums for malpractice insurance are unreasonable or exorbitant.

A survey quoted in "Building and Design Construction" for January 1980, showed that liability premiums paid by architects and engineers rose from $25 million in 1969 to $175 million last year. To quote from the article, "payments by insurance companies for building-related casualty claims, including property damage, which includes remedial work and bodily injury, have shot from an estimated $32 million in 1969 to $235 million last year." If these statistics are compared, they show an increase in premiums of 700 percent and a corresponding increase in claims of 735 percent.

Our surveys of a number of underwriters in this market show that recent developments have been encouraging. Rates for professional liability have been stable for the past 3 years, and underwriting activities by a number of companies in this highly specialized line have led to increased price competition among insurers.

Design professionals and their brokers may now seek a number of alternative bids in order to obtain the lowest rate. Confirmation of our surveys of the market came from a surprising source—published reports of statements of brokers and design professionals in trade journals.

A January 1980 article in Building and Design Construction, entitled "Competition Forces Insurors to Ease Rate Hikes," stated:

"If a single word can describe the current state of the liability market for architects, engineers, and contractors, that word is 'better.'

"Both brokers and buyers agree that the architectural engineer professional insurance market is now quite competitive."

New approaches have been developed in the past 4 years to deal with the underwriting problems created by high claims costs in this line. These techniques include the underwriting of coverage on a "project" basis, that is, for each building, bridge, or other structure designed by the firm rather than by providing a single policy to cover all liability; drafting limitations of liability into design service contracts; the creation of captive insurance companies; and the adoption of retrospective rating plans in which, depending upon its experience, an insured firm may receive payment from the insurance company or be required to pay an additional premium.

If what proponents of the legislation intend is a substantial increase in the amount of the deductible over those currently in effect in order to reduce premiums, they may be operating under a misconception.

Self-insurance of a substantially increased deductible will not provide the dramatic reduction of premiums for liability insurance which architects and engineers are seeking. The rates for professional liability coverage reflect a continuing problem of severity—the size of the claims—rather than frequency—the number of claims—and the most important factor determining the cost of this line has been the severity of claims.

In summary, we believe that the additional tax deductions already provided to architects and engineers with the Congress adoption of a 10-year net operating loss carryback in 1978 provide sufficient relief, and that no further tax subsidy can be justified.

Liability insurance is now widely available, and the rates have been stable for 3 years. By obtaining bids from a number of carriers, architects and engineers should be able to take advantage of growing competition among underwriters.

Finally, we believe that the solution proposed by S. 2512, a tax subsidy for self-insurance of the deductible, is unworkable. The use of increased deductible will not provide the dramatic reduction of premiums architects and engineers are seeking where rates reflect problems of severity rather than frequency.

The only effective way to reduce unreasonable professional liability claims is to convince State legislatures to reform court statutes and to modify judgments by State courts.

[Statement of Brenda Viehe-Naess follows:]

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TESTIMONY OF BRENDA R. VIEHE-NAESS
TAX COUNSEL
AMERICAN INSURANCE ASSOCIATION

ON S.2512, PARTIAL SELF-INSURANCE ACT
FOR ARCHITECTS AND ENGINEERS

BEFORE SUBCOMMITTEE ON TAXATION & DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE

SEPTEMBER 10, 1980

JACK MOSELEY, CHAIRMAN   WILLIAM O. BAILEY, VICE CHAIRMAN   WAVERLY G. SMITH, VICE CHAIRMAN   T. LAWRENCE JONES, PRESIDENT

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SUMMARY OF TESTIMONY ON S.2512 PARTIAL SELF-INSURANCE ACT FOR ARCHITECTS AND ENGINEERS

1. Professional liability tax-exempt trust fund bills and product liability trust fund bills were considered and rejected by the 95th Congress. A 10-year net operating loss carryback was adopted in their place as part of the Revenue Act of 1978. The reasons which led to the proposal's rejection in 1978 apply with equal force today, viz., a tax subsidy for self-insurance of a deductible is neither efficient nor appropriate; no regulatory supervision comparable to that of insurance companies exists to provide adequate safeguards for injured parties; and encouraging small businesses to self-insure through tax deductions and trusts is an unworkable concept.

2. Availability is no longer a problem. Design firms are now able to obtain bids from several different insurance carriers.

3. Rates in malpractice insurance for architects and engineers have stabilized. Major increases occurred in 1974-75 as a result of a dramatic increase in the size of judgments, but they have been stable for the past 3 years. Underwriting competition in this highly specialized line has increased, and architects and engineers may now seek bids from competing insurance carriers to obtain the lowest rate.

4. The size of deductibles is not so large that it will jeopardize the financial stability of a professional firm.

5. A substantial increase of the deductible above current levels will not provide the dramatic reduction of premiums for liability insurance which architects and engineers are seeking. The rates for professional liability coverage reflect a continuing problem of severity (the size of claims) rather than frequency (the number of claims), and further increases in deductibles will have only a very limited effect upon claims incurred or rates.

6. The architectural and engineering professions are composed primarily of small firms. It is doubtful that a substantial portion of their member firms could take advantage of the deduction. Large businesses and professional firms can self-insure and are already doing so in architects and engineers professional liability and other lines without tax deductions. Small businesses cannot self-insure with or without tax deductions.

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TESTIMONY ON S.2512
SERVICE LIABILITY PARTIAL
SELF-INSURANCE ACT OF 1980

Mr. Chairman and Members of the Subcommittee:

I am Brenda R. Viehe-Naess, Tax Counsel of the American Insurance Association, a trade association representing 150 stock property-casualty insurance companies, which write multi-line coverage throughout the United States. Their combined premiums in 1979 represented more than 1/3 of the property and casualty insurance premiums in the United States, and their combined assets accounted for slightly less than 1/3 of the total assets of property-casualty insurers.

The question whether to grant a deduction for amounts set aside for self-insurance of professional liability was considered at length by the 95th Congress, which saw a number of bills introduced in both the House and Senate. The proposal had been one of several recommendations made by the Interagency Task Force on Product Liability, a study headed by the Department of Commerce. After further consideration, Commerce Secretary Juanita Kreps announced on July 20, 1978, that the Administration had decided not to endorse the proposal. To quote from the testimony of Deputy Assistant Secretary for Tax Legislation Daniel I. Halperin before this subcommittee on August 28, 1978, the reasons for the Administration's conclusions were:

> First, the superficially appealing notion that the tax law discriminates in favor of commercial insurance and against self-insurance is in fact based on a misapprehension.
>
> Second, the existing proposals for current deductibility of contributions to self-insurance trusts provide an opportunity for deferral of taxes and thereby would operate to subsidize self-insurance. Because self-insurance is inherently inefficient by contrast with commercial insurance, and because of technical difficulties stemming from the inability to estimate future product liability losses, we concluded that extending such a subsidy would not be appropriate.
>
> Finally, we concluded that existing law, with some modification, would provide virtually the same tax benefits, other than deferral, as proposals providing current deductibility for contributions to a self-insurance trust, and with far less administrative complexity. The necessary modification ... would be to provide a special 10-year net operating loss carryback ...

At the same time that this issue was before Congress, the American Bar Association was asked to consider a resolution in support of legislation which provided tax incentives for the creation of self-insurance trust funds for product liability losses. That resolution was disapproved by both the Section of Taxation and the Section on Insurance, Negligence, and Compensation Law.

We believe that the considerations of tax and public policy which led to the rejection of the proposal in 1978 apply with equal force today and that they require that the legislation prcposing a special deduction for architects and engineers be rejected as well.

It is a long-established principle of the tax law that amounts are not deductible under the accrual method of accounting until "all events" have

occurred which establish the fact of the liability giving rise to the deduction, and the amount of the deduction can be determined with reasonable accuracy. Treas. Regs. §1.446-1(c)(1)(ii) and §1.461-1(a)(2). Reserves set aside for anticipated workman's compensation claims and other self-insurance have consistently been denied a deduction. Rev. Rul. 60-275, 1960-2 C.B. 43. Spring Canyon Coal Co. v. Comm'r, 43 F.2d 78 (10th Cir., 1930) cert. denied, 284 U.S. 654 (1931). Thriftimart, Inc. v. Comm'r, 59 T.C. 598. Rev. Rul. 80-191, 1980-29 I.R.B. 18. The fact that these funds are held by an independent trustee rather than the taxpayer has not altered the treatment of contributions. Spring Canyon Coal Co. v. Comm'r, ante. Payments to a wholly owned insurance subsidiary - a "captive" insurer - have also been disallowed where the court found that risk-sharing and risk-distribution did not exist. The Carnation Co. v. Comm'r., 71 T.C. No. 39 (1978). See also Rev. Rul. 77-316, 1977-2 C.B. 53.

There are no compelling policy reasons which would justify departing from the well-established rule denying deductions for self-insurance reserves. The availability of coverage is no longer a problem. The number of carriers writing architects and engineers professional liability insurance has increased since 1974-75, and it is difficult to imagine that a design firm would be unable to obtain one or more quotes for coverage. In the current market, the more reasonable explanation for firms "going bare" - operating without insurance - is a conscious decision to risk an adverse judgment rather than pay the cost of insurance.

The cost of liability insurance, which we understand to be the principle concern of architects and engineers, increased during the early 1970's and

peaked in the underwriting crisis of 1974-75. These increases were the products of changes in the tort law which led to a substantial increase in the size of court awards as well as an increase in the number of claims. As the size of claims and the trend of claims changed, underwriters were forced to raise premiums to meet rising claims costs. Yet, because the increase in premiums is attributable to changes which occurred in the tort law and in the pattern of judgments against architects and engineers, it is hard to accept the contention of supporters of this legislation that the premiums for malpractice insurance are unreasonable or "exorbitant." A survey quoted in Building & Design Construction for January, 1980, showed that liability premiums paid by architects and engineers rose from $25 million in 1969 to $175 million last year. To quote from the article, "payments by insurance companies for building-related casualty claims, including property damage (which includes remedial work) and bodily injury, have shot from an estimated $32 million in 1969 to $235 million last year." If these statistics are compared, they show an increase in premiums of 700% and a corresponding increase in claims of 735%.

Our surveys of a number of underwriters in this market show that recent developments have been encouraging. Rates for professional liability have been stable for the past 3 years, and the underwriting activities of a number of companies in this highly specialized line have led to increased price competition among insurers. Design professionals and their brokers may now seek a number of alternative bids in order to obtain the lowest rate. Confirmation of our surveys of the market come from a surprising source -

published reports of statements of brokers and design professionals in trade journals. A January, 1980, article in Building & Design Construction entitled "Competition Forces Insurors to Ease Rate Hikes" stated

> If a single word can describe the current state of the liability market for architects, engineers and contractors, that word is "better." ...
>
> Both brokers and buyers agree that the A/E professional liability insurance market is now quite competitive. ...
>
> "Based on what we've seen in the past year, we have more reason for optimism than at any time in the 11 years I've been with the National Society of Professional Engineers," said Jack McKee, staff director of NSPE's Private Engineers in Professional Practice section, about the current professional liability insurance picture. (pp. 61 and 62)

New approaches have been developed in the past four years to deal with the underwriting problems created by high claims costs in this line. These techniques include the underwriting of coverage on a "project" basis, i.e., for each building, bridge or other structure designed by the firm rather than by providing a single policy to cover all liability; drafting limitations of liability into design services contracts to set a maximum for damages which could be sought from the firm; the creation of captive insurance companies similar to those created by physicians and attorneys (See "How Firms Ease Liability Insurance Costs," Building & Design Construction, Dec. 1978, p. 58); and the adoption of a retrospective rating plan in which, depending on his experience, an insured may either receive payment from the insurance company or be required to pay an additional premium (See "Competition Forces Insurers to Ease Rate Hikes," Building and Design Construction, p. 61, January, 1980).

If what proponents of the legislation intend is a substantial increase in the amount of the deductible over those currently in effect in order to reduce premiums, they may be operating under a misconception.

Self-insurance of a substantially increased deductible will not provide the dramatic reduction of premiums for liability insurance which architects and engineers are seeking. The rates for professional liability coverage reflect a continuing problem of severity (the size of claims) rather than frequency (the number of claims), and the most important factor determining the cost of this line of insurance has been the severity of claims. An increase in the size of the deductible will reduce premiums where frequency rather than severity is the determinant of the cost of insurance, but increasing the size of the deductible will have only a nominal impact upon total claims, and, therefore, will not reduce premiums substantially in lines like professional liability where severity is the principal determinant of rates.

If the provisions of S.2512 are subjected to critical review, there appear to be certain problems with the proposal which bring into question its effectiveness. The maximum deductions of $100,000 or 5% of gross receipts established for taxpayers by S.2512 having a severe professional liability problem seem to be determined primarily by administrative considerations of ease of computation. They bear no relationship whatsoever to the projected level of a firm's professional liability claims. The bill also fails to require that the design firm make regular contributions of an amount sufficient to fund projected claims. In the absence of such a requirement, it is possible that a pattern of irregular contributions could develop similar to that which marked contributions to small pension plans of closely held corporations before ERISA---a taxpayer could set aside

amounts to shelter income during highly profitable years while omitting contributions altogether during lean years. Granting a tax deduction for plans which lack adequate funding requirements and adequate safeguards to ensure that amounts will be available to injured parties seems inconsistent with the Congressional policy which established rigorous standards for pension trusts as a quid pro quo for the deduction of contributions to pension trusts.

Finally, we concur with members of the Administration and the Congress who concluded, after a thorough review of the Interagency Task Force's proposal for tax incentives for self-insurance of product and professional liability, that encouraging small and medium sized businesses to self-insure was an unworkable concept. Small businesses lack the claims handling facilities provided routinely by insurance coverage and, in the hope of avoiding costly legal fees, they may defer seeking legal counsel as quickly as they would under an insured program, thereby exacerbating problems of settling a substantial claim. In fact, surveys made during prior consideration of the tax-exempt trust fund proposal showed that few small businesses were interested in being self-insured against product liability risks. A "Survey Report on Product Liability" published by the National Federation of Independent Business in January, 1977, found that 42.8 percent of small businesses responding could not establish a self-insurance fund. Another 24.8 reported that they could do so, but only with difficulty. 5.9 percent replied that a fund was readily possible, while 8 percent had already established a self-insurance fund.

In the case of architects and engineers, it is hard to believe that utilization of the deduction for self-insurance reserves would be much more widespread. The design professions are composed largely of small firms whose cash flow is highly sensitive to the fluctuations of the economy. According to a 1977 survey by the American Institute of Architects, 79% of their member firms had 10 or fewer employees, and 94% had 25 or fewer.* It appears that utilization of tax-exempt trust funds would be concentrated among those few firms in the engineering or architectural professions large enough to set aside reserves and that the benefits of any deduction would not be distributed broadly among firms throughout the profession.

* Source: American Institute of Architects Memo, No. 576, August 20, 1979.

CONCLUSION

In summary, we believe that the additional tax deductions already provided architects and engineers by the Congress's adoption of a 10-year net operating loss carryback in 1978 provide sufficient relief and that no further tax subsidy can be justified. Liability insurance is now widely available, and rates have been stable for the past three years. By obtaining bids from a number of carriers, architects and engineers should be able to take advantage of the growing competition among underwriters. Finally, we believe that the solution proposed by S.2512 - a tax subsidy for self-insurance of the deductible - is unworkable. The use of increased deductibles will not provide the dramatic reduction of premiums architects and engineers are seeking where rates reflect problems of severity rather than frequency. The only effective way to reduce unreasonable professional liability claims is to convince state legislatures to reform tort statutes and to modify judgments by state courts.

Senator BYRD. Thank you.
The next witness.

STATEMENT OF J. SPRIGG DUVALL, PRESIDENT, VICTOR O. SCHINNERER & CO.

Mr. DUVALL. Mr. Chairman, and Senator Dole, my name is Sprigg Duvall. I am president of Victor O. Schinnerer & Co., located here in Washington. We have been professional liability counselors to the American Institute of Architects, and the Society of Professional Engineers since 1957. Since 1959, we have been the principal underwriting manager in the United States for professional liability insurance for architects, engineers, and land surveyors.

I would appreciate the opportunity to submit a more complete and detailed written statement for the committee.

Senator BYRD. Without objection.

Mr. DUVALL. I think that the committee should be aware that the architect or engineer engaged principally in design for construction, represents a very unique exposure among professional liability risks.

It is a quite distinct exposure from that of doctors, dentists, and other health care professionals, in that their essential exposure to loss is for bodily injury or death claims, generally claims brought by a single claimant, the patient or the patient's representative. The architect or engineer has a similar, and equally severe bodily injury exposure for injury or death to workers during the construction process, as well as the public following completion of the structure.

In the case of lawyers, accountants, and similar professions, the risk is one of what we call intangible financial loss, not measured in terms of death or injury, or in terms of tangible property damage, but rather loss of income, loss of use of facilities. The architect and engineer also has that exposure.

The third exposure that is not common to any other profession is the direct damage to the structure. Take the worse case, the collapse of a building. Because of these very unique, very complex, very costly to investigate and defend type of claims, the loss experience for these people has dramatically deteriorated.

Our data indicate that the frequency of claims has almost tripled since 1960, from about 12½ claims per 100 insured to almost 35 this year. The severity of claim, the amount paid by the insurance companies over and above the insured's deductible amount has more than tripled in this same period, from almost $5,500 in 1960 to almost $19,000 this year. So we have had a compounding effect on the insureds' premiums.

We, therefore, are in favor of this bill because we believe it brings three distinct benefits to this particular class of professionals. It will not make possible, nor encourage self-insurance.

What it will do is provide an opportunity for these very small businesses to set aside funds in a reasonably good year in order to meet their deductible obligations which may fall due in a year when they are not doing well financially, and even worse in a year like the past one in which credit was very difficult and sometimes impossible to obtain, and only obtainable at very high interest rates.

To take an even worse case situation which this bill would go a long way toward correcting, and it does happen more frequently than we would like to see, that an insured is called upon to pay two or more deductibles in the same year. It takes a very long time for these claims to be resolved, and there is no way of knowing when the call will be made on him for this deductible amount. Again, by being able to set aside on a reasonable, regular basis a modest portion of his income, he will be in the financial position of weathering the storm of substantial amounts of uninsured loss at a particular time.

Finally, as the law stands today throughout the country, when an architect or an engineer ceases to practice for whatever reason his liability continues for periods of as long as 12 years, for example, in Maryland, and in a few States without limit. His only alternative today is to continue to carry insurance for as long as he lives, and in most States as a matter of prudence his estate must continue to carry his insurance until it is distributed.

By permitting an orderly set aside of funds, at a point in time after the practice has ceased, and at a point in time when usually the income to the professional is substantially reduced, he will be able to reduce or eliminate the need for insurance through the maintenance of this fund.

We, therefore, urge your favorable consideration of this bill.

Thank you for the opportunity to be here.

[Statement of Sprigg Duvall follows:]

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J. Sprigg Duvall, IV
President

SYNOPSIS OF TESTIMONY OF J. SPRIGG DUVALL IN SUPPORT OF S.2512 BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY, COMMITTEE ON FINANCE

Mr. Duvall is president of V. O. Schinnerer & Company, the program administrator of the professional liability insurance program commended for architects and engineers by the American Institute of Architects and the National Society of Professional Engineers. Mr. Duvall will be speaking in support of S.2512 because of the bill's positive implications for design professionals, the insurance underwriters and the public. S.2512 will make professional liability insurance more affordable, thus enabling professionals to purchase the coverage and be financially responsible when a client or the public is injured or damaged due to professional negligence.

Professional liability claims against architects and engineers have escalated dramatically since 1960. Today, approximately one firm in three can expect a claim each year. At the same time, the costs associated with these claims have risen dramatically. Thus, for many firms, professional liability insurance costs are second only to payroll as an expense of running a professional practice.

S.2512 will enable professionals to set aside pre-tax dollars as a reserve for professional liability exposures. For most architects and engineers, this will mean having funds available for payments of high deductibles which can apply to these claims, or, it will enable the professionals to increase their deductibles to reduce premium costs.

S.2512 will have a relatively slight impact on the Federal revenues. It will have a major impact on the ability of architects and engineers to maintain their economic balance in light of the financial hardships resulting from increased professional liability exposures.

**STATEMENT OF J. SPRIGG DUVALL, PRESIDENT
VICTOR O. SCHINNERER AND COMPANY, INC.
BEFORE THE
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT GENERALLY
OF THE
COMMITTEE ON FINANCE,
UNITED STATES SENATE**

September 10, 1980
Washington, D. C.

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STATEMENT OF J. SPRIGG DUVALL
IN SUPPORT OF S. 2512
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
GENERALLY, COMMITTEE ON FINANCE, UNITED STATES SENATE
September 10, 1980

I am J. Sprigg Duvall, president of Victor O. Schinnerer & Company, Inc., the program administrator for the professional liability insurance programs commended for architects and engineers and other design professionals by the American Institute of Architects, and the National Society of Professional Engineers. Our firm has served as the professional liability insurance counsellor to AIA and NSPE since 1957, and we presently are the principal underwriting manager in the United States for professional liability insurance for architects and engineers. At this time, we insure more than 6,000 design professional firms.

We are grateful for this opportunity to testify in favor of S. 2512. With me, today, is Paul L. Genecki, a vice president of our firm.

Other witnesses will address the specific provisions of the partial self-insurance program for which this Bill provides a tax deduction within certain limits. Rather than duplicate their testimony on these matters, I would like to discuss the professional liability insurance aspects of the problem to which this proposed tax measure is directed.

Since the end of World War II, all professions in the United States have seen a substantial increase in the claims made against their members for professional liability or malpractice. Professional Liability claims have become a serious professional and financial problem for all professions, irrespective of whether legal liability ultimately is imposed.

Within the professional liability arena, there are three categories of exposure, or types of claims, that confront professionals:

1. Personal injury including bodily injury and death.

2. Damage to tangible property.

3. Intangible financial losses, such as loss of property rental income, loss of mortgage commitments, and losses occasioned by increases in interest rates attributable to delays.

For hospitals, doctors, dentists and other health care providers, the professional liability exposure is almost entirely bodily injury or death and usually involves but a single claimant. Lawyers and accountants have a professional liability exposure that usually encompasses intangible financial loss and, with the exception of SEC related matters, involves a sole claimant. Architects and engineers, however, regularly are confronted with professional liability claims involving multiple parties and arising out of any of these categories of exposure.

Claims against design professionals alleging losses in all three categories are not atypical. This is the major distinction in the professional liability exposure facing architects and engineers as contrasted to all other classes of professionals. Indeed, it is a unique and very complex exposure. In fact, in claims against design professionals, the cost of the investigation and defense can equal or exceed the original design cost of a project.

To date, the professional liability problem for architects and engineers has been especially complex because of the wide variety of sources from which claims can arise. There are many influences which affect the design professional's daily practice in this regard. Professional liability claims against architects and engineers can result from alleged negligence in the project design or in the preparation of the drawings and specifications. They can arise from services performed during the construction phase while acting as the owner's agent; or from allegedly improper specifications for new materials and products, or

from specifications for traditional products used in a new way without adequate testing; or from the increasing scope of government regulations such as building codes or standards, environmental laws, and regulations related to occupational safety; or from the constraints imposed by time and money in an era of high inflation and interest rates which result in demands to complete projects more quickly than normal; or, finally, from the changing attitudes of the courts and society in regard to the accountability of professionals for the consequences of their acts.

One way the insurance industry measures this professional liability problem is to look at the frequency of claims against architects and engineers. Measuring that frequency in terms of numbers of claims per 100 architect or engineer firms per year, our records indicate that the frequency in 1960 was 12.5 claims per 100 firms insured in the program which we manage. By 1975, the frequency rate had just about tripled to 37.3 claims per 100 firms. In 1980, early indications are that that frequency rate is 34.4 claims per 100 firms. Put another way, the "risk" probability is that one-third of all design professionals firms will experience a professional liability claim in 1980. A majority of claims are disposed of without the need for any indemnity payment by the insurance companies, but the services of defense attorneys and expert witnesses, and the time spent by a design professional to establish a successful defense, can be extremely costly. This cost is usually borne by the architect or engineer under his insurance policy deductible or out of pocket. As can be seen, this overwhelming increase in claim frequency is a particularly acute problem for design professionals.

The other major parameter used to measure professional liability is the severity of claims. This quantifies the cost of claims. (Frequency quantifies the number of claims.) Starting at the same point used above to measure claim frequency, 1960, the value of an average claim was $5,481. This amount is derived by dividing the total incurred loss for the claims by the total number of claims. This amount is in excess of the insureds' deductibles and reflects only the insurance company's claims experience in the first $250,000 layer of insurance. By 1977, the average claim had reached $17,773. When all of 1980's claims have been reported and resolved, the actuaries tell us that that average will exceed $18,500.

You already have heard from other witnesses that the cost of professional liability insurance truly is a burden to architects and engineers. The cost of professional liability insurance to an architect or engineer, in addition to their obligation to pay substantial deductibles, is somewhere in the range of 2% to more than 10% of gross billings. The cost of professional liability insurance, after personnel or salary costs, is the highest expense item for many architects or engineers.

It is important to understand how architects' and engineers' professional liability insurance policies are written to see the benefits inherent in S. 2512. These insurance policies are written on a "claims-made" basis -- i.e. the insurance must be in force when the claim is made, irrespective of when the professional services were performed. And, these policies contain substantial deductibles on a per claim basis, which apply to both indemnity payments made to a claimant and to the investigative and legal costs incurred in defending against the claim. In many cases, an architect or engineer who is absolved of liability must pay thousands of dollars just to establish the successful defense. (In some cases, insureds elect to pay higher premiums to reduce or eliminate the deductible for certain types of claims. However, the underlying problem with the expense associated with professional liability insurance remains.) Under the insurance program for which we serve as the underwriting manager, the current minimum <u>per claim</u> deductible is $2,000. The most commonly carried deductibles are in the $5,000 to $10,000 range. Rather obviously, any firm that has even a single claim is faced with a substantial financial exposure irrespective of insurance coverage.

The proposed tax deductions for amounts paid into a reserve for service liability losses represents fair and equitable tax treatment of what, by any reasonable standard, is a bona fide business expense of the design professional. In the ordinary conduct of a firm's business, we believe a responsible architect or engineer would set aside funds, not only for his own protection, but also for the ultimate protection of the public, for potential professional liability claims. Insurance premium costs are, of course, deductible at present. Monies contributed to a reserve for similar purposes should, in all fairness, be accorded similar tax treatment.

No real distinction should be made between these two forms of financial protection and, therefore, there should be no disparate treatment for tax purposes.

In our opinion, there are three benefits to be derived from S. 2512:

1. In years of less than satisfactory financial performance, it would enable architects and engineers to pay their deductibles, on professional liability insurance policies, out of funds deposited during good business years.

2. It would allow architects and engineers to more easily afford to pay multiple deductibles in those years in which they might be faced with more than one claim.

3. After ceasing to practice, it would allow design professionals to pay the costs associated with claims, with funds accumulated during years of active practice, thus alleviating the burden created by the necessity to continue to pay professional liability insurance premiums as a measure of post-practice protection. This burden thus would be alleviated without affecting recovery by consumers in situations involving valid claims.

We believe that S. 2512 will enable more firms to become better equipped to deal with these financial realities. It will not produce an immediate or dramatic reduction in professional liability insurance premiums. In fact, the short term effect would be to increase total professional liability related costs as design professionals make contributions to trusts while continuing to pay for insurance at current rate levels. But, with a tax-qualified reserve, architects and engineers will be able, over time, to increase their deductibles on commercially purchased insurance, and thus eventually will benefit from a related decrease in premium costs. The reserve that could be established because of S. 2512 will alleviate the financial hardship that can arise whether a firm has the misfortune to incur a single claim or multiple claims within an abbreviated time span.

In all of this, as well, the public has a vital interest. There can be little doubt that members of the public as well as professionals' clients are directly benefited by architects and engineers having financial resources in the event of a professional liability claim. If a person is injured or damaged by a design professional's negligence, there can be no meaningful recovery in the absence of insurance or personal assets. If a professional has chosen not to purchase professional liability insurance because of the expense, or has insufficient resources to pay the deductible, the injured party rather than the professional will suffer the financial burden. We see S. 2512 as a solution to this very real problem. The tax qualified reserve should encourage design professionals to become better equipped to deal with the unfortunate consequences of professional liability.

We strongly urge that S. 2512 be given favorable consideration, and we thank you for this opportunity to present our views.

Senator BYRD. Thank you, sir.
The next witness.

STATEMENT OF CHARLES E. SCHWING, PRESIDENT, AMERICAN INSTITUTE OF ARCHITECTS

Mr. SCHWING. Mr. Chairman, Senator Dole. My name is Charles E. Schwing. I am a practicing architect from Louisiana, and I am also the president of the American Institute of Architects. Accompanying me is Alexander Zakupowsky, Jr., of the firm of Deloitte, Haskins & Sells who put together the "Design Professionals Liability Study," which we would like entered in the record along with the more detailed statement.

Senator BYRD. It will be inserted.

Mr. SCHWING. Thank you, sir.

I am grateful for the opportunity to speak to the merits of S. 2512, a piece of urgently needed legislation which is of prime importance to the entire design profession, as well as the public.

As a practicing architect, and as a president representing over 30,000 licensed professionals, the burden of ever-increasing professional liability coverage is a problem with which I have more than firsthand knowledge.

As Senator Mathias pointed out, in the last year alone the average cost of liability insurance has gone up more than 26 percent. This exorbitant cost is driving an increasingly large number of our colleagues out of the insurance market altogether.

Architects, as small businessmen, the average firm size is nine people and less—I practice in a firm of four people—find ourselves faced with the very real fear of having to go bare—no liability coverage. This is not in the professional's interest, nor is it in the public's interest. The public is our clients.

Architects and engineers wish to meet their responsibility to the consumer. Valid liability claims should and must be paid. Yet, as insurance costs skyrocket, few of us can continue to afford the premiums.

Our survey points out that 80 percent of those that do not carry liability insurance, do not because they cannot afford it. In the

State of California nearly half of all practicing architects are going bare. Many Californians, for example, may be unable to receive compensation for valid liability claims.

In a society that has become increasingly litigation prone, the upshot is higher insurance costs and claims experience. S. 2512 will assist us in meeting the costs of our insurance policies as well as our responsibility to consumers with valid liability claims.

Architects and engineers are on the cutting edge of our society. We are the creators of our built environment. With our Nation's growing energy demand and lessening supply, we are being called upon to meld conservation and innovation, efficiency, and creativity, to take risks, to experiment and explore with new material, new designs, new technology.

S. 2512 will enable us to continue being innovative, not falling back into the tried-and-true comfort of the status quo. When you consider that our built environment accounts for 38 percent of our energy consumption, you will see that architects and engineers have their work cut out for them in solving these problems.

We seek to meet challenges, to be the problem solvers. We ask only to be afforded the opportunity to protect ourselves as we expand our knowledge and imagination.

Permitting architects and engineers to deduct from their gross income, as set forth in S. 2512 money to be placed into a self-insurance fund to be used to cover the lower end of our liability coverage as we continue to utilize conventional insurance to cover our upper exposure, will protect us small businessmen from going bare or going broke.

Clearly, S. 2512 would go a long way in assisting us in responding to the burden of liability coverage cost. We wish to commend Senators Mathias, Bentsen, and Packwood for not only their insight into this growing problem, but the scope of this action.

The American Institute of Architects urges passage of S. 2512.

Thank you.

[Statement of Mr. Charles E. Schwing and report of the American Institute of Architects follow:]

THE AMERICAN INSTITUTE OF ARCHITECTS

STATEMENT BY

Charles E. Schwing, FAIA
President
The American Institute of Architects

on

S.2512, The Service Liability Partial
Self-Insurance Act of 1980

to

U.S. Senate Committee on Finance
Subcommittee on Taxation and Debt Management Generally

September 10, 1980

1735 NEW YORK AVENUE, N.W. • WASHINGTON, D.C. 20006 • (202) 626-7300

MR. CHAIRMAN, MY NAME IS CHARLES E. SCHWING, FAIA AND I AM PRESIDENT OF THE AMERICAN INSTITUTE OF ARCHITECTS. ACCOMPANYING ME IS MR. ALEXANDER ZAKUPOWSKY JR., OF THE FIRM OF DELOITTE, HASKINS AND SELLS WHO PUT TOGETHER THE DESIGN PROFESSIONALS LIABILITY STUDY, WHICH WE HAVE PLACED BEFORE YOU. JOINING WITH US IN OUR COMMENTS IS MR. WILLIAM R. RATLIFF, PRESIDENT-ELECT OF THE AMERICAN CONSULTING ENGINEERS COUNCIL. ACCOMPANYING MR. RATLIFF IS MR. ROBERT A. WARDEN OF PEABODY, RIVLIN, LAMBERT & MEYERS. IN DEFERENCE TO THE COMMITTEE'S BUSY SCHEDULE I WILL BE BRIEF, AND HAVE SUBMITTED FOR THE RECORD A MORE DETAILED STATEMENT.

I AM GRATEFUL FOR THE OPPORTUNITY TO SPEAK TODAY TO THE MERITS OF S.2512, THE SERVICE LIABILITY PARTIAL SELF INSURANCE ACT OF 1980 - A PIECE OF URGENTLY NEEDED LEGISLATION WHICH IS OF PRIME IMPORTANCE TO THE ENTIRE DESIGN PROFESSION.

AS A PRACTICING ARCHITECT AND AS A PRESIDENT REPRESENTING OVER 30,000 LICENSED PROFESSIONALS, THE BURDEN OF EVER INCREASING PROFESSIONAL LIABILITY COVERAGE IS A PROBLEM WITH WHICH I HAVE MORE THAN FIRST HAND KNOWLEDGE. IN THE LAST YEAR ALONE, THE AVERAGE COST OF LIABILITY INSURANCE HAS GONE UP MORE THAN 26%. THIS EXORBITANT COST IS DRIVING AN INCREASINGLY LARGE NUMBER OF OUR COLLEAGUES OUT OF THE INSURANCE MARKET ALTOGETHER.

ARCHITECTS, AS SMALL BUSINESSMEN, THE AVERAGE FIRM SIZE IS NINE PEOPLE AND LESS - FIND OURSELVES FACED WITH THE VERY REAL FEAR OF HAVING TO GO BARE: NO LIABILITY COVERAGE. THIS IS NOT IN EITHER

THE PROFESSIONS' INTEREST, OR THE PUBLIC INTEREST- THE CLIENTS WE SEEK TO SERVE. ARCHITECTS AND ENGINEERS WISH TO MEET THEIR RESPONSIBILITY TO THE CONSUMER. VALID LIABILITY CLAIMS MUST BE SETTELD. YET, AS INSURANCE COSTS SKY ROCKET FEWER OF US CAN CONTINUE TO AFFORD COVERAGE. OUR SURVEY POINTS OUT THAT 90% OF THOSE THAT DO NOT CARRY LIABILITY INSURANCE, DO NOT BECAUSE THEY CAN NOT AFFORD IT. IN THE STATE OF CALIFORNIA NEARLY HALF OF ALL PRACTICING ARCHITECTS ARE GOING BARE - NO LIABILITY COVERAGE. MANY CALIFORNIANS, FOR EXAMPLE, MAY BE UNABLE TO RECEIVE COMPENSATION FOR VALID LIABILITY CLAIMS. IN A SOCIETY THAT HAS BECOME INCREASINGLY LITIGATION PRONE THE UPSHOT IS HIGHER INSURANCE COSTS AND CLAIMS EXPERIENCE. S.2512 WILL ASSIST US IN MEETING THE COSTS OF OUR INSURANCE POLICIES AS WELL AS OUR RESPONSIBILITY TO CONSUMERS WITH VALID LIABILITY CLIAMS.

ARCHITECTS AND ENGINEERS ARE ON THE CUTTING EDGE OF OUR SOCIETY. WE ARE THE CREATORS OF OUR BUILT ENVIRONMENT. WITH OUR NATION'S GROWING ENERGY DEMAND AND LESSENING SUPPLY WE ARE BEING CALLED UPON TO MELD CONSERVATION AND INNOVATION - EFFICIENCY AND CREATIVITY; TO TAKE RISKS, TO EXPERIMENT AND EXPLORE WITH NEW MATERIAL, NEW DESIGNS, NEW TECHNOLOGY. S.2512 WILL ENABLE US TO CONTINUE BEING INNOVATIVE - NOT FALLING BACK INTO THE TRIED AND TRUE COMFORT OF THE STATUS QUO. WHEN YOU CONSIDER THAT OUR BUILT ENVIRONMENT ACCOUNTS FOR 38% OF OUR ENERGY CONSUMPTION, YOU WILL SEE THAT ARCHITECTS AND ENGINEERS HAVE THEIR WORK CUT OUT FOR THEM IN SOLVING THESE PROBLEMS.

WE SEEK TO MEET CHALLENGES - TO BE PROBLEM SOLVERS. WE ASK ONLY TO BE AFFORDED THE OPPORTUNITY TO PROTECT OURSELVES AS WE EXPAND OUR KNOWLEDGE AND IMMAGINATION.

PERMITTING ARCHITECTS AND ENGINEERS TO DEDUCT FROM OUR GROSS INCOME, AS SET FORTH IN S.2512, MONEY TO BE PLACED INTO A SELF-INSURANCE FUND TO BE USED TO COVER THE LOWER END OF OUR LIABILITY COVERAGE AS WE CONTINUE TO UTILIZE CONVENTIONAL INSURANCE TO COVER OUR UPPER EXPOSURE, WILL PROTECT US SMALL BUSINESSMEN FROM GOING BARE OR GOING BROKE.

CLEARLY, S.2512 WOULD GO A LONG WAY IN ASSISTING US IN RESPONDING TO THE BURDEN OF LIABILITY COVERAGE COST. WE WISH TO COMMEND SENATOR MATHIAS FOR NOT ONLY HIS INSIGHT INTO THIS GROWING PROBLEM, BUT THE SCOPE OF HIS ACTION. THE AMERICAN INSTITUTE OF ARCHITECTS URGES PASSAGE OF S.2512.

THANK YOU . . . . .

THE AMERICAN INSTITUTE OF ARCHITECTS

AMERICAN CONSULTING ENGINEERS COUNCIL

JOINT STATEMENT OF

THE AMERICAN INSTITUTE OF ARCHITECTS

AND

THE AMERICAN CONSULTING ENGINEERS COUNCIL

BEFORE THE

SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

September 10, 1980

Washington, D.C.

OUTLINE OF
AIA/ACEC JOINT STATEMENT

Nature of Design Professions

- Professional services for the private sector, government and grantees.
- Small businesses.

A-E Liability Problems

- Victims of litigation-prone society.
- Numerous claims, including third-party suits.
- Nature of insurance coverage and costs.
- Uninsured expenses of claims.
- Large numbers of design firms unable to afford insurance.

Legislative Remedy -- S. 2512

- Sponsors of bill.
- Trust funds and permitted uses.
- Utilization of legislation.
- Fund categories and contributions.
- Penalties for unauthorized distributions.
- Narrow scope for bill.
- Protection for trust assets.
- Revenue estimate

Justification

- Design professions and built civilization.
- Make maximum use of A-E potential.

Conclusion

- Serious problems exist -- S. 2512 is a remedy.
- Congress can help A-Es and the public interest.

AIA/ACEC JOINT STATEMENT
IN SUPPORT OF S. 2512

Mr. Chairman and Members of the Subcommittee, representatives of the American Institute of Architects (AIA), Charles E. Schwing, President, and of the American Consulting Engineers Council (ACEC), William R. Ratliff, President-Elect, appear before you today in support of S. 2512, the Service Liability Partial Self-Insurance Act of 1980. Accompanying us are Alex Zakupowski of Deloitte, Haskins & Sells, and Robert Warden, of Peabody, Rivlin, Lambert & Meyers.

Who We Are

The American Institute of Architects is a nationwide organization comprised of approximately 31,000 members. The American Consulting Engineers Council is a federation of approximately 3,800 construction-related design engineering firms having 100,000 employees.

We and the other design profession organizations and their member firms are a labor-intensive industry employing state-licensed professionals and supporting staff to perform various construction-related architectural and engineering functions.

These include designing, surveying, planning, evaluating, making studies and inspecting construction projects as representatives of owners. A-Es are not construction contractors, but professionals who are in the employ of owners/clients. While much of our work is performed in the private sector, we also have direct contracts with governments at all levels, as well

as with states and local communities under various federal grant programs.

Most engineering and architectural firms in the United states are categorized as small businesses. Many are one- and two-person operations. Sixty-four percent of the firms have fewer than ten employees. The average size of an architectural firm is nine. Seventy-five percent of ACEC firms employ 20 or less; 90 percent of consulting engineering firms have fewer than 50 employees.

Architectural and engineering firms are typical of small businesses today, for they must struggle to overcome lack of capital, high inflation, rising costs and increasing litigation.

A-E Liability Problems

Ours is a litigation-prone society. One of the most serious difficulties facing design professionals is that of liability! A-E firms experience very real and very frustrating problems with liability claims and costs for protecting themselves from them.

A recent study by the accounting firm of Deloitte, Haskins & Sells (DHS) (Appendix I) shows that one-third of all A-E firms, regardless of size, experienced liability claims cver the past five years. This DHS study also found that as the size of the firm grows, so does the likelihood of experiencing claims. Two-thirds of the larger firms reported at least one claim during the same five-year period.

These claims against A-Es are not always based upon alleged acts or errors by design firms, but include increasing numbers of third-party lawsuits, where litigants attempt to collect from anyone potentially suable.

To help protect themselves, design firms carry substantial amounts of insurance. According to DHS, the average policy is for $449,000, with a deductible of $8,000. The costs of insurance, the study revealed, are relatively speaking more severe for smaller firms than for larger ones.

Liability premiums for all sizes of A-E firms are high, along with the levels of deductibles which firms must often accept in order to hold down the costs of insurance or to raise their upper levels of coverage. The DHS study revealed that 95 percent of the firms surveyed believe that their liability isnurance premiums are high. Further, 64 percent of the firms surveyed reported that their insurance costs exceeded two percent of their gross receipts. A more limited 1979 ACEC membership survey showed the average amount of gross revenues spent for insurance was 2.9 percent.

In testimony delivered to the House Committee on Ways and Means on a similar legislative proposal in 1978, a design community witness stated, "For many A-Es, insurance coverage is now the largest single cost item after payroll. What is more, purchased insurance is generally a fixed cost for construction designers, while the construction industry is highly cyclical."

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Despite insurance policies, there are uninsured expenses for design firms facing claims. Since the vast majority of claims against architects and engineers are relatively small, this means that A-Es must pay as first costs claims and legal fees up to the levels of their deductibles from out-of-pocket. These uninsured first costs of liability can be especially destructive to small businesses.

Whether one wins or loses on a claim, there are always costs to the firm. In addition to the cash expenses referred to above, the A-E firm must absorb the intangible costs of uncompensated professional time spent in investigation and defense preparation. Since an engineer or architect, like any professional, essentially sells his or her time, this can be a significant loss.

The possibility of liability claims does not end when a project is completed, for liability coverage for design firms is written on a "claims-made" basis. Since insurance covers claims for errors, omissions or acts only during the term of the policy, design firms must maintain insurance long after projects have been completed. In some cases this could literally be forever, as not all states have statutes of limitations!

Living with deductibles is another fact of life as design firms seek to help control expenses. Yet current tax laws discriminate against those who accept high deductibles to reduce premiums or to raise policy coverage. Monies now paid into reserve accounts are not deductible as business expenses until

actually paid on claims, though payments on insurance premiums are deductible.

Adding to the serious situation we have described above is the shocking finding by DHS that 24 percent of the firms surveyed have no liability insurance coverage. They are, to use industry vernacular, "going bare". Some areas of the country have even greater numbers unprotected. An AIA membership survey, taken in 1979, showed that 54 percent of Texas and 49 percent of California architects are without insurance.

A-E firms "go bare" largely because they cannot afford the insurance costs attendant to their work. Eighty percent of those surveyed by Deloitte, Haskins & Sells, who do not now carry liability insurance, reported that high cost is the major reason. This situation is most unfortunate and unhealthy. It may prevent consumers and others having legitimate claims from collecting on them and it can result in A-E firms being forced out of business. Perhaps some suits which go on and on do so only because the firms may not have the means to settle claims.

We believe that a sound and healthy A-E profession is an asset and a necessity for our society and economy. We believe it can be protected and assisted in its efforts to cope with our increasingly litigation-prone society.

Legislative Remedy

The membership of AIA and ACEC, as well as the Committee on Federal Procurement of Architectural and Engineering Services

(COFPAES), strongly urge passage of S. 2512. Introduced by Senator Charles McC. Mathias and co-sponsored by two Members of this Subcommittee (Senators Bentsen and Packwood), Senator Durenberger of the full Committee and Senator Magnuson, S. 2512 will deal effectively with the design profession's liability problems. We believe that S. 2512, if enacted into law, will help provide significant relief for the design community and will help in the settling of legitimate claims.

Senator Mathias' imaginative approach will permit A-E firms to create and use service liability tax-deductible trust funds in order to meet the out-of-pocket first costs of settling legitimate claims and defending themselves when required. Design professionals would be allowed to use assets from trust funds for: (1) claim settlements; (2) legal or investigative costs; and (3) incidental costs for administering the trust fund.

It is important to understand that S. 2512 is not intended to replace insurance, but to supplement it. Senator Mathias and his co-sponsors have crafted a legislative vehicle with which design firms can accumulate reserves to settle legitimate liability claims and pay for legal defenses under the levels of their deductibles without seriously disrupting cash flows. The legislation will permit design firms to, in effect, "pre-deduct" funds which become, at a later time, items tax-deductible as business expenses.

While only four percent of A-E firms now use the non-deductible set-asides, two-thirds of the firms surveyed by DHS indicated that they would make some use of the design liability trust funds if Congress enacts S. 2512. Fifty-eight percent of those queried reported that use of the trust fund, as permitted under S. 2512, would cause them to increase their deductible amounts. Such adjustments would permit increasing policy coverages or reducing premium costs.

S. 2512 defines two categories of liability problems and provides corresponding levels of trust fund deductions for them. Taxpayers with "severe service liability insurance problems" are defined as those who are unable to obtain $1 million of liability insurance and those who can obtain such insurance, but only at the cost of a premium in excess of two percent of their gross receipts for a year.

Those having "severe" problems would be permitted to make annual contributions limited to the lesser of: (1) five percent of the taxpayer's gross receipts for the year from activities which might give rise to service liability; (2) a cumulative limitation equal to 15 percent of the taxpayer's average gross receipts (based on a five-year moving average) from such activities, minus any amounts already contributed to the account in prior years by the taxpayer; or (3) $100,000.

All other taxpayers would be limited to deductions equal to the lesser of: (1) two percent of the current year's gross receipts; (2) ten percent of the average receipts during the

five-year base period, minus prior-year contributions; or (3) $25,000.

All distributions from the proposed service liability trust funds would be taxable when made. However, if the amounts are used by taxpayers to satisfy service liability claims, the taxpayer will be able to take an offsetting deduction. In order to discourage and penalize unauthorized distributions from trust funds (i.e., use of a trust fund for anything but service liability purposes), a ten-percent penalty tax would be added to the tax due on the amount of the distribution.

It is clearly the intention of the bill's sponsors and the design community that use of the trusts established under the provisions of S. 2512 be limited solely to A-E firms. "Double-dipping" -- taking a deduction for a liability claim/legal fee and one for a trust fund in the same year -- is also not intended. Should any doubt exist that these might be permitted, we stand ready to assist in any necessary modifications of the bill or preparations of report language to cover the situations.

To insure that a liability trust-fund is adequately protected, limitations are placed on use of its assets. Service liability trust fund assets may only be invested in United States securities, state or local securities, bank deposits or other investments permitted to trustees or fiduciaries under state laws. Further, the assets of a trust cannot be invested into the business of the taxpayer establishing the trust.

While the problems of the design professions and their effects on society are very important when judging the merits of S. 2512, we would be remiss in not offering our best estimate of the "revenue loss" involved.

Deloitte, Haskins & Sells estimates that the total amount of federal income savings to be derived by the design professionals under the provisions of S. 2512 for 1981 is $50 million. However, it is also estimated that within five years $32.8 million of this tax benefit will be recaptured as funds are used to satisfy liability claims ($25.8 million) and to pay legal expenses ($7 million). These findings are based upon the two important assumptions noted earlier: (1) trust usage is limited to design firms; and (2) A-E firms must use trust funds rather than other assets to meet liability needs to prevent "double-dipping" tax deductions in a given year.

Justification For Enactment

Architectural and engineering firms are literally at the cutting edge of our built civilization. In the words of Senator Mathias when he introduced S. 2512, "The incredible technology that the design profession has fostered makes it the medium by which we shall create our future." We are here asking you and the Congress for help and consideration in recognition of the contributions architects and engineers have made and can make to the growth and development of our civilization.

Design professionals are vital to all that is built for our use. They create skyscrapers, span mighty rivers, harness the power of wind, water and the sun, develop energy sources, create transportation systems, promote energy conservation and do countless other things which many take for granted. A-Es are highly qualified, technically proficient, individuals, trained through education and practical experience to develop the innovative ideas and plans that will provide a better world for all of us.

Conclusion

We believe that serious liability problems threaten the design professions and inhibit making maximum use of their capabilities. Passage of S. 2512 will help to solve the very real liability problems of the small business-men and -women who comprise the design professions.

It will also encourage those who would extend the state of the art in architecture and engineering. In an era of growing scarcity and rising costs, the design community is the key to energy conservation, use of new materials, reduction of costs and development of better techniques.

Mr. Chairman and Members of the Subcommittee, we thank you for this opportunity to present our views on what we consider to be a vital matter. We will be pleased to answer any questions you may have.

Deloitte
Haskins+Sells

DESIGN PROFESSIONALS LIABILITY STUDY

Prepared for

THE AMERICAN INSTITUTE OF ARCHITECTS

and

THE AMERICAN CONSULTING ENGINEERS COUNCIL

July 30, 1980

Deloitte Haskins+Sells

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July 30, 1980

President
The American Institute of Architects
1735 New York Avenue, N.W.
Washington, D.C. 20006

President
The American Consulting Engineers Council
1015 15th Street, N.W.
Washington, D.C. 20005

Dear Sirs:

Enclosed is our report on the Design Professionals' Liability Study that we conducted on your behalf. As more fully explained in our report, the study shows:

- The architect/engineering profession is dominated by small firms.
- The profession's liability problems are high insurance costs and claims experience.
- A large majority of firms favor federal legislation that would allow a tax deduction for contributions to a tax exempt professional liability trust.
- Over half of the firms that indicated an interest in the proposal said that their contributions would satisfy their liability needs.
- The estimated amount of federal income tax savings to be derived by the profession from the liability proposal for 1981 is $50 million. However, we estimate that within five years $32.8 million of this tax benefit will be recaptured as funds are used to satisfy liability claims and pay legal expenses.

We appreciate this opportunity to be of service to The American Institute of Architects and The American Consulting Engineers Council.

Very truly yours,

Deloitte Haskins & Sells
DELOITTE HASKINS & SELLS

BEST COPY AVAILABLE

DESIGN PROFESSIONALS LIABILITY STUDY

Prepared by

DELOITTE HASKINS & SELLS

for

THE AMERICAN INSTITUTE OF ARCHITECTS

and

THE AMERICAN CONSULTING ENGINEERS COUNCIL

July 30, 1980

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INTRODUCTION

Earlier this year, The American Institute of Architects (AIA) and The American Consulting Engineers Council (ACEC) commissioned a survey to gather information about their members' professional liability problems. The survey was undertaken in response to the concern expressed by many architectural/engineering firms (hereinafter referred to as A/E firms) with the high cost of maintaining professional liability insurance.

The primary purpose of the survey, in addition to documenting the extent and magnitude of the professional liability problem, was to measure the utility of federal legislation that would permit A/E firms to establish a tax-exempt professional liability trust for payment of liability claims. A summary of this proposal is included in the questionnaire packet as Exhibit A.

Results of the survey are presented in this report in both summary and detail form. The results are focused on the following issues:

- Profile of the A/E profession.
- Nature of the professional liability problem.
- Views on the proposed legislation.
- Estimate of tax savings.

The report also includes a description of the survey population and tabulations of survey responses.

SUMMARY OF RESULTS

Profile of the profession*

The survey indicates that the profession is dominated by small firms. Sixty-four percent of the firms surveyed reported fewer than 10 employees and average annual gross billings of $135,000. Seventy-nine percent reported fewer than 20 employees and an average gross billing of $447,000.

The corporation was the predominant form of firm responding (48 percent of firms), with proprietorships second (35 percent of firms). Partnerships accounted for 16 percent of the response.

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* Because of the size of the 10 largest firms responding to the survey compared with the size of the other responding firms, it was necessary to exclude these 10 largest from the general survey results in order to present the results fairly. The responses of the 10 largest firms are presented in Exhibit C.

Nature of the professional liability problem

Over one-third of all firms reported at least one liability claim during the past five years. Analyzed further, we found that two-thirds of the larger firms (30 - 199 employees) reported at least one claim during this period. The number of claims reported shows a general increase as the size of the firm increases.

Seventy-six percent of the firms surveyed reported that they carry liability insurance. Of those firms, 46 percent said they carry it because of client requirements. Insurance premium costs, as a percentage of gross billings, appear to decrease as the size of the firm increases. For smaller firms, with one to nine employees, insurance premiums average approximately 3 percent of gross billings. This ratio decreases to approximately 2 percent for the larger firms with 30 - 199 employees. Sixty-four percent of the firms reported that their insurance costs exceed 2 percent of gross receipts.

Almost three-quarters (73 percent) of those firms surveyed believe that insurance premiums are very high; 22 percent believe them to be somewhat high, and 5 percent believe them to be moderate. None responded with the view that insurance premiums were somewhat low or very low.

Eighty percent of those that do not carry liability insurance reported that its high cost was the major reason for not carrying it. Only 9 percent said they did not have insurance because professional liability was not a concern.

Views on proposed legislation

Over two-thirds of the firms surveyed indicated that they would be likely to establish a tax-exempt trust. At present, only 4 percent of those surveyed reported that they set aside funds or create reserves for liability purposes. The major reason for firms expressing a lack of interest in establishing a trust is that they cannot afford to set aside the funds. Almost three-quarters of the firms that viewed the availability of funds as a major obstacle to utilization of the proposal were the smaller firms with one to nine employees.

Many firms reported that they would set aside significantly less than the maximum allowable amount. Overall, the firms indicated that they would set aside an average of between 2 and 3 percent of their present annual gross billings.

In response to an inquiry as to what firms would do about their insurance coverage once they established a liability trust, 58 percent of the firms indicated they would increase the deductible amount on their policy.

Table 1

FORM OF BUSINESS ORGANIZATION

	Overall	Architects	Engineers
Proprietorships	35%	41%	18%
Partnerships	16	21	6
Corporations	48	37	75
Other	1	1	1

Corporations are the most predominant business form, particularly for the engineering firms. However, most architectural firms classified themselves as proprietorships, with corporations the second largest category.

Numbers of employees

To give an indication of the size of each firm, the questionnaire asked for the number of full-time employees of each firm replying to the survey. Table 2 illustrates the results of this question.

Table 2

SIZE OF FIRMS

Size of Firm (number of employees)	Percent of Firms
1 - 9	69
10 - 19	16
20 - 29	6
30 - 199	9
Total	100

The large majority of firms have few employees. Sixty-nine percent have one to nine employees and 85 percent have fewer than 20 employees.

These results closely parallel previous findings regarding the sizes of firms forming the membership of The AIA and The ACEC.

To illustrate, the 1979-80 profile of ACEC membership shows that 75 percent of member firms have fewer than 20 employees and 63 percent

have fewer than 12 employees. In addition, a 1980 survey of consulting engineering firms, conducted by Consulting Engineer magazine, found that 78 percent of those firms had 25 or fewer employees and 55 percent had fewer than 10 employees. A limited survey of AIA membership conducted in June 1979 found that 78 percent of these firms had nine or fewer employees.

Types of services

Eighteen percent of architectural firms replying to the survey provided interior planning and some type of engineering service in addition to their architectural services. Seven percent provided construction management services and 6 percent said they provided other types of services.

Of engineering firms in the survey, 51 percent were involved in civil engineering, 66 percent in structural engineering, 38 percent in mechanical engineering, and 28 percent in electrical engineering. Fifteen percent were providing architectural services and 16 percent said they were involved in construction management.

Annual gross billings

Firms were asked to provide their annual gross billings for the preceding five years. The replies were averaged to obtain an average annual gross billing for each firm for the five-year period. The results were then summarized by firm size as shown in the following table.

Table 3

GROSS BILLINGS BY SIZE OF FIRM

Firm Size (number of employees)	Average Annual Gross Billings	Annual Gross Billing Range
1 - 9	$ 135,000	$ 1,000 - $1,400,000
10 - 19	447,000	87,000 - 1,385,000
20 - 29	722,000	175,000 - 1,462,000
30 - 199	1,440,000	384,000 - 4,900,000

The upper level of the gross billing range remains fairly constant for firms with up to 29 employees. As would be expected, the larger the firm in terms of full-time employees, the higher the average annual gross billings.

The average annual gross billing for all the firms replying to the survey was $350,000, reflecting the predominance of firms in the one to nine employee category.

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Nature of professional liability problem

Claims history

Of the total number of firms replying to the questionnaire, over one-third have experienced liability claims. The following table reflects the percentage of firms experiencing liability claims.

Table 4

PERCENTAGE OF FIRMS EXPERIENCING LIABILITY CLAIMS BY SIZE OF FIRM

Firm Size (number of employees)	Percentage of Firms Experiencing Liability Claims
1 - 9	22
10 - 19	40
20 - 29	65
30 - 199	67

As the size of the firm grows, so does the liability claim experience. The frequency of claims reported by firms with over 20 employees is approximately three times that of the smaller firms with one to nine employees.

Firms were also asked how many liability claims they had experienced during the past five years. The following table summarizes responses by incidence of claims for the five-year period for firms that have experienced liability claims.

Table 5

INCIDENCE OF CLAIMS BY SIZE OF FIRM FOR FIRMS HAVING CLAIMS

Firm Size (no. employees)	No. of Claims experienced in the past 5 yr. period				
	at least 1	at least 2	at least 3	at least 4	5 or more
1 - 9	100%	34%	10%	5%	2%
10 - 19	100	47	21	8	5
20 - 29	100	53	21	10	-
30 - 199	100	67	55	32	30

Generally, as firm size increases, so does the number of claims reported by firms that have experienced claims. Only 2 percent of the smaller firms with claims reported more than four claims within the past five years, whereas 30 percent of the larger firms with claims experienced more than four claims during the same period. However, no firms in the 20 - 29 employee group reported more than four claims.

Firms were asked to give details of the dollar amounts of the claims they had experienced. This information is illustrated in the following table.

Table 6

AVERAGE DOLLAR AMOUNT OF CLAIMS EXPERIENCED BY FIRMS WITH CLAIMS

Firm Size (number of employees)	Average Dollar Amount of Claims Over the Past Five Year Period
1 - 9	$ 180,000
10 - 19	1,209,000
20 - 29	269,000
30 - 199	1,870,000

As pointed out earlier, no firms in the 20 - 29 employee group reported more than four claims. This experience is reflected in a disproportionately low average dollar amount of claims reported by this group.

Legal fees

Firms having liability claims were asked how much they had paid in legal fees relating to those claims over the past five-year period. The answers to this question were stratified by size of firm and are presented in the following table.

Table 7

LEGAL FEES BY SIZE OF FIRM

Firm Size (number of employees)	Average Legal Fees for Past 5 Yr. Period	Legal Fee Range for Past 5 Yr. Period
1 - 9	$ 5,000	$2,000 - $ 30,000
10 - 19	8,000	1,000 - 26,000
20 - 29	8,000	1,000 - 14,000
30 - 199	20,000	1,000 - 130,000

Average legal fees, as reported, increase as the size of the firm increases. Annual legal fees average approximately $2,000 per firm.

Insurance

Firms were asked whether they carried professional liability insurance and, if they did, whether it was carried because of client requirements. Seventy-six percent of the firms surveyed indicated that they did carry professional liability insurance. Forty-six percent of these firms carried the insurance because of client requirements.

Firms carrying liability insurance also supplied information about their insurance policy limits, deductible amounts, and premiums over the past five years. The results were averaged to obtain annual figures for purposes of interpretation. The average yearly policy limit was $449,000 and the deductible amount averaged $8,000. Only 12 firms reported coverage in excess of $1 million. In the case of premium costs, the replies were broken down by firm size and compared with average annual gross billings. The following table reflects the results.

Table 8

AVERAGE PREMIUMS AND
COMPARISONS TO GROSS BILLINGS BY SIZE OF FIRM

Firm Size (no. employees)	Average Premium	Average Gross Billings	Premiums/ Billings
1 - 9	$ 4,000	$ 135,000	3.0%
10 - 19	12,000	442,000	2.7
20 - 29	16,000	722,000	2.2
30 - 199	30,000	1,440,000	2.1

The highest premium to gross billing ratio is experienced by firms in the one to nine employee category, the smallest in size. Then, as firm size increases, the premium/gross billing ratio decreases. However, in no size category does this ratio fall below 2 percent for firms with fewer than 200 employees.

The results of the survey show that 64 percent of the responding firms pay in excess of 2 percent of their gross receipts for insurance premiums. For the smallest firms with one to nine employees, premiums reported were as high as 37.5 percent of gross billings; 78 percent of these firms reported premiums in excess of 2 percent of gross billings.

Firms that carry liability insurance were asked their view on its present cost. Seventy-three percent of the firms believe that insurance premiums are very high, 22 percent believe them to be somewhat high,

and 5 percent believe them to be moderate. None responded with the view that insurance premiums were somewhat low or very low. Thus, in total, 95 percent of those that carry liability insurance feel the cost is at least somewhat high.

For firms that do not carry liability insurance at present, 80 percent gave high cost as their main reason for being uninsured. Only 9 percent said it was because professional liability was not a concern, and only 2 percent said they could not obtain the desired coverage.

Reserves

Only 22 firms of the 588 surveyed indicated that they currently set aside funds or established reserves. This amounts to less than 4 percent of the firms. In total, these firms reported that they set aside or reserved $166,000 annually.

Views on proposal

Firms that would use proposal

Firms were asked whether they would be likely to establish a tax-exempt liability trust to partially or fully self-insure against liability losses. A detailed breakdown of their responses is given in the following table.

Table 9

VIEWS ON PROPOSAL

Size of Firm (no. employees)	Percent Likely to Utilize Trust
1 - 9	62
10 - 19	77
20 - 29	87
30 - 199	78
For all Firms	67

Overall, two-thirds of all firms responding to this question indicated that they were likely to establish a professional liability trust.

Upon further analysis of these results, we found that of the firms experiencing liability claims, 76 percent said they would use the proposed trust. Sixty percent of those that did not have a history of claims said they were likely to use the trust. Thus, there is a high acceptance of the proposal regardless of a firm's claims history.

Fifty-six percent of those firms that do not carry liability insurance at present favored the proposal; over two-thirds of those that said the present cost of their insurance is very high indicated they would probably use the trust.

Firms that would not use the proposal

Those who replied 'no' to establishing a professional liability trust were asked to rank their reasons in order of importance. A ranking of 'one' was assigned to the most important reason, 'two' for the next most important, and so on. The following table shows the proportion of firms not likely to establish a professional liability trust voting for that particular reason within a ranking.

Table 10

ANALYSIS OF WHY FIRMS WOULD NOT
USE A PROFESSIONAL LIABILITY TRUST

Reasons for Not Establishing Trust	Ranking of Reasons by Firms Not Likely to Establish a Trust			
	1	2	3	4
Professional liability not a concern	6%	5%	5%	10%
Prefer commercial liability insurance	12	18	16	13
Could not afford to set aside funds	49	24	8	7
Tax benefits not sufficient incentive	10	32	27	20
Tax penalty on unauthorized distributions	12	8	19	20
Permissible investments for funds not acceptable	1	7	22	23
Other	10	6	3	7

The major reason for firms not using the proposed trust is that they cannot afford to set aside the funds. Preference for commercial liability insurance and the tax penalty on unauthorized distributions rank as the second most important reasons for not being likely to use the trust. A significant percentage of firms indicated as their second most important reason that the tax benefits of the proposal are not a sufficient incentive to set aside funds. A very low percentage of firms indicated that their reason was that professional liability was not a concern. The limitations on investments only became significant as the third or fourth reason for not being likely to establish a trust.

Amount to be set aside

The firms that indicated they would use a professional liability trust said they would set aside a total of $3,481,000 annually, amounting to an overall average of approximately $10,000 per firm. The replies from these firms were analyzed further to determine the amount which would be set aside by size of firm and the relationship to their gross billings. The results of this analysis are illustrated as follows.

Table 11

AVERAGE AMOUNT TO BE SET ASIDE AND COMPARISON TO GROSS BILLINGS BY SIZE OF FIRM

Firm Size (no. employees)	Average Annual Gross Billing	Average Amount Would Set Aside	Percent of Gross Billings Set Aside
1 - 9	$ 135,000	$ 4,500	3.3
10 - 19	447,000	10,500	2.3
20 - 29	722,000	17,000	2.4
30 - 199	1,440,000	29,000	2.0

The amount to be set aside as a percentage of gross billings is highest for firms in the one to nine employee category and lowest for firms in the 30 - 199 employee category. Each classification of firm by size would set aside at least 2 percent of their annual gross billings. Fifty-two percent of the firms responded that the amount they would set aside would be sufficient to cover their needs.

Action to be taken on insurance coverage

Firms in favor of establishing a professional liability trust were asked what they would do with their present insurance coverage. The following table summarizes their replies.

Table 12

INDICATED CHANGES IN INSURANCE COVERAGE

Actions With Regard to Present Insurance	Percent
Raise deductible	58
Raise policy limit	19
Lower policy limit	12
Discontinue commercial coverage	11

Most firms (58 percent) would raise their deductible amount. Raising of the policy limit is the second choice and lowering the policy limit the third. These results indicate that firms are more likely to retain their present insurance policies, while altering their terms, rather than discontinue their insurance coverage altogether.

Estimate of tax savings

If the proposed professional liability trust legislation, as outlined in the survey, is enacted with an effective date that would allow its use for taxable years beginning after December 31, 1980, the expected federal income tax savings for members of the A/E profession for 1981 is approximately $50 million.

The proposal is designed to encourage firms to set aside funds for future liability losses and expenses by allowing a tax deduction at the time the funds are set aside instead of at the time the losses and expenses are incurred. Because of this, the tax benefit derived in 1981 is not permanent but rather is an acceleration of deductions that would otherwise be allowable in the future years when the losses and expenses are actually incurred. This acceleration of tax deductions amounts to a deferral of income tax payments. At the time the trusteed funds are used to satisfy these losses and expenses, the deferral is terminated.

Based on the history of claims reported in the survey over the last five years, it is estimated that $25.8 million of the initial $50 million tax deferral will be terminated as it is used to pay liability claims within the first five years of the proposal's existence. Furthermore, based on the history of legal fees paid as reported in the survey, it is estimated that $7 million of the 1981 tax deferral will be terminated within the same period. The methodology used to make these estimates is explained in Exhibit D.

EVALUATION OF RESULTS

The A/E profession is dominated by small firms. The nature of the professional liability problem projected by the firms appears to be twofold. First, they clearly expressed the view that insurance costs are high. This was especially true for the smaller firms. The second part of the problem is the claims experience. As the size of a firm grows, so does the likelihood of experiencing claims. Although insurance costs and claims experience are problems expressed by all sizes of firms, the relative importance appears to shift from insurance costs to actual claims as the size of the firm increases. A large majority of firms favor federal legislation that would allow a tax deduction for contributions to a tax-exempt professional liability trust. This is true whether or not the firms currently have insurance or have experienced claims. If the legislation were enacted, most firms would qualify as having a severe liability problem. Over half of the firms

that indicated an interest in the proposal said that their contributions would satisfy their liability needs, although only a small percentage said they would discontinue commercial coverage.

Exhibit A

THE AMERICAN INSTITUTE OF ARCHITECTS

AMERICAN CONSULTING ENGINEERS COUNCIL

DESIGN PROFESSIONALS LIABILITY STUDY

May 9, 1980

Dear Member:

The high cost of maintaining professional liability insurance is a concern shared by many firms in the architectural/engineering profession. For some, the financial burden posed by escalating premium costs is considerable.

In our continuing efforts to serve the best interest of the profession and the public, AIA and ACEC have initiated an in-depth study of the professional liability insurance problem and possible solutions to that problem. One of these solutions is set forth in proposed federal legislation that would permit design professionals to set aside a portion of pre-tax income from services to pay any ultimate liability resulting from those services. The amount set aside would be placed in a tax-exempt professional liability trust. Attachment 1 explains the provisions of the legislation in greater detail.

But before we proceed with our legislative strategy, we must be able to provide the Congress with a better view of the scope of the problem and the viability of the solution. First, we need to verify the extent and magnitude of the liability insurance problem among profession members. Second, we need to measure the potential utility to firms of the method set forth in the proposal.

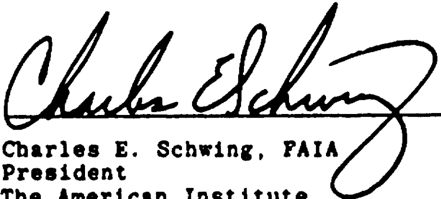
To do this, we have engaged the firm of Deloitte Haskins & Sells to conduct a survey of our membership. The survey is designed to provide the documentation we need to secure strong congressional backing for our legislation. Your prompt response is essential to the success of our efforts.

To ensure the confidentiality of the information your firm provides questionnaires will be returned directly to Deloitte Haskins & Sells for tabulation. In no case will specific date from firms be disseminated.

We think the time it will take you to complete the questionnaire will be well spent. We know it will help us better serve you and other members of our profession. Because you are part of a selected sample of architectural/engineering firms, it is important that you respond.

We ask that you please return this questionnaire directly to Deloitte. Haskins, & Sells, 1101 Fifteenth Street, NW., Washington, D.C. 20005 no later than May 30, 1980. A self-addressed, business reply envelope is enclosed for your convenience.

Thank you for your cooperation.



Charles E. Schwing, FAIA
President
The American Institute
of Architects

George W. Barnes
President
The American Consulting
Engineers Council

THE AMERICAN INSTITUTE OF ARCHITECTS

AMERICAN CONSULTING ENGINEERS COUNCIL

DESIGN PROFESSIONALS LIABILITY STUDY

AIA/ACEC PROFESSIONAL LIABILITY SURVEY

Description of Firm

1. Form of firm

   ____ proprietorship

   ____ partnership

   ____ corporation

   ____ other (specify) ______________________________

2. Current number of full-time employees

3. Type(s) of services provided (check all that apply)

   ____ architecture ____ electrical engineering

   ____ civil engineering ____ interior planning

   ____ structural engineering ____ construction management

   ____ mechanical engineering ____ other (specify) __________

4. Annual gross billings of your firm for each of the last five years (please estimate if necessary)

   $__________1979

   $__________1978

$____________1977

$____________1976

$____________1975

Projected gross billings of your firm for 1980 and 1981

$____________1980

$____________1981

Insurance Coverage

5. Does your firm now carry professional liability insurance with a commercial insurance company?

   Yes _____ No _______

   If yes, is it carried because of client requirements?

   Yes _____ No ________

   If not, why not?

   ________ too costly

   ________ not able to obtain desire coverage

   ________ professional liability not a concern

   ________ other (specify) ____

6. Aside from insurance carried with a commercial company, does your firm set aside funds or establish reserves for liability claims?

   Yes _____ No _______

   If yes, how much on an annual basis? $______________

If your firm has carried professional liability insurance during any of the past five years, please answer questions 7,8,9, and 10.

7. Upper limit of policy coverage

   __________1979

   __________1978

   __________1977

   __________1976

   __________1975

8. Amount of deductible

__________1979

__________1978

__________1977

__________1976

__________1975

9. Amount of annual premium

__________1979

__________1978

__________1977

__________1976

__________1975

10. Do you feel the present cost of your firm's liability insurance is:

__________very high

__________somewhat high

__________moderate

__________somewhat low

__________very low

Claims History

11. Number of liability claims your firm has had, regardless of outcome, over the past five years

__________1979

__________1978

__________1977

__________1976

__________1975

12. Amount, disposition, and cost of claims to firm and insurance carrier during the past five years (Please include all claims whether or not settled.) If necessary, attach a schedule.

Year of claim	Amount of claim	Method of settlement	Amount of settlement	Paid by firm	Paid by insurer
______	$______	__________	$__________	$______	$______
______	$______	__________	$__________	$______	$______
______	$______	__________	$__________	$______	$______
______	$______	__________	$__________	$______	$______
______	$______	__________	$__________	$______	$______
______	$______	__________	$__________	$______	$______

13. Estimate of legal fees paid by your firm to resolve liability claims for each of the past five years:

    ______1979

    ______1978

    ______1977

    ______1976

    ______1975

14. Has your firm ever experienced a liability loss that exceeded taxable income for the year the loss was incurred?

    Yes________ No________

Views on Proposal

The questions that follow are designed to measure the potential utility to firms of a tax-exempt professional liability trust that could be used to partially or fully self-insure against a firm's liability losses. A description of this trust and the provisions that would govern its use are contained in Attachment 1. Please read it carefully before continuing with the questionnaire and refer to it when necessary for clarification.

15. Would your firm be likely to establish a tax-exempt liability trust as described in Attachment 1 to partially or fully self-insure against liability losses?

    Yes__________ No_________

    If not, why not? (if more than one reason applies, please rank in order of importance using 1 to indicate the most important reason, 2 for the next important, etc.)

_______professional liability not a concern

_______prefer commercial liability insurance

_______could not afford to set aside funds

_______tax deductions and tax-free accumulation of income not sufficient incentive

_______tax penalty on unauthorized distributions

_______permissible investments for funds not acceptable

_______other (specify)_______________________________

If you answered yes to the first part of question 15, please answer the remaining questions. If you answered no, you have completed the questionnaire. At your option, you may fill in the information requested in the final section of the survey. Thank you.

16. What amount do you think your firm would contribute annually to a tax-exempt liability trust (within the allowable limits)?

$_______________

Do you think this amount would be sufficient to cover your professional liablility needs?

Yes__________ No________

17. If your firm established a tax-exempt liability account, which of the following actions would you be likely to take regarding your present commerical liability insurance? (check all that apply)

_______no commercial coverage at present time

_______discontinue commercial coverage

_______lower policy limit

_______raise deductible

_______raise policy limit

_______other (specify) _______________________________

Optional Information

The following information is requested but not required

Firm name____

Address____

Telephone____

Principal Contact__________________________________
(name) (title)

68-906 O - 81 - 25

Attachment 1

Summary of Professional Liability
Legislative Proposal

The purpose of this proposal is to allow architectural/ engineering firms a limited tax deduction for funds set aside to satisfy professional liability claims and associated expenses, such as attorneys' fees, incurred in defending or settling such claims. Each firm would be permitted to establish a trust into which the funds would be deposited. The funds of the trust would be invested in low-risk investments such as government securities or government-insured bank accounts. In no case could such assets be invested in the business of the firm establishing the trust. Income earned on the trust investments would be tax free. All funds withdrawn from the trust would be taxable. However, if a firm used trust funds to satisfy liability claims or associated expenses, it would receive an offsetting tax deduction. If it used trust funds for other than liability purposes, a substantial penalty would be imposed in addition to the regular tax. In addition, if controlling interest in a firm with a liability trust were sold or the firm ceased to exist, all amounts in the trust would be subject to regular income tax.

The major benefit of establishing a professional liability trust would be the tax-free accumulation of income on funds set aside to satisfy claims. The major disadvantage of establishing the trust is the loss of the current use of the funds for the operations of the firm or distribution to the principals.

The amount of a firm's annual deduction would be determined by the severity of its liability insurance problem. Firms that are unable to obtain $1 million of liability insurance coverage at a premium cost not exceeding 2 percent of annual gross receipts would be permitted to deduct the lesser of 5 percent of the current year's gross receipts from services or $100,000. This deduction would be permitted until the firm accumulated a fund equal to 15 percent of its average annual gross receipts from services (based on a five-year moving average).

All other firms would be permitted to deduct the lesser of 2 percent of the current year's gross receipts from services or $25,000 until the firm accumulated a fund equal to 10 percent of its average gross receipts from services (based on a five-year moving average).

The following table may help you determine your annual deduction.

Firms With Severe Product Liability Insurance Problem
Insurance Premium for $1 Million of Coverage
Exceeds 2% of Gross Receipts

Gross Receipts	Annual Deduction	Overall Limitation
less than $2,000,000	5% of current gross receipts	15% of average gross receipts
$2,000,000 or more	$100,000	15% of average gross receipts

Firms with Non-Severe Product Liability Insurance Problem
(Insurance Premium for $1 Million of Coverage
Does Not Exceed 2% of Gross Receipts)

Gross Receipts	Annual Deduction	Overall Limitation
less than $1,250,000	2% of current gross receipts	10% of average gross receipts
$1,250,000 or more	$25,000	10% of average gross receipts

AIA/ACEC SURVEY

Exhibit B

Summary results for respondents excluding ten largest firms

Total questionnaires returned: 588

Firm profile

	No. Firms	%
Proprietorship	204	35
Partnership	97	16
Corporation	281	48
Other	6	1

	No. Firms	Total	Average
Full-time employees	550	6,441	12
Annual gross billings	576	$201,669,000	$350,000
Projected 1980 annual gross billings	555	$274,166,000	$494,000

Claims History

	No. Firms	%
Firms with liability claims	194	34
Firms without liability claims	381	66

Number of claims experienced over past five year period: 425

	No. Firms	Total	Average
Legal fees over past five year period	173	$ 1,391,000	$ 8,000

Number of firms experiencing liability loss greater than taxable income: 14

Claims history, continued

	No. Firms	Total	Average
Amount of claims over past five year period	146	$103,521,000	$709,000

Insurance

Carrying liability insurance		No. Firms	%
	Yes	440	76
	No	142	24

Because of client requirements		No. Firms	%
	Yes	200	46
	No	235	54

Reasons why firms do not have insurance	No. Firms	%
Too costly	128	82
Not able to obtain desired coverage	4	2
Professional liability not a concern	15	10
Other reasons	10	6

	No. Firms	%
Firms setting aside funds or creating reserves	22	4

	No. Firms	Total	Average
Funds or reserves set aside	17	$ 166,000	$10,000

Insurance, continued

Policy terms:	No. Firms	Total	Average
Annual upper limit	452	$203,167,000	$449,000
Annual deductible amount	452	$ 3,801,000	$ 8,000
Annual premium amount	444	$ 4,370,000	$ 10,000

Views on present cost of insurance	No. Firms	%
Very high	324	73
Somewhat high	96	22
Moderate	25	5
Somewhat low	-	-
Very low	-	-

Views on proposal		No. Firms	%
Would establish a liability trust	Yes	382	67
	No	189	33

Major reason for not establishing trust	No. Firms	%
Professional liability not a concern	13	6
Prefer commercial insurance	26	12
Cannot afford to set aside funds	100	49
Insufficient tax incentive	20	10
Tax penalty on unauthorized distributions	25	12
Investments for funds not acceptable	2	1
Other	20	10

Views on proposal, continued

	No. Firms	Total	Average
Amount firms would contribute to trust	361	$3,481,000	$10,000

Is this sufficient to cover liability needs	No. Firms	%
Yes	174	48
No	185	52

Actions with regard to present insurance	No. Firms	%
Would discontinue commercial coverage	40	11
Lower policy limit	48	12
Raise deductible	220	58
Raise policy limit	74	19

AIA/ACEC SURVEY

Exhibit C

Summary results of ten largest firms responding to survey

FIRM PROFILE

Form of firm	All Corporations
Average number of full-time employees	431
Average annual gross billings	$14,266,000

CLAIMS HISTORY

Having liability claims	80%
Total claims for 8 firms over past 5 year period	229
Total amount of claims for 7 firms over past 5 year period	$80,222,000
Average annual legal fees	$ 213,000
Experienced liability loss greater than taxable income	Nil

INSURANCE

Carrying liability insurance	90%
Because of client requirements	33%
Presently setting aside liability funds	30%
Average amount set aside	$ 98,000
Average upper limit of insurance coverage	$ 5,500,000
Average deductible amount	$ 68,000
Average amount of annual premium	$ 184,000
Believe present cost of insurance is somewhat to very high	78%

VIEWS ON PROPOSALS

Would establish liability trust	80%
Amount would contribute (in total)	$ 125,000
Would discontinue commercial insurance coverage	Nil
Would raise amount deductible	63%

Estimate of Tax Savings
Methodology

Exhibit D

The estimate of federal income tax savings to be derived by the A/E profession from the professional liability proposal was made on the basis of the survey results, published statistics of income, and other data and assumptions provided by The AIA and The ACEC.

The survey responses were used to determine the percentage of firms that can be expected to utilize a professional liability trust and the amount they can be expected to contribute to such a trust. These data were stratified by firm size and projected to the entire population of A/E firms eligible to establish a professional liability trust. An adjustment was made for the large number of firms with income below the level at which it is expected trusts will be established. Another adjustment was made for firms that would derive minimum tax deferral because of the limitation on their deduction and the significance and frequency of their claims history. Marginal tax rates were assigned by size of firms on the basis of average billings and assumed deductions. These tax rates were applied to the amount that is expected to be contributed to professional liability trusts to arrive at an estimate of tax savings.

Historical data reported on claims experience and legal fees were correlated to amounts responding firms indicated they would contribute to the trust. The claims experience and legal fees of these firms were used to estimate the amount that would be includable in income as funds are withdrawn from the trusts to pay claims and legal fees over a five-year period.

Senator BYRD. Thank you, sir.
The next witness.

STATEMENT OF WILLIAM R. RATLIFF, PRESIDENT-ELECT, AMERICAN CONSULTING ENGINEERS COUNCIL, ACCOMPANIED BY ROBERT WARDEN, ESQ., PEABODY, RIVLIN, LAMBERT & MEYERS

Mr. RATLIFF. Mr. Chairman, Senator Dole, my name is Bill Ratliff. I am president-elect of the American Consulting Engineers Council.

Mr. Chairman, A–E's, architects and engineers, are not construction contractors. We are licensed professionals who are in the employ of our clients. Ninety percent of consulting engineering firms have fewer than 50 people. We are predominantly small businesses.

The costs of insurance are high. They are proportionately higher for small firms. Sixty-four percent of the design firms spend 2 percent or more of their gross revenues for professional liability insurance. A full 24 percent are presently going bare without any professional liability coverage.

Mr. Chairman, the imaginative proposals contained in the proposed bill by Senator Mathias and his two cosponsors, Senators Bentsen and Packwood, both members of this committee, will permit A–E firms to create and use service liability tax-deductible trust funds to meet out-of-pocket first costs of legitimate claims and to defend themselves.

The trust use is limited to claim settlements, legal costs and administering the trust.

As stated by Senator Mathias, S. 2512 is not intended to replace insurance, but increase deductibles, allowing increased coverage or reduced premiums. A penalty will be applied for unauthorized distributions from the trust fund.

I must admit, Mr. Chairman, that I am a little bewildered at the Treasury's position that this actually would tie up capital as opposed to having it in the system. The bill provides that these funds may only be invested in U.S. securities, State or local securities, bank deposits, or other investments permitted to trustees or fiduciaries.

It was my impression that one of America's problems is that we are not saving enough. It seems to me that this would actually help that situation rather than hurt it.

Double dipping, that is, taking a deduction for a claim and for the trust fund, is clearly not intended.

Deloitte, Haskins & Sells estimate that the total amount of Federal income savings to be derived by the design professionals under the provisions of S. 2512 for 1981 is $50 million. However, it is also estimated that within 5 years $32.8 million of this tax benefit will be recaptured as funds are used to satisfy liability claims.

We believe that S. 2512, if enacted, will provide significant relief. Not, as the Treasury says, minimal relief, but significant relief for design firms as they pursue the innovative solutions to today's complex problems.

Mr. Chairman, thank you. We will be happy to respond to any questions.

[Statement of Mr. William R. Ratliff follows:]

SUMMARY STATEMENT

OF

WILLIAM R. RATLIFF

PRESIDENT-ELECT

ON BEHALF OF

THE AMERICAN CONSULTING ENGINEERS COUNCIL

REGARDING

THE SERVICE LIABILITY PARTIAL SELF-INSURANCE ACT OF 1980

BEFORE THE

SUBCOMMITTEE ON TAXATION

AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

September 10, 1980
Washington, D.C.

SUMMARY STATEMENT OF WILLIAM R. RATLIFF

Mr. Chairman, my name is William R. Ratliff and I am President-Elect of the American Consulting Engineers Council (ACEC). Accompanying me is Mr. Robert W. Warden of Peabody, Rivlin, Lambert and Meyers.

During this brief oral presentation I will focus on the nature of design firm liability coverages and application of S. 2512's provisions to our liability problems.

Liability Coverage

- A-Es are not construction contractors, but licensed professionals who are in the employ of owners/clients.
- Firms carry substantial amounts of liability insurance averaging $449,000, with deductibles averaging $8,000.
- Costs of insurance are high; they are proportionately higher for small firms; 64 percent of desisn firms spent two percent or more of gross revenues for insurance.
- Use of deductibles to reduce costs or increase coverage makes A-E firms pay out-of-pocket first costs for claims and legal fees.
- Insurance protection is required after projects are completed; literally "forever" in states without statutes of limitation.

Mr. Chairman, the imaginative proposals contained in the proposed bill by Senator Mathias and his co-sponsors, S. 2512, will permit A-E firms to create and use service liability tax-deductible trust funds to meet out-of-pocket first costs of

legitimate claims and defending themselves.

- Trust use is limited to claim settlements, legal costs and administering the trust.
- S. 2512 is not intended to replace insurance, but to supplement it up to levels of deductibles.
- Two-thirds of the design firms surveyed would make some use of trust funds if established.
- A penalty of ten percent will be applied for unauthorized distributions, plus the regular tax. Use of trust fund assets is tightly controlled.
- The Bill is intended just for engineers and architects.
- "Double-dipping" -- taking a deduction for a claim and for the trust fund -- is clearly not intended.

Deloitte, Haskins & Sells estimates that the total amount of federal income savings to be derived by the design professionals under the provisions of S. 2512 for 1981 is $50 million. However, it is also estimated that within five years $32.8 million of this tax benefit will be recaptured as funds are used to satisfy liability claims ($25.8 million) and to pay legal expenses ($7 million). These findings are based upon the two important assumptions noted earlier.

We believe that S. 2512, if enacted into law, will provide significant relief for design firms.

Fifth-eight percent of those queried reported that use of the trust fund, as permitted under S. 2512, would cause them to

increase their deductible amounts. Such adjustments would permit increasing policy coverages or reducing premium costs.

Mr. Chairman, we are asking for your help for ourselves in the design professions and in the public interest. It is we who create skyscrapers, span mighty rivers, harness the power of wind, water and the sun, develop energy sources, create transportation systems, promote energy conservation and do countless other things which many take for granted.

Mr. Chairman and Members of the Subcommittee, we thank you for this opportunity to present our views on what we consider to be a vital matter. We will be pleased to answer any questions you may have.

Senator BYRD. Thank you, gentlemen.

Let me ask you this. I suppose the insurance rates vary somewhat, but generally speaking what is the insurance on product liability?

Mr. DUVALL. Maybe I should answer that, Senator. The rate ranges from about 2 percent to as high as 12 percent of a particular firm's fees. It depends on the type of work they do, and the area of the country in which they are located. A structural engineer, for example, pays substantially higher rates than an architect would pay. A civil engineer will pay slightly less.

Ms. VIEHE-NAESS. Could I add to that the fact that the survey done by Mr. Duvall's firm shows that current billings last year went up from 2.3 percent to 2.7 or 2.9.

Mr. DUVALL. I don't remember which point it was. But that is again an average. The smaller firms pay substantially above the average. The larger the firm, the lower the rate. It is a very sharp drop.

Senator BYRD. Thank you.

Senator Dole.

Senator DOLE. I have no questions.

Thank you.

Senator BYRD. Thank you, ladies and gentlemen.

Next we have a panel consisting of Mr. Arden B. Engebretsen, vice president and treasurer of Hercules, Inc., accompanied by Howard J. Silverstone, Esq.; and Ernest S. Christian, Jr., Esq., of Patton, Boggs & Blow, on behalf of U.S. Industries, Inc.

STATEMENT OF ARDEN B. ENGEBRETSEN, VICE PRESIDENT-TREASURER, HERCULES, INC., ACCOMPANIED BY HOWARD J. SILVERSTONE, ESQ.

Mr. ENGEBRETSEN. Thank you, Mr. Chairman.

I appreciate the opportunity to appear before this subcommittee. I assure the committee that I will be brief. We have offered a more complete statement to the committee, and I would ask that it be included in the record.

Senator BYRD. Without objection.

Mr. ENGEBRETSEN. We are addressing here a very technical issue, one which I think deserves the title of narrow in scope. But I do not believe it qualifies as special interest. Indeed, we have had it characterized earlier by the Treasury witness as being of general interest, with which we agree.

We acknowledge that the Treasury has expressed interest in addressing broader issues, and we appreciate their interest in this, but feel that it does not diminish the need for the committee's consideration and, hopefully, favorable approval of the bill as submitted.

We are here to recommend the correction of an oversight resulting in 1976 when the tax law was changed to provide that income from the sale of a patent is considered U.S. source, while income derived from the use of a patent through licensing is treated as foreign source.

The 1976 law was enacted, in part, to restrict the artificial sourcing of a transaction abroad, such as stock being taken outside of the country and sold, and thereby avoiding appropriate taxes. The sale of a patent right was also caught up in the act.

We believe that the proposed amendment to the act is justified because we are not talking about an opportunity for abuse since the place of use of the patent is almost in all respects the source of the income. Therefore, it does not offer the opportunity to artificially source income in order to avoid the application of the tax.

Therefore, we urge the committee's prompt and favorable consideration of S. 2915 as presented.

Thank you, Mr. Chairman.

[Statement of Arden B. Engebretsen follows:]

68-906 O - 81 - 26

HEARING ON S. 2915

before the

SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT GENERALLY

of the

COMMITTEE ON FINANCE
UNITED STATES SENATE

September 10, 1980

STATEMENT OF

HERCULES INCORPORATED
910 Market Street
Wilmington, Delaware 19899

Mr. Chairman, I am Arden B. Engebretsen, Vice President & Treasurer of Hercules Incorporated, Wilmington, Delaware
I am testifying in support of S.2915. I am accompanied by Howard J. Silverstone of the law firm of McClure & Trotter.

S. 2915 contains a technical amendment that is designed to correct an oversight in the drafting of section 904(b)(3) when it was amended by the Tax Reform Act of 1976. Under section 904(b)(3) certain income from the sale of a patent or similar right outside the United States that is entitled to capital gain treatment is treated as if it were earned inside the United States. As a consequence, this income is not treated as foreign source income in computing the limitation on the amount of U.S. tax that is entitled to be offset by foreign taxes imposed on foreign source income.

As a general rule, income from the sale or exchange of personal property is treated as earned outside the United States if the sale or exchange of such property is outside the United States. Income from the use of a patent outside the United States is treated as being earned outside the United States. Thus, on a sale of a patent the place where title passes is generally determinative of where the income is earned, and on a license of a patent the place where the patent is used is generally determinative of where the income is earned.

The 1976 Act added a special foreign tax credit source rule for gain from the sale or exchange outside the United States of items of personal property that are capital assets. These rules are contained in section 904(b)(3)(C) and are designed to prevent taxpayers from artificially placing the source of the capital gain in a low tax jurisdiction where there is no business purpose for realizing the gain in that jurisdiction. The report of the Committee on Finance states that:

"Since most foreign countries (including the United States) impose little, if any, tax on sales of personal property by foreigners if the sales are not connected with a trade or business in that country, the present system permits taxpayers to plan sales of their assets in such a way so that the income from the sale results in little or no additional foreign taxes and yet the amount of foreign taxes they can use as a credit against their U.S. tax liability is increased." S. Rep. No. 94-938, 94th Cong., 2d Sess. 243 (1976).

The statute states that if the gain is subject to a foreign tax of 10 percent or more, the source of the gain is not being placed in that particular foreign jurisdiction solely for tax purposes. The Committee's report states that:

"It was concluded that if the foreign government significantly taxes a sale, that sale probably did not take place in that country purely for tax purposes. The committee concluded that a tax of 10 percent of the gain was substantial for these purposes." Id. at 245.

There are certain limited exceptions in the law which are intended to exclude from the U.S. income source rule gains realized from the sale or exchange of a "capital asset" that arises in a country in which the taxpayer has a business or personal connection on the ground that such "capital gains" are not being earned within that country solely for tax purposes. For example:

a) In the case of an individual, the gain will not be recharacterized as being earned inside the U.S. if the property is sold in the individual's country of residence.

b) In the case of a corporation selling stock in a second corporation, the gain will not be recharacterized as being earned inside the U.S. if the sale occurs in a country where the second corporation derived more than 50 percent of its gross income over the preceding three-year period.

c) In the case of a sale of personal property (other than stock) that is used in a trade or business, the gain will not be recharacterized as being earned inside the U.S. if the property is sold in a country which the taxpayer derived more than 50 percent of his gross income for the previous three-year period.

In line with the above exceptions to the U.S. income source rule of Sec. 904(b)(3)(C), S. 2915 provides, in effect, that if a patent, invention, model or design (whether or not patented), a copyright, a secret formula or process, or any other similar property right is sold to an unrelated party for use in a foreign country, or countries, any gain realized from such sale will not be recharacterized as gain from sources within the United States.

As a general rule, income from the use of a patent outside the United States is not entitled to capital gain treatment and, thus, is not recharacterized under the statute as being earned inside the United States regardless of whether the licensee or user is or is not controlled by the transferor.

The factual basis in support of foreign source income treatment of such gain is that it is impossible to artificially source the gain from the sale of a patent, or similar property, because the source and foreign taxation of such gain is determined by the country in which such patent, or similar property is used. In this regard, gain from the sale of a foreign patent, or similar property, is no different from ordinary royalty income under a licensing arrangement. The country of use is the source of the income. Thus, it makes little sense to treat income from the transfer of a patent as being earned outside the United States if the gain is ordinary income but as being earned inside the United States if the gain is capital gain.

With the proposed amendment to Sec. 904(b)(3)(E) the pre-1976 source rules with respect to gain realized from a sale, exchange or disposition of a patent or similar property for use in a foreign country will be restored.

SUMMARY OF PRINCIPAL POINTS

1. Under existing law, ordinary licensing income from the use of a patent, an invention, a model or design, a copyright, a secret formula or process outside of the United States is treated as foreign-source income regardless of the amount of foreign tax withheld on such licensing income and regardless of whether the taxpayer used such property in his trade or business outside the United States at some time prior to the grant of a license to the foreign user.

2. Prior to November 12, 1975 (the effective date of the Tax Reform Act of 1976), such foreign source income tax treatment also applied to licensing income derived from a sale, exchange or grant of an exclusive license of similar property to a foreign licensee or transferee.

3. With the signing into law of the Tax Reform Act of 1976, the foreign source income tax treatment with respect to royalties and other proceeds realized from a sale, exchange, or other disposition of foreign patents and personal property as described in (1) above was changed to U.S. income source tax treatment by including sales and exchanges of such property in the category of personal property described in broader scope in Sec. 904(b)(3)(C) and (E) on which foreign source income treatment would no longer prevail or apply.

4. Gain from a sale, exchange or other disposition of Sec. 1231 assets with personal property characteristics was included in the statutory source rule change contained in Sec. 904(b)(3)(C), except where such assets have been used by a taxpayer in the country in which the sale or exchange has been made.

5. In view of the fact that it is very difficult, if not impossible, to artificially source the gain realized upon the sale, exchange or disposition of a foreign patent, or similar property, because its value is governed by the country in which it is used, the source rules with respect to such gain should be the same as with ordinary licensing income.

6. Accordingly, Sec. 904(b)(3) should be amended to exclude gains realized from a sale, exchange or other disposition of a patent, an invention, model or design (whether patented or not), a copyright, a secret formula or process, or any other similar property right, so as to restore the pre-1976 tax treatment as to the source of gains realized from a sale, exchange or disposition of such assets.

Senator BYRD. Thank you, Mr. Engebretsen.
Mr. Christian, you may proceed.

STATEMENT OF ERNEST S. CHRISTIAN, JR., ON BEHALF OF U.S. INDUSTRIES, INC., PRESENTED BY CHARLES TEMKIN

Mr. TEMKIN. Unfortunately, Mr. Christian became ill and could not testify. My name is Charles Temkin, and I am a partner of his.

Our statement is already in the record. I would just like to make some brief comments before the committee here.

We would agree with what Mr. Engebretsen said. Our bill is, in a sense, a companion measure, because it is designed to deal with another type of defect in the same legislation which caught up the sale of patents. The question that we deal with is when the sale of stock in a subsidiary is considered to be United States or foreign source. The consequence of saying that it is foreign source means that it increases the limit on the amount of foreign taxes for which a credit is allowable.

As was just indicated, prior to the 1976 act it was possible for taxpayers to take a U.S. subsidiary and sell its stock abroad, clearly an abusive and manipulative transaction. In response largely to that, the 1976 Reform Act contained a provision that would source capital gains in the United States rather than abroad unless certain provisions were made.

The conditions which were outlined then were poorly conceived and arbitrary. One of them was that the sale would be foreign source if the country in which the subsidiary was sold was a country where it had done more than 50 percent of its business. This has an irrational impact on the subsidiaries that in fact do business in a number of foreign countries, and none which has a 50 percent source of income.

Second, the act contains a provision that if there is a 10-percent tax imposed by the foreign country, then the sale will be considered foreign. It is our understanding that since the passage of the act, and in sort of a spirit of international cooperation, some foreign countries have enacted a 10-percent tax in order to allow any U.S. taxpayer to take a capital asset and sell it in their country, and they will impose a tax essentially on just profits. There is no logic why a 10-percent tax is the key to allowing such an expense to the Treasury.

One correction was made in the 1978 act, and it was done retroactively, to enable liquidations to be treated as having a foreign source if the corporation being liquidated was essentially a foreign corporation. What we would like to do is to have that same rule apply to the sale of stock as well as liquidation when the corporation is truly foreign.

I would like to respond briefly to the Treasury's statement. On the positive side, they are trying to come up with a set of rules which is more broad than just dealing with capital gains. They would set aside certain income baskets, expanding on section 904(d).

We have been working with them for some time. They still have not come out with a fully fleshed out proposal, but we would be happy to support and help them with our suggestions when they arrive at such a proposal.

On the negative side, they have said that what we are asking for is special interest, and it is sort of evil that it is retroactive. It is irritating somewhat to hear the charge of special interest. It is the case that under the Treasury proposals, what they are thinking about, if they were law right now, the transaction that the taxpayer engaged in would have been treated as foreign source.

So it is not that we are asking something which is aberrational or manipulative, when, in fact, if they had their way our transaction would have been on the good side of their rule. So it is not special interest in the sense that we are the only people affected or that we would be getting something which is special from what every other taxpayer is entitled to.

On the issue of retroactivity, while it is particularly inappropriate to make a law that has some incentive effect retroactive, the law here is not designed to encourage any behavior in particular. In fact, the rule which was enacted in 1976 was simply defective when it was put forth. One correction has already been made retroactively in the 1978 act, and we simply would like to join in making another change along the lines of the one which Congress made in 1978.

Thank you.

[Statement of Ernest S. Christian follows:]

SUMMARY OF PRINCIPAL POINTS

STATEMENT OF ERNEST S. CHRISTIAN, JR.
ON BEHALF OF U.S. INDUSTRIES
ON
S. 3070

1. S. 3070 would result in the amendment of section 904(b)(3)(D) of the Code to equate sales of foreign subsidiaries with liquidations of them for purposes of computing the foreign tax credit. Section 904(b)(3)(D) was itself added to the Code (by the Revenue Act of 1978) as a technical correction to the Tax Reform Act of 1976, which enacted section 904(b)(3)(C) of the Code.

2. The general rules for treating capital gains for tax credit purposes, embodied in section 904(b)(3)(C), were poorly conceived and arbitrary. They have failed to put an end to the ability of some taxpayers to manipulate the source of capital gains; but, at the same time, they have caused legitimate foreign sales of truly foreign subsidiaries to be treated as having a U.S. source for tax credit purposes.

3. Sales of at-least-80-percent-owned subsidiaries deriving more than 50 percent of gross income abroad are comparable to liquidations of such subsidiaries. Therefore, the refinement of the general rules applicable to liquidations, which is embodied in section 904(b)(3)(D), should be expanded to apply to such sales as well.

STATEMENT OF

ERNEST S. CHRISTIAN, JR.

BEFORE THE

SENATE FINANCE COMMITTEE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

HEARINGS ON S. 3070

FOREIGN TAX CREDIT ADJUSTMENTS

FOR CAPITAL GAINS

SEPTEMBER 10, 1980

Mr. Chairman, and members of the Committee. My name is Ernest S. Christian, Jr.; and I am appearing on behalf of U.S. Industries. Thank you very much for the opportunity to testify before you in support of S. 3070, which was introduced by Senator Durenberger. This legislation would make a technical change to the rules for computing the foreign tax credit in the situation where a corporation sells the stock to a foreign subsidiary.

It should be mentioned that this topic was the subject of a hearing before this Committee about a year ago, in connection with this Committee's consideration of H.R. 2797, the Technical Correction Act of 1979.

It should also be noted that S. 3070 is almost a companion measure of S. 2915, which was introduced by Senator Roth and which also would change the foreign tax credit rules with respect to certain foreign-source capital gains. S. 2915 deals with dispositions of patents, copyrights, or similar property and S. 3070 with disposition of stock; but both bills derive from the same need -- the need to adjust the arbitrary and poorly conceived mechanism adopted in the Tax Reform Act of 1976 for preventing taxpayer manipulation of the source of capital gains for tax credit purposes. I therefore endorse S. 2915 as well as S. 3070.

Briefly, what S. 3070 would do in technical terms is to amend section 904(b)(3)(D) of the Code, which modifies the general sourcing rule set forth in section 904(b)(3)(C). Under

subparagraph (C), gain from the sale by one corporation of stock in a second corporation is, for purposes of computing the foreign tax credit limitation, considered to have a U.S. source unless the sale takes place in either (1) the country where the second corporation derived more than 50 percent of its gross income within the 3-year period preceding the year of sale or (2) a country which taxes the gain at a rate of at least 10 percent. Subparagraph (D) makes this rule inapplicable to the liquidation of a foreign corporation which derived abroad more than 50 percent of its gross income within the preceding 3-year period. S. 3070 would expand subparagraph (D) to embrace also the sale of at least 80 percent of the stock of such a foreign corporation.

This change is more easily explained in light of the background of section 904(b)(3). Subparagraph (C) was enacted by section 1034 of the Tax Reform Act of 1976, as noted earlier. Its purpose, as reported in the General Explanation of the Act, was "to prevent taxpayers from selling their assets abroad primarily to utilize any excess foreign tax credits which they may have available from other activities." Its exemptions of sales subject to a tax of at least 10 percent or consummated in the country of principal operation were based on the belief that such sales were probably not transacted abroad purely for tax purposes.

Subparagraph (D) was added as a refinement of subparagraph (C) by section 701(u)(2)(C) of the Revenue Act of 1978. Although the purpose of subparagraph (C) was reaffirmed, it was noted that because gain from a liquidation is considered to have its source in the country of incorporation, such a transaction presented no potential for being artificially arranged in a low-tax foreign country. Thus, it was considered inappropriate to recharacterize any resulting gain as automatically having a U.S. source, unless that the foreign corporation actually derived the bulk of its income from U.S. sources.

What S. 3070 would accomplish would be to equate, with a subparagraph (D) liquidation, the sale of at least 80 percent of all classes of stock of a foreign corporation which meets the subparagraph (D) income requirement. In other words, subparagraph (C) would not apply to the disposition of a nonportfolio investment in a foreign corporation which derives the majority of its income abroad. Regardless of whether such a transfer takes place in a foreign country other than that of incorporation or operations, the vice that subparagraph (C) is aimed at is missing. Such an exchange does not involve the use of a foreign situs merely to inflate the limiting fraction; rather, some foreign locale is a natural result of the facts of foreign incorporation and business. Even if a choice among countries outside the United States is dictated by tax considerations, the existence of this range of choice is not.

Senator BYRD. Senator Dole.

Senator DOLE. I think that if we hurry we might be able to finish the other panel before the vote that we have to vote on.

Senator BYRD. Yes.

Our next panel, Hon. Joseph J. Long, Sr., Maryland State senator; Paul E. Fleener, director of government affairs, Kansas Farm Bureau; and Jay C. Boyton, Esq., Lord, Martin & Kill Kelley, on behalf of Belle Peabody Brown Foundation.

We have 6 minutes before the committee will need to adjourn to cast a vote in the Senate. Could we ask each of you to reduce your testimony to approximately 2 minutes so that we may conclude this hearing before we vote?

STATEMENT OF HON. JOSEPH J. LONG, MARYLAND STATE SENATOR

Mr. LONG. Mr. Chairman, Senator Dole, I am Joseph Long, State senator from the 36th Legislative District of Maryland.

S. 2900 is a very important piece of legislation to the watermen of my district. Present law exempts those watermen owning boats weighing 10 tons or less from the Federal unemployment tax and penalizes those with boats weighing over 10 tons by making those owners pay unemployment insurance taxes even though they are subject to the very same catch restrictions as the lighter boats.

During the 1979 Maryland General Assembly session, I introduced legislation that would increase this restriction from the 10-ton figure to 15 tons. I had the full support of the Maryland Watermen's Association as well as the approximately 40 percent of the Chesapeake Bay fishing fleet owners.

After introducing this legislation, I learned that this was a Federal law and if enacted in Maryland would place the Maryland Employment Security Administration fund in nonconformity with the Federal statute, and jeopardizing the unemployment insurance fund in Maryland.

It was then that I asked Senator Mathias' office to investigate this inequity and consider the introduction of legislation to correct it.

I would ask that serious consideration be given by this subcommittee to an amendment that would erase the present outstanding Federal unemployment tax liabilities and judgments that have been placed against those watermen affected by this present law. This is truly a real hardship on them and some have found it impossible to pay. Some of them are going to lose their home, and everything else.

I would ask that the subcommittee give S. 2900 and my proposed amendment favorable consideration.

Thank you for allowing me to testify on S. 2900.

[Statement of Senator Joseph Long follows:]

JOSEPH J. LONG, SR.
36TH LEGISLATIVE DISTRICT
WICOMICO-WORCESTER-SOMERSET

CONSTITUTIONAL AND PUBLIC LAW COMMITTEE

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Testimony Offered by State Senator Joseph J. Long, Sr. 36th Legislative District - State of Maryland, in support of S2900 sponsored by Senator Mathias before the Subcommittee on Taxation and Debt Management at 9:00 A.M. on September 10, 1980, in Room 2221 of the Dirksen Senate Office Building.

MR. CHAIRMAN AND MEMBERS OF THE TAXATION AND DEBT MANAGEMENT SUBCOMMITTEE -- I AM STATE SENATOR JOSEPH J. LONG, SR. OF THE 36th LEGISLATIVE DISTRICT OF MARYLAND.

S2900 IS A VERY IMPORTANT PIECE OF LEGISLATION TO THE WATERMEN OF MY DISTRICT. PRESENT LAW EXEMPTS THOSE WATERMEN OWNING BOATS WEIGHING 10 TONS OR LESS FROM THE FEDERAL UNEMPLOYMENT TAX AND PENALIZES THOSE WITH BOATS WEIGHING OVER 10 TONS BY MAKING THOSE OWNERS PAY UNEMPLYMENT INSURANCE TAXES EVEN THOUGH THEY ARE SUBJECT TO THE VERY SAME CATCH RESTRICTIONS AS THE LIGHTER BOATS.

DURING THE 1979 MARYLAND GENERAL ASSEMBLY SESSION, I INTRODUCED LEGISLATION THAT WOULD INCREASE THIS RESTRICTION FROM THE 10 TONS FIGURE TO 15 TONS. I HAD THE FULL SUPPORT OF THE MARYLAND WATERMEN'S ASSOCIATION AS WELL AS THE APPROXIMATE 40% OF THE CHESAPEAKE BAY FISHING FLEET OWNERS. AFTER INTRODUCING THIS LEGISLATION, I LEARNED THAT THIS WAS A FEDERAL LAW AND, IF ENACTED IN MARYLAND, WOULD PLACE THE MARYLAND EMPLOYMENT SECURITY ADMINISTRATION FUND IN NONCONFORMITY WITH THE FEDERAL STATUTE AND JEOPARDIZE THE UNEMPLOYMENT INSURANCE FUND IN MARYLAND.

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JOSEPH J. LONG, SR.
36TH LEGISLATIVE DISTRICT
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PAGE #2 TESTIMONY S2900

IT WAS THEN THAT I ASKED SENATOR MATHIAS' OFFICE TO INVESTIGATE THIS INEQUITY AND CONSIDER THE INTRODUCTION OF LEGISLATION TO CORRECT IT.

I WOULD ASK THAT SERIOUS CONSIDERATION BE GIVEN BY THIS SUBCOMMITTEE TO AN AMENDMENT THAT WOULD ERASE THE PRESENT OUTSTANDING FEDERAL UNEMPLOYMENT TAX LIABILITIES AND JUDGMENTS THAT HAVE BEEN PLACED AGAINST THOSE WATERMEN AFFECTED BY THIS PRESENT LAW. THIS IS TRULY A REAL HARDSHIP ON THAM AND SOME HAVE FOUND IT IMPOSSIBLE TO PAY.

I WOULD ASK THAT THE SUBCOMMITTEE GIVE S2900 AND MY PROPOSED AMENDMENT FAVORABLE CONSIDERATION.

THANK YOU FOR ALLOWING ME TO TESTIFY ON S2900.

SENATOR JOSEPH J. LONG, SR.
36th LEGISLATIVE DISTRICT
MARYLAND

Senator BYRD. Thank you, Senator Long. We are pleased to have you. I might say that I had the privilege once of addressing the Maryland Legislature. It is a fine body.

Mr. LONG. Thank you, Senator, for inviting me here today.

Senator BYRD. We are glad to have you.

Next witness.

Senator DOLE. I am pleased to welcome Paul Fleener to our hearing this morning. Mr. Fleener is a director of the Kansas Farm Bureau, and he has a keen interest in the effects of what we do in this committee on the tax burden of farmers—not just the amount of tax they pay, but the cost to them of trying to figure out what we, and the IRS, are trying to do. Anything we can do to simplify matters is, I am sure, welcomed by farmers in Kansas and across the country.

I would just add that the Kansas Farm Bureau represents the great majority of Kansas farmers, and I know that Paul Fleener is

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an able and eloquent spokesman for their point of view. We will all benefit from attention to his remarks today.

STATEMENT OF PAUL E. FLEENER, DIRECTOR, PUBLIC AFFAIRS DIVISION, KANSAS FARM BUREAU

Mr. FLEENER. I am Paul Fleener, director of public affairs of the Kansas Farm Bureau.

Senator Byrd, we appreciate very much the opportunity to make some brief comments this morning. We have a statement that we would ask be incorporated in the record.

Senator BYRD. It will be inserted in the record.

Mr. FLEENER. My statement is in support of S. 2916. We find it incomprehensible that the Department of the Treasury says that "equity is not worth the cost of the burden it imposes on administrability," as I understood the gentleman to say this morning.

We think that there is an inequity in the tax law. It is an unintended one. We believe the intention of the Congress was honorable when the investment tax credit provisions were considered, and when the Revenue Act of 1978 was considered.

We believe that it was the intention of the legislation that Senator Dole has introduced, S. 2916, that the investment credit apply uniformly to farmers, small businessmen, and to others who are seeking to be productive in our economy.

So, Mr. Chairman, we are asking that this committee give favorable consideration to S. 2916.

I would like also to say that we in the Kansas Farm Bureau and the American Farm Bureau Federation, which will file a statement with the committee, support the installment sales bill, H.R. 6883. My written statement contains words that relate to a third bill that is not on your agenda, but is one which we feel needs some attention in this session of the Congress.

Thank you very much.

[Statement of Mr. Paul E. Fleener follows:]

SUMMARY OF STATEMENT OF PAUL E. FLEENER, DIRECTOR, PUBLIC AFFAIRS DIVISION, KANSAS FARM BUREAU

1. Kansas Farm Bureau, representing 56,000 family farming operations, supports S. 2916, which allows investment credit claim against Alternative Minimum Tax.
2. Capital formation is important to farmers. Alternative Minimum Tax operates counter to that objective.
3. S. 2916 "corrects inequity" of investment credit treatment.
4. We urge the Senate Committee on Finance to recommend favorably and seek enactment in 1980 of this legislation, S. 2916.
5. Ask examinations of "Highway Use Tax," and exemption for non-highway use farm and soil conservation trucks.
6. Support "Installment Sales" between related parties.

STATEMENT OF PAUL E. FLEENER, DIRECTOR, PUBLIC AFFAIRS DIVISION, KANSAS FARM BUREAU

Kansas Farm Bureau appreciates the opportunity to comment briefly on S. 2916, a measure designed to amend the Internal Revenue Code to provide that the investment credit may be claimed against the Alternative Minimum Tax. Those who operate family farms and ranches in Kansas are appreciative of the fact Senator Dole and Senator Talmadge introduced, on July 1, 1980, S. 2916. We are confident that farmers and small businessmen throughout the country are supportive of this legislation and would join with us in thanking the Senate Committee on Finance for giving consideration to it at this time.

Our reading and understanding of the intent of Congress in regard to the Revenue Act of 1978 leads us to believe that the Congress will act expeditiously to rectify

what we firmly believe to be an unintended result of the enactment of the Revenue Act of 1978.

Capitol formation has been in the past, and is even more so in these inflationary times, a concern of the family farm operator and small businessman. The alternative minimum tax works counter to that and is punitive in its application.

Investment tax credit provisions have had an "on-again, off-again" history. The Congress has now wisely made permanent the investment tax credit to encourage capital formation and the development of productive business and industry in the United States. Unfortunately, the way the Revenue Act of 1978 was developed, and more specifically the way the alternative minimum tax was written into the Revenue Act of 1978, the investment tax credit is not available for a farmer, a small businessman, or another unincorporated entity.

The *concept* of the alternative minimum tax is, again as we understand it, workable. We understand it to be a substitute for the minimum tax that existed prior to the Revenue Act of 1978. Its application and result, however, has caused sufficient concern among farmers and ranchers to lead them to seek either correction of what is perceived to be an inequity, or repeal of the provision. We are here today supporting the legislation which we understand will "correct the inequity." We are here in suport of S. 2916.

When the legislation was introduced on July 1, 1980, Senator Dole made introductory comments setting forth the reasons this amendatory language is necessary. Senator Dole said the legislation "would allow the investment tax credit to offset the alternative minimum tax on a current basis so long as the investment credit is connected with the active conduct of business." It was the stated intention of the Senior Senator from Kansas that the new legislation would "not create a new tax shelter for passive investors." He went ahead to say that "the legislation would make sure that farmers and other small businesmen who have not incorporated their business will be able to use the investment tax credit *as was intended by Congress* (emphasis added).

It is our belief that incorporating the language of S. 2916 into the Internal Revenue Code of 1954 would have a minuscule effect on revenues accruing to the federal treasury. However, provisions of S. 2916 would be *significant* for farmers and small businessmen.

The capital gains deduction, which was eliminated as an item of tax preference when the Revenue Act 1978 was passed, is added back on Form 6251 when calculating the alternative minimum taxable income. By making capital gains subject to the alternative minimum tax, and by *disallowing* the use of investment tax credit when calculating the alternative minimum tax, this new tax is punitive to farmers and small businessmen.

We respectfully ask the Senate Committee on Finance to act favorably on S. 2916. It is our hope that this legislation receives favor in the full Congress and becomes a part of the significant legislation enacted by the 96th Congress.

Highway use tax exemption discussed

Mr. Chairman, and members of the Committee, there are two other tax related items which we want to bring to the attention of the Committee today. They affect farmers and ranchers throughout the country. There have been legislative attempts to correct the items to be discussed.

Since the creation of the Highway Trust Fund, there has been a "highway use tax" principally designed for over-the-road heavy vehicles, which has been a major source of trust fund revenues. This use tax is designed primarily for commercial truckers to contribute toward the public expense of a road and highway system which admittedly helps them and helps our total economy. However, the highway use tax has also been applied against non-highway use vehicles, principally farm trucks.

On February 8, 1979, Senators Dole and McGovern introduced S. 396, a bill to exempt farm trucks and soil and water conservation trucks from the highway use tax. This exemption was, in fact, a part of the Revenue Act of 1978 at one time. It was deleted in conference but passed the Senate rather handily. On the date of introduction of S. 396, Senator Dole said "this bill has been carefully drawn to limit the exemption to bona fide farmer-owned, not for hire, farm use trucks." There was in 1979 broad support on both sides of the aisle for elimination of this unfair tax burden on the owners of farm use trucks. We would respectfully submit that the Senate Committee on Finance may find it appropriate to again incorporate the language of S. 396 in tax legislation being considered by the 96th Congress. We would encourage you to do so.

The final item we would discuss briefly relates to installment sales between related parties. The use of Section 453(b) of the Internal Revenue Code has allowed farmers and owners of other small businesses to transfer ownership of property to

their children in a manner acceptable to and within the financial means of both parties. The farmer is able to spread taxable gains over a number of years, and the son or daughter is given additional time to acquire funds to pay for the property. Without Section 453(b), the farmer would be faced with the prospect of paying a substantial tax because the total gain would be reportable in the year of sale.

Members of Congress have repeatedly indicated a desire to protect the integrity of the family farm. We submit to this Committee that installment sales, to allow the transfer of farm properties from one generation of farmers to the next, are of utmost importance in protecting the family farm. We encourage this Committee to look with favor on legislation to provide appropriately for installment sales between related parties.

Thank you very much for allowing us to make this brief statement on tax issues of concern to farmers and ranchers in Kansas.

Senator BYRD. Thank you.

I might say that Kansas has an outstanding representative on this committee.

Mr. FLEENER. We agree wholeheartedly.

Senator BYRD. Senator Dole.

Senator DOLE. Thank you, Mr. Chairman.

The other bill that he refers to is the highway use tax, and we will pick that up, we have done it before in the Senate, and we pass it easily. We usually do that without hearings.

[The prepared statement of Senator Durkin follows:]

STATEMENT OF SENATOR JOHN A. DURKIN

Mr. Chairman, committee members, I would like to thank you for the opportunity to make a statement before you today and I would like to welcome three constituents of mine, Mr. Ralph Gibbs, Mr. Jay Boynton, and Mr. Samuel McCracken who are here to speak on behalf of the Arthur S. Brown Manufacturing Company and the Belle Peabody Brown Foundation, both of which play important roles in two New Hampshire communities.

Mr. Chairman, last month I introduced an amendment, S. 3076, which is intended to avoid a potentially disastrous situation for the Arthur S. Brown Manufacturing Company, the Belle Peabody Brown Foundation and the small towns of Tilton and Northfield, New Hampshire.

This legislation would exempt the Brown Foundation from Sections 4942 and 4943 of the Internal Revenue Code of 1954 and prevent the possible dissolution of this worthy charitable organization and/or the sale and relocation of the Brown Manufacturing Plant.

Allow me to offer a brief overview of the problem and to outline the very simple solution which has been proposed. I am sure my friends from New Hampshire will expand on my comments and provide the Committee with greater detail on the situation.

The Arthur S. Brown Manufacturing Company is a small but vital manufacturing corporation which is one of two major industrial employers in the adjoining towns of Tilton and Northfield. The Company employs approximately 150 local people and is very important to these small New England towns as a stable, long-term employer. Last year, the Arthur S. Brown Manufacturing Company had a payroll of $1,360,000 with FICA and Withholding taxes collected and paid in the amount of $345,500. In addition, the Company provided fringe benefits for health/accident insurance and pension in the approximate amount of $200,000. In these days of high unemployment, the Brown Company clearly provides an invaluable service to the workers of these New Hampshire towns.

The Belle Peabody Brown Foundation is a charitable organization initially incorporated on May 10, 1949, to engage in various charitable enterprises including providing scholarships to young people going to college. In 1957 one hundred percent of the stock of the Arthur S. Brown Manufacturing Company was transferred under the will of Arthur S. Brown to the Belle Peabody Brown Foundation, with instructions that the Company be maintained as a going business to employ the people in the area who had worked there for many years.

A strict application of Section 4943 of the Internal Revenue Code, relating to taxes on excess business holdings, would not permit the Foundation to continue holding 100 percent of the stock and, since there would be no market for the stock unless the entire business is sold, sale would ultimately be required. Further, if the minimum investment return rule of Section 4942 is applied, the Foundation would

not have the cash to fund the type of philanthropic work set forth in its charter and the Company would not be able to make such funds available.

When Sections 4942 and 4943 were enacted, the Herndon Foundation discovered that it faced hardships similar to the difficulties I have described. A special exemption to the business holdings provisions gave specific relief to the Herndon Foundation and the exemption to Section 4943 was later extended to Section 4942.

Today I am asking the Committee to give favorable consideration to S. 3076 which would amend Sections 4942 and 4943 and provide similar relief for the Belle Peabody Brown Foundation.

I feel that the Arthur S. Brown Manufacturing Company and the Belle Peabody Brown Foundation through the responsible employment of local people by the Company and through the charitable purposes of the Foundation provide extremely beneficial and ongoing services.

The strict application of Sections 4942 and 4943 may well eliminate these benefits and cause substantial hardship for the people, towns and other charities involved. The amendment I have offered would avoid a potentially disastrous situation and would have no significant impact on Federal revenues.

I thank the Committee for its time and I urge the Committee members to act favorably on my amendment.

Senator BYRD. The next witness.

STATEMENT OF JAY C. BOYNTON, ESQ., ON BEHALF OF THE BELLE PEABODY BROWN FOUNDATION

Mr. BOYNTON. Mr. Chairman, my name is Jay Boynton. I am an attorney in New Hampshire. I represent the Belle Peabody Brown Foundation. I am here to talk about S. 3076 which deals with two provisions of the code, 4942 and 4943, that are giving our particular foundation potentially a great deal of difficulty, and may cause its dissolution.

I have submitted a statement, and I would ask that it be included in the record.

Senator BYRD. It will be included in the record.

Mr. BOYNTON. Basically, Mr. Chairman, the Arthur S. Brown Co. is a small company that employs 150 people. It was left under the will of Arthur S. Brown, all of its stock, to the Belle Peabody Brown Foundation, which is a charity and makes contributions to hospitals, schools, and the like in New Hampshire.

The combination of the minimum investment return and the divestiture requirements of the two sections that I mentioned are likely to cause the dissolution of the corporation, which would have a very substantial impact on the two small towns involved.

Primarily, the difficulty is caused because there are only two major competitors for the product that this company produces. The sale to anyone else would be very difficult.

The Treasury Department has suggested that we may explore an ESOP sale of the stock to employees. Basically, this is just not practical. The company employs people who are mostly over 40, largely women, who are the second of two employed persons in a family. There are just no assets with which they could buy the company. The same holds true for the sale to other local businessmen.

I thank you for your attention, and your patience.

[Statement of Jay C. Boynton follows:]

S. 3076
September 10, 1980

Summary of Testimony
of
Jay C. Boynton, Attorney for
The Belle Peabody Brown Foundation

1. The Arthur S. Brown Manufacturing Co. is a small manufacturer in central New Hampshire producing endless belts. It is one of two major industries in the adjoining towns of Tilton and Northfield and employs approximately 150 people. Nationally, there are two other major competitors sharing a market of approximately $8 million in total sales.

2. Last year the company's payroll was $1,360,000 with FICA and withholding collected and paid of $345,500. Fringe benefits for health/accident and pension totaled approximately $200,000.

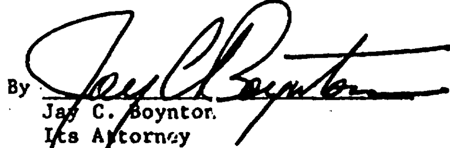
3. All of the stock of the Arthur S. Brown Manufacturing Co. was transferred under the will of Arthur S. Brown in 1957 to The Belle Peabody Brown Foundation, a charity which was initially incorporated in 1949. For years, the company has provided stable employment for the community and has provided funds for the charitable work of the foundation. The company has not, however, in recent years shown a consistent profit.

4. We believe that a strict application of either the "minimum investment return" requirements of IRC, Section 4942 or the "divestiture" requirements of IRC, Section 4943 would necessitate the dissolution of the organization and/or the possible sale and probable relocation of the plant itself.

5. The Herndon Foundation faced similar hardships and obtained relief through legislative action (H.R. 6642) creating its own special exception. S. 3076 provides similar relief for The Belle Peabody Brown Foundation. The language of S. 3076 is carefully drawn to limit its application to a very restricted class, probably including only The Belle Peabody Brown Foundation and requires the payment of dividends insuring a flow of funds to the charity. We believe no significant tax revenue loss will occur if S. 3076 is adopted.

Respectfully submitted,

THE BELLE PEABODY BROWN FOUNDATION



By Jay C. Boynton
Its Attorney

S. 3076
September 10, 1980

Proposed Testimony
of
Jay C. Boynton, Attorney for
The Belle Peabody Brown Foundation

Gentlemen:

Thank you very much for the opportunity to discuss S. 3076 with you today.

My comments will outline the hardship created by Internal Revenue Code Sections 4942 and 4943 as they apply to the Arthur S. Brown Manufacturing Co., the Belle Peabody Brown Foundation and the small towns of Tilton and Northfield, New Hampshire.

Historical Context: The Arthur S. Brown Manufacturing Co. is a small but vital manufacturing corporation producing endless belts. Nationally, there are two other major competitors sharing a market for these products of approximately $8 million in total sales. The endless belts produced by Arthur S. Brown have a wide variety of uses and form essential components of space industry equipment, copying and other office machines and specialty and industrial equipment employing "belt drive" mechanisms.

One hundred percent of the stock of the Arthur S. Brown Manufacturing Co. was transferred under the will of Arthur S. Brown, who died on May 15, 1957, to the Belle Peabody Brown Foundation. The Foundation is a charitable organization initially incorporated on May 10, 1949.

The Arthur S. Brown Manufacturing Co. is one of two major industrial employers in the adjoining towns of Tilton and Northfield and employs approximately 150 local people. It is a very vital industry to the business community and the government, and has a very significant impact on these small New England towns as a long-term and stable employer. Last year, the Arthur S. Brown Manufacturing Co. had a payroll of $1,360,000 with FICA and withholding collected and paid in the amount of $345,500. In addition, the company provided fringe benefits for health/accident insurance and pension in the approximate amount of $200,000. This should be contrasted with the income tax paid by the foundation of $229.

The Problem: Sections 4942 and 4943 of the Internal Revenue Code, as potentially applied to the Arthur S. Brown Manufacturing Co. and the Belle Peabody Brown Foundation, create the following special problems which we believe are unique to this small local industry:

a. The corporation, although an active ongoing concern, has paid negligible dividends. From an exempt organization's point of view, if the minimum investment return rule of Section 4942 is applied, the foundation simply would not have the cash to fund the type of work as set forth in its charter, and the Arthur S. Brown Manufacturing Co. would not be able to make such funds available. Since the code requires an invasion of principal if income is not sufficient to meet the percentage requirement, the results could be disastrous.

b. The foundation acquired all of the outstanding stock of the Arthur S. Brown Manufacturing Co. through the will of Arthur S. Brown and still owns 100% of the stock. There is, therefore, no market for the stock unless the entire business is sold. A strict application of Section 4943 would not permit the foundation to continue holding 100% of the stock, and sale would ultimately be required. If the divestiture is required, it is likely that a sale to a foreign or out-of-state corporation will result with a subsequent relocation of the plant and the loss of an industry vital of these communities.

In summary, it is likely that the strict application of Sections 4942 and/or 4943 to the Belle Peabody Brown Foundation will necessitate the dissolution of the organization and/or the possible sale and probable relocation of the manufacturing plant itself.

<u>The Solution</u>: When Sections 4942 and 4943 were enacted, the Herndon Foundation discovered that it faced hardships similar to the difficulties described above. A special exemption to the business holdings provisions gave specific relief to the Herndon Foundation and the exemption to Section 4943 was later extended to Section 4942. S. 3076 would provide similar relief for the Belle Peabody Brown Foundation. We recognize that there is some danger in drafting special legislation of this type to "opening the flood gates." S. 3076 has been carefully drawn to limit its application by definition to a very restricted class of organizations, probably only including the Belle Peabody Brown Foundation. In this regard, while other corporations might meet the more general definitions, it is most unlikely that any other bequest would be subject to an intervening life estate. Because specific dates are used, it would be impossible for any tax planner to create other qualifying organizations subsequent to the date of enactment. In addition, S. 3076 requires

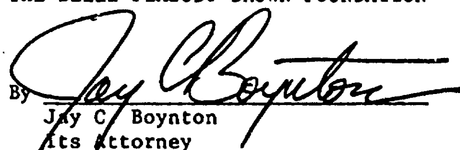
the corporation to pay out in dividends in each calendar year, an amount equal to at least 30% of the average earnings of the corporation during the current year and two preceding calendar years. This provision will insure a flow of funds to the foundation and the continuation of its charitable purposes.

In conclusion, we feel that the Arthur S. Brown Manufacturing Co. and the Belle Peabody Brown Foundation, through the charitable purposes of the foundation and through the responsible employment of local people by the company, provide extremely beneficial and ongoing services. The strict application of Sections 4942 and 4943 may well eliminate these benefits and cause substantial hardship for the people, town and other charities involved. S. 3076 would avoid a potentially disastrous situation and would have no significant impact on federal revenues.

Once again, I would like to thank you on behalf of the Arthur S. Brown Manufacturing Co. and the Belle Peabody Brown Foundation for your interest today. We will be pleased to provide any additional information you think might be helpful.

Respectfully submitted,

THE BELLE PEABODY BROWN FOUNDATION



By
Jay C. Boynton
Its Attorney

Senator BYRD. Thank you, gentlemen.

The subcommittee will stand in adjournment.

[Whereupon, at 11:45 a.m., the subcommittee adjourned, subject to call of the Chair.]

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

GAYLORD NELSON, WIS., CHAIRMAN
SAM NUNN, GA.
JOHN C. CULVER, IOWA
WALTER D. HUDDLESTON, KY.
DALE BUMPERS, ARK.
ROBERT MORGAN, N.C.
JAMES R. SASSER, TENN.
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WILLIAM B. CHERKASKY, EXECUTIVE DIRECTOR
HERBERT L. SPIRA, CHIEF COUNSEL
ROBERT J. DOTCHIN, MINORITY STAFF DIRECTOR

United States Senate
SELECT COMMITTEE ON SMALL BUSINESS
WASHINGTON, D.C. 20510

September 8, 1980

Senator Harry Byrd
Chairman, Subcommittee on
Taxation Generally
Senate Committee on Finance

Dear Harry:

The Small Business Committee has received a number of letters commenting favorably on the Installment Sales Revision Act of 1980 (S. 2451, H.R. 6883) which is presently before your Subcommittee.

The author of the first letter, Mr. Bruce Fielding, is the Secretary to the Board of Directors of the National Federation of Independent Business, and also served as an appointed member of the Federal Paperwork Commission. His letter states:

"In my personal opinion, this bill has been very carefully and objectively drafted and simplifies an area of tax law that has waylaid many an unwary taxpayer. The revisions contained in this bill are long overdue."

The second letter is from Thomas Huntzinger, also an independent Certified Public Accountant, whose small business practice led to his selection as chairman of one of the capital formation working sessions at the White House Conference on Small Business. He cites several aspects of current law which discourage legitimate installment sales, and believes the bill will improve the climate in this area.

The third letter is from an Ohio industrialist who sold his company to its Employee Stock Ownership Trust, and is presently experiencing difficulties selling the plant to the E.S.O.T. because of present installment sales provisions.

This thoughtful correspondence will be enclosed for your information, together with an excerpt from a newsletter from the National Association of Small Business Investment Companies which is favorable to the legislation.

As a result of such representations by small business and professional persons, I am persuaded to think that the legislation would be helpful to the small business community and I will do all I can to bring about its enactment.

I applaud you on your decision to have the Subcommittee consider the installment bill in hearings, and request that this material be included in the record of proceedings for consideration by the Subcommittee membership.

You have been consistently helpful to the cause of the nation's independent business and farm owners. I commend you for these efforts.

Sincerely,

GAYLORD NELSON
Chairman

GN;hs

FIELDING & LOCKSLEY
An Accountancy Corporation
1643 Sterlin Road, Suite 201
Mountain View, California 94043

BRUCE G. FIELDING, CPA
FRANK W. LOCKSLEY, CPA

July 3, 1980

Senator Gaylord Nelson, Chairman
Senate Small Business Committee
424 Old Senate Office Building
Washington, D.C. 20510

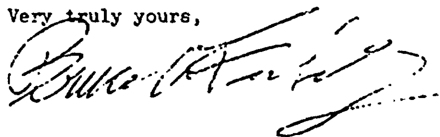
Dear Senator Nelson,

As a member of Treasury Department Small Business Advisory Committee I have had the opportunity of participating in an advisory capacity in connection with certain aspects of the Installment Sales Revision Act of 1980 (S2451, HR6883). In my personal opinion, this bill has been very carefully and objectively drafted and simplifies an area of tax law that has waylaid many an unwary taxpayer.

The revisions contained in this bill are long overdue. I would urge you to support its passage in its present form.

I would like to add as an addendum to this letter my appreciation for the cooperation which I have always received from your staff. It is a real pleasure working with Herb Spira. I feel certain that without your urging and Herb's help we may never have had a Treasury Small Business Advisory Committee.

Very truly yours,



cc: H.L. Gutman

jlg

BEST COPY AVAILABLE

WASDIN, DARNELL AND PENLAND, P.C.
CERTIFIED PUBLIC ACCOUNTANTS
P. O. DRAWER 648
BREMEN, GEORGIA 30110

TELEPHONE:
404-537-2324

September 10, 1980

Mr. Michael Stern, Staff Director
Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Stern,

I am writing this letter for inclusion in the printed record of the Senate Finance Subcommittee on Taxation and Debt Management hearing on the House-passed Installment Sales Revision Bill of 1980 (H. R. 6883) to be held on September 10, 1980.

While I agree with the intent and purposes of this bill, I must lodge a most vehement objection to the effective date set forth in Section 5(b) of the bill. As presently drafted, that section reads: The amendment made by Section 3 shall apply in the case of decedents dying after the date of the enactment of this Act. It should read: The amendment made by Section 3 shall apply in the case of installment obligations entered into after the date of the enactment of this Act by decedents dying after the date of the enactment of this Act.

This change is necessary because the section, as presently drafted, in effect retroactively amends the law. I am sure that there are many installment obligations now in existence which were created to take advantage of the present law as it relates to cancellations of installment obligations owed by related parties. These transactions are now matters of fact and cannot be rescinded. I am sure that they have in many cases been bequeathed by the prospective decedent to the obligor through the vehicle of a will which now cannot be changed because of the incapacity of the prospective decedent.

It would be grossly unfair to change the law as it relates to an existing installment obligation because an installment obligation cannot be retroactively terminated, because many installment obligations were planned to take advantage of the law as it now exists and cannot be changed, and because many wills drawn in reliance on present law relating to installment obligations cannot be changed.

Very truly yours,

H. Guy Darnell, Jr.

President

STATEMENT

OF

CONNECTICUT MUTUAL LIFE INSURANCE COMPANY

before the

TAXATION AND DEBT MANAGEMENT SUBCOMMITTEE

OF THE SENATE FINANCE COMMITTEE

by

ROBERT R. GOOGINS

EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL

CONNECTICUT MUTUAL LIFE INSURANCE COMPANY

on

H.R. 6883 WHICH REVISES THE TAXATION

ON INSTALLMENT SALES

September 10, 1980

STATEMENT OF CONNECTICUT MUTUAL LIFE INSURANCE COMPANY TO THE TAXATION AND DEBT MANAGEMENT SUBCOMMITTEE OF THE SENATE FINANCE COMMITTEE ON THE INSTALLMENT SALES REVISION ACT OF 1980 (H.R. 6883)

This statement is submitted by Connecticut Mutual Life Insurance Company, a Connecticut corporation having its home office in Hartford, Connecticut. The Connecticut Mutual conducts a nationwide life insurance business being licensed in all fifty states and the District of Columbia. Its life insurance business is conducted through approximately 100 General Agencies and several thousand full-time agents and brokers located throughout the Country. The Company's assets exceed five billion dollars and annual gross income exceeds one billion dollars. Approximately two billion dollars of the Company's assets are invested in or secured by real estate, thereby providing the economy with much needed capital in connection with the development of its urban and agricultural real estate base.

We appreciate this opportunity to comment in connection with the Public Hearing on H.R. 6883, a bill to revise installment sales taxation. In particular, since Congress is considering this major revamping of Section 453 of the Internal Revenue Code, which we support, we urge that a provision be added at this time to repeal or revise Section 453 (d)(5) which specifically applies to transfers of installment obligations to life insurance companies or to partnerships of which a life insurance company is or becomes a partner. In this regard, the Company also supports the statement of the American Council of Life Insurance which also urges the repeal or revision of Section 453 (d)(5).

SPECIFIC COMMENTS

Revision of Installment Sales Taxation - Tax Treatment of Transfers of Installment Obligations to Life Insurance Companies or Partnerships in which a Life Insurance Company is or Becomes a Partner

Section 453 (d)(5) of the Internal Revenue Code generally provides that, notwithstanding other sections of the Code, gain must be recognized on a transfer of an installment obligation to a life insurance company or a partnership in which a life insurance company is or becomes a partner. This burdensome provision is in direct contrast to the remainder of the Section 453 (d) which generally allows for nonrecognition of gain on installment obligations when they are transferred to corporations (other than life insurance companies) in otherwise tax-free transactions (e.g. Section 351 - transfers to a controlled corporation, Section 721 - contributions of property by a partner to a partnership).

It would appear that Section 453 (d)(5) is now a legislative anomoly, since it no longer addresses the problem which caused its enactment. Indeed, this Section now creates problems which were never intended. This Section was enacted September 2, 1958 as part of the Technical Amendments Act of 1958 (Public Law 85-866). Up to and including the time of its enactment, the deferred gain on installment obligations was not taxable income to life insurance company transferees. In fact, the Senate Committee Report, 85th Cong., 2D Sess., S. Rep. No.1983 (1958) 41, 57, for this section states, following a discussion of tax-free transfers of installment obligations, that "... where the transferee is a life insurance company, the profit element in

the uncollected installment obligation is not taxed because it is a type of income excluded from life insurance company gross income."

Several months after the enactment of Section 453 (d)(5) the Life Insurance Company Income Tax Act of 1959 was enacted and was generally effective for tax years beginning after December 31, 1957. As a result of this Act, as amended, ordinary income and the excess of net long-term capital gain over net short-term capital loss are includable in life insurance company taxable income. The excess of net short-term capital gain over net long-term capital loss is also includable in its gross investment income and consequently, by formula, in its taxable income.

In short, the Life Insurance Company Income Tax Act of 1959 significantly changed the tax treatment of life insurance companies by expanding their tax base to a total income computation. Thus, the basic reason for Section 453 (d)(5) no longer exists since any gain realized on an installment obligation transferred to a life insurance company is now an item of income which must be included in the company's tax calculation. The unnecessary retention of this Section unduly inhibits life companies from fully playing their important role in providing important capital to meet the Country's real estate developmental needs.

For this reason, we believe it appropriate to repeal Section 453(d)(5).

American Council of Life Insurance

1850 K Street, N.W.,
Washington, D.C. 20006
(202) 862-4000

September 9, 1980

STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE TO THE TAXATION AND DEBT MANAGEMENT SUBCOMMITTEE OF THE SENATE FINANCE COMMITTEE ON THE INSTALLMENT SALES REVISION ACT OF 1980

This statement is submitted by the American Council of Life Insurance, a trade association representing 504 life insurance companies which, in the aggregate, account for approximately 95 percent of the life insurance in force in the United States and hold 97 percent of the assets of all United States life insurance companies.

We are pleased to have this opportunity to comment in connection with the public hearings on H.R. 6883, a bill passed by the House of Representatives to revise installment sales taxation. In particular, we urge that a provision be added to H.R. 6883 to provide for the repeal or revision of section 453(d)(5) of the Internal Revenue Code which deals with the tax treatment of transfers of installment obligations to life insurance companies.

Section 453(d)(5) of the Internal Revenue Code generally provides that, notwithstanding other provisions of the Code, gain must be recognized on the transfer of an installment obligation to a life insurance company (or to a partnership of which a life insurance company is a partner). For the reasons given below, we urge that section 453(d)(5) of the Code be repealed as part of the revisions of the installment sales provisions included in H.R. 6883.

Section 453(d)(5) was enacted by the Technical Amendments Act of 1958 (Public Law 85-866) in order to meet a particular problem arising under the tax provisions then applicable to life insurance companies. At that time, which was prior to the enactment of the Life Insurance Company Income Tax Act of 1959, life insurance companies were taxed only on their investment income. Thus, the following situation could have arisen with respect to the transfer of installment obligations to a life insurance company. If the transfer was in connection with a tax-free transaction (for example, a transaction described in section 351), no gain was recognized by the transferor. Moreover, the gain, when subsequently realized by the life insurance company, was not subject to tax since it was not an item of investment income. The purpose of section 453(d)(5) was to tax the transferor of the installment obligation in this situation by providing that the non-recognition of gain provisions did not apply in the case of such a transfer.

The Life Insurance Company Income Tax Act of 1959 significantly changed the tax treatment of life insurance companies by expanding their tax base to a total income computation. Thus, the basic reason for section 453(d)(5) no longer exists since any gain realized on an installment obligation transferred to a life insurance company is now an item of income which must be included in the company's tax calculation. For this reason, we believe it appropriate to repeal section 453(d)(5).

If it is determined, however, that complete repeal of section 453(d)(5) is not appropriate, we urge that it be amended so that it

will not apply where the insurance company elects to include installment income in gross investment income. This was the approach taken by the Ways and Means Committee during the development of the tax reform bill in 1974. (Section 223 of Ways and Means Committee Print No. 2, Tentative Draft of Title II, Changes Primarily Affecting Corporations)

We appreciate having the opportunity to present our views. We would be happy to attempt to furnish any additional information which the Subcommittee might think helpful.

Larry Frenkel
ATTORNEY AT LAW
CERTIFIED PUBLIC ACCOUNTANT

P.O. BOX 128
27 NORTH MADISON AVENUE
SPRING VALLEY, NEW YORK 10977
(914) 425-2044

September 5, 1980

Mr. Michael Stern
Staff Director Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D.C. 20510

Re: Installment Sale Revision Act of 1980 HR 6883

Dear Mr. Stern:

The purpose of this letter is to comment on certain aspects of the proposed Installment Sale Revision Act of 1980 to be aired before the Senate Finance Committee on September 10, 1980.

Proposed Internal Revenue Code §453(e) provides for a recognition of income by one who sells on the installment basis to a "related person" when such related person disposes of the property in what is referred to as a "second disposition."

Proposed Internal Revenue Code §453(f)(1) defines related person as "... a person whose stock would be attributed under §318(a) to the person first disposing of the property." Internal Revenue Code §318(a) is broad in its application and the adoption of the §318(a) attribution rules may lead to results not intended or contemplated by the proposed legislation. For example, Internal Revenue Code §318(a)(2)(A) provides that "(s)tock owned, directly or

indirectly, by or for a partnership or estate shall be considered as owned proportionately by its partners or beneficiaries." In light of the proposed amendment to §453, this provision could be interpreted so that, on an installment sale by a partner having a 5 percent interest in a partnership, to the partnership, followed by a second disposition by the partnership the partner would recognize all of the gain at the time of the second disposition or, in the alternative, would recognize 5 percent of the gain at the time of the second disposition. The result, pursuant to the proposed legislation, is thus ambiguous and unclear. In addition, it is not clear that either result accomplishes the intent of the proposed legislation.

Therefore, I recommend that the Committee examine proposed §453(f)(1) in light of these comments and draft a definition of related person to fit the intent of the Installment Sale Revision Act of 1980.

Thank you for your consideration.

Very truly yours,

Larry Frenkel

National Council of Farmer Cooperatives
1800 MASSACHUSETTS AVENUE, N.W. • WASHINGTON, D.C. 20036 • TELEPHONE (202) 659-1525

PROPOSED AMENDMENTS TO H.R. 6883 AND/OR S. 2451
"INSTALLMENT SALES REVISION ACT OF 1980"

The National Council of Farmer Cooperatives deems it vital to farmers and their cooperatives that two small amendments are necessary in order that farmers will be entitled to the full benefits of the Installment Sales Revision Act of 1980, the same as other taxpayers, as follows:

1. In proposed new IRC §453(b), we suggest an additional sentence at the end thereof, to be part of the entire Subparagraph (b) and not indented under either Subparagraph (1) or Subparagraph (2), as follows:

> "Nothing contained in this subparagraph shall be deemed to except from the term 'installment sale' any sale of agricultural or horticultural products by the producers thereof."

The purpose of this additional sentence is to make it clear that all farmers may use the installment method, if they qualify otherwise, regardless of whether they operate on the cash or accrual method of accounting. Most individual farmers operate on the cash method, and keep no inventories, as permitted by the Internal Revenue Code. On the other hand, family farm corporations and other types of farmers are generally required by the Internal Revenue Code to use the accrual basis, including inventories. The proposed §453(b), as it stands, would exclude the latter group from the benefits of the installment method of reporting, for no justifiable reason. Such accrual basis farmers would then be forced to qualify, if they can, under new §453A--the "dealer" provision. To avoid uncertainty and argument, the above suggested sentence seems desirable, since it would remove all doubt as to the ability of agricultural producers to take advantage of the installment sales provisions, no matter what method of accounting they may use for other purposes.

2. Under proposed new IRC §453(f), we would suggest a new subsection (7), to read as follows:

> "(7) Cooperatives and Their Patrons--For purposes of this section, a cooperative marketing the products of its patrons shall not be deemed to be acting as the agent of such patrons."

The importance of this additional provision so far as farmers who deal with cooperatives is concerned is illustrated by the following:

a. Both the Internal Revenue Service and the courts have recently held that where a farmer sells his produce to or through a dealer, and enters into a deferred payment contract with the dealer at the time of delivery of the crop, such deferred payment contract will not be recognized for tax purposes where it is determined that the dealer is acting only as agent for the farmer, and not as a principal. Thus, where the dealer resells the farmer's crop in the year of delivery for all cash, such receipt by the agent is considered receipt by the farmer-principal, the deferred payment contract notwithstanding. Warren v. United States, 613 F.2d 591 (CA 5, 1980); Rev. Rul. 79-379, 79-2 C.B. 204.

b. Although there are a number of bases or legal theories which attempt to define the relationship between a cooperative and its patrons, one of the oldest and most widely accepted theories with respect to marketing cooperatives is that the cooperative acts as the agent for its patrons in disposing of their crops. This theory is particularly relevant where pools are used, with the cooperative acting as the pool manager on behalf of the pool members. If this theory is applied in the tax area, as the Internal Revenue Service might well argue, in light of authorities cited above, then any deferred payment contract entered into between the patron and his cooperative would be voided for tax purposes if the cooperative turned around and sold the patron's agricultural products for spot cash in the year of delivery to it, as is most often the case. A clear danger is thus presented that would deny the benefits of the installment sale provisions to farmers dealing through agricultural cooperatives, as compared to other farmers growing the same crops but selling them to ordinary commercial buyers under deferred payment contracts. The negative results which would be produced with respect to agricultural cooperatives are easy to imagine. The proposed amendment will reaffirm the patron's right to deal with his cooperative on a deferred payment basis, and will forestall the apparent disposition of the Service to depart from their previous recognition of this right, see Rev. Rul. 58-162, 58-1 C.B. 234; Rev. Rul. 73-210, 73-1 C.B. 211.

Attached hereto are the proposed amendments inserted in their proper places in the bill.

Please do not hesitate to contact Donald E. Graham, General Counsel of the National Council of Farmer Cooperatives for further information or assistance.

1 "(B) INVENTORIES OF PERSONAL PROP-
2 ERTY.—A disposition of personal property of a
3 kind which would properly be included in the in-
4 ventory of the taxpayer if on hand at the close of
5 the taxable year.

Nothing contained in this subparagraph shall be deemed to except from the term "installment sale" any sale of agricultural or horticultural products by the producers thereof.

6 "(c) INSTALLMENT METHOD DEFINED.—For purposes
7 of this section, the term 'installment method' means a method
8 under which the income recognized for any taxable year from
9 a disposition is that proportion of the payments received in
10 that year which the gross profit (realized or to be realized
11 when payment is completed) bears to the total contract price.
12 "(d) ELECTION OUT.—
13 "(1) IN GENERAL.—Subsection (a) shall not apply
14 to any disposition if the taxpayer elects to have subsec-
15 tion (a) not apply to such disposition.
16 "(2) TIME AND MANNER FOR MAKING ELEC-
17 TION.—Except as otherwise provided by regulations,
18 an election under paragraph (1) with respect to a dis-
19 position may be made only on or before the due date
20 prescribed by law (including extensions) for filing the
21 taxpayer's return of the tax imposed by this chapter
22 for the taxable year in which the disposition occurs.
23 Such an election shall be made in the manner pre-
24 scribed by regulations.

1 "(6) LIKE-KIND EXCHANGES.—In the case of any
2 exchange described in section 1031(b)—
3 "(A) the total contract price shall be reduced
4 by the amount of any property permitted to be re-
5 ceived in such exchange without recognition of
6 gain,
7 "(B) the gross profit from such exchange
8 shall be reduced by the amount of gain not recog-
9 nized by reason of section 1031(b), and
10 "(C) the term 'payment' does not include any
11 property permitted to be received in such ex-
12 change without recognition of gain.
13 Similar rules shall apply in the case of an exchange
14 which is described in section 356(a) and is not treated
15 as a dividend.

"(7) COOPERATIVES AND THEIR PATRONS — For purposes of this section a cooperative marketing the products of its patrons shall not be deemed to be acting as the agent of such patrons."

16 "(g) USE OF INSTALLMENT METHOD BY SHAREHOLD-
17 ERS IN SECTION 337 LIQUIDATIONS.—
18 "(1) RECEIPT OF OBLIGATIONS NOT TREATED
19 AS RECEIPT OF PAYMENT.—
20 "(A) IN GENERAL.—If, in connection with a
21 liquidation to which section 337 applies, in a
22 transaction to which section 331 applies the
23 shareholder receives (in exchange for the share-

COMMUNICATING FOR AGRICULTURE

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Phone (218) 739-2511

Mr. Michael Stern
Staff Director
Senate Finance Committee
Taxation and Dept. Management Subcommittee
2221 Dirksen Building
Washington, DC 20510

Dear Mr. Stern:

CA (Communicating for Agriculture), Inc., a nonprofit, nonpartisan rural advocacy organization with members in 43 states, submits the following testimony on behalf of H.R. 6883, due to be considered by the Senate Finance Committee's Taxation and Debt Management Subcommittee at a hearing September 10:

CA supports the revised bill, H.R. 6883, with some reservations. However, our organization urges its passage.

Because CA is committed to the preservation and strengthening of the family farm -- family small business concept, it opposed the legislation in its original form.

The original legislation would have made it more difficult for parents to transfer farms and businesses to sons and daughters. It would have made capital gains taxes on sales to related persons due in their entirety immediately at the time of such sales. This would have discouraged generation-to generation transfer of farms and small businesses, because there are many sellers who simply wouldn't have the cash on hand to pay the full amount of taxes without first having the money represented by the sale.

Now, however, the legislation has been changed to where it no longer represents a serious threat to generation-to-generation continuity. In the revised bill, the immediate tax requirement wouldn't apply to family farms or businesses except in cases where the second generation results within two years.

There are some potential problems with the new legislation. Let's look at a hypothetical situation: John Peterson dies in April of 1975 and leaves the farm to his wife Mary. The farm is valued at $300,000 by his estate. Mary Peterson and her children farm the farm until the spring of 1980, when she sells the farm to her eldest son, Tom for $500,000. Tom qualifies for a guaranteed loan through the Minnesota Farm Security Act. Tom signs a

contract for deed with his mother, paying $50,000 down. Past services rendered on the farm are part of the payment. The balance is to be paid at $22,500 per year over 20 years.

So far, so good. But if Tom at any point within two years is forced to sell the farm due to family problems or other reasons, it could present serious tax problems for Mary Peterson.

This just represents a potential problem, and CA hopes that it doesn't occur. However, it might be possible to present the possibility of such a problem if some minor adjustments could be made in H.R. 6883. As economic barriers are removed or minimized, CA would like to see that caution is used so no new ones are created.

However, even with its current minor weakness, H.R. 6883 is far better than the legislation that came before it. CA supports H.R. 6883, and urges its passage.

Thank you for allowing CA to submit testimony on this important legislation. If any format changes or clarifications are needed, please contact our organization at the above address.

Sincerely,

Jerry Barney
Communications Director

JB:kb

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September 1, 1980

Senate Committee on Finance
Michael Stern, Staff Director
Rm. 2227 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Re: Installment Sales Revision Bill of 1980(H.H.6883)

Dear Sir:

We note that the Senate Finance Sub-committee on Taxation and Debt Management has scheduled hearings on the Installment Sales Revision Bill of 1980 (H.R. 6883) for September 10, 1980. Although we will be unable to attend the hearing, we would like to take this opportunity to express our thoughts regarding a desirable amendment to the proposed legislation which, we feel, should be given considered attention.

Proposed Section 453(h) of H.R. 6883 would allow a shareholder receiving a liquidating distribution from a corporation to report a portion of his gain on the installment basis where the shareholder actually receives installment obligations rather than cash or other property. We strongly support the proposal which is designed to eliminate the harsh treatment under present law which requires shareholders to pay tax on all gain in the year of the liquidating distribution, even where no current funds are received out of which the tax may be paid. However, Section 453(h)(1)(A) limits the benefits of installment reporting to those installment obligations which were generated by a corporate sale of non-inventory assets made during the Section 337 12-month liquidation period.

It seems to us that the proposal does not go far enough in its efforts to liberalize the tax treatment accorded shareholder distributees in a corporate liquidation context. We feel that installment reporting should be available in connection with all installment obligations distributed in a corporate liquidation, regardless of whether the obligations were generated during the Section 337 12-month period or prior to that time. In each case, the liquidity considerations are the same. The shareholder has not received cash (or property which is easily converted into cash) which he can use to pay his taxes. Fairness dictates an extension of the installment method of reporting and there does not appear to be any compelling reason for drawing a distinction between the two types of installment obligations.

Our suggested extension of proposed Section 453(h) corresponds completely with the policy underlying Section 453 which is stated in the House Ways and Means Committee report on H.R. 6883, dated May 21, 1980, to be as follows:

> The function of the installment method of reporting income is to permit the spreading of the income tax over the period during which payments of the sales price are received. Thus, the installment method alleviates possible liquidity problems which might arise from the bunching of gain in the year of sale when a portion of the selling price has not been actually received.

Other than liquidity considerations, the stated purpose of proposed Section 453(h) is to provide treatment to a shareholder receiving installment obligations from a liquidating corporation which is similar to the treatment accorded a shareholder selling stock on the installment method. It is entirely possible that a purchaser of corporate stock would design his payment terms to correspond with the expected cash flow of the corporation. Consequently, the terms of installment obligation corporate assets would impact on the terms of the purchaser's installment obligation. The stock selling shareholder would be accorded installment reporting privileges. The same treatment should be afforded to shareholder recipients of installment obligations in a liquidation context.

To implement our proposal, we suggest that proposed Section 453(h) of H.R. 6883 should be amended by eliminating the phrase "acquired in respect of a sale or exchange by the corporation during the 12-month period set forth in Section 337(1)". As a result, all installment obligations distributed by a liquidating corporation would be similarly treated and gain attributable to all installment obligations would be reportable by the shareholder recipient under the installment method.

Serious consideration of the proposed amendment to Section 453(h) deserves immediate consideration. We believe that our suggestion would greatly benefit taxpayers and that it is entirely consistent with the underlying general purpose of Section 453, both under present law and as it would stand if amended.

Very truly yours,

AIKEN, ST. LOUIS & SILJEG

Susan W. Carlson

SWC:pw
cc: Mr. Alexander Zakupowsky, Jr., CPA
cc: Stephen F. Dodd, CPA

STEVEN L. ARCHBOLD
ATTORNEY-AT-LAW
NORTH BROADWAY 402-373-4240
BLOOMFIELD, NE 68718

August 21, 1980

Mr. Michael Stern
Staff Director
Committee on Finance
Room 2227
Dirksen Senate Office
Building
Washington, D.C. 20510

"Statement Concerning H.R. 6883"

Gentlemen:

I strongly urge you to adopt some kind of installment sales tax revision bill. I strongly support H.R. 6883, but I also strongly urge you, in the strongest terms possible, to make the effective date of this new law January 1, 1981.

My reasons for bringing the effective date of the bill to your attention, are as follows: In the agriculture sector of this country, this bill would drastically change the estate planning techniques now employed by many attorneys. The effect of making the bill retroactive, as presently proposed, would be to totally change the tax effect of transactions that are now irreversible. I suggest, in the strongest terms, that this effective date be changed to either a prospective date or a set date of January 1, 1981. It is imperative that estate planning attorneys, in the agricultural sector of this country, be allowed to change

their estate planning techniques prior to the implementation of this bill.

Thank you for your consideration.

Sincerely,

Steven L. Archbold
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JOHN E. MARIANO

TELEPHONE 285-3461
AREA CODE 716

September 9th, 1980

Michael Stern, Staff Director
Committee on Finance
Room 2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Sir:

Our office has had a recent occasion to check into the impact of the existing tax structure relative to a sale of corporate assets and the consequence of distributing the sale proceeds to a principal stockholder after dissolution.

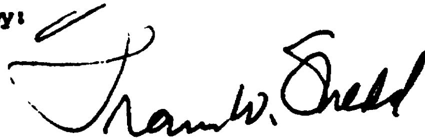
COPY

The impact in our particular instance was absolutely devastating to the recipient stockholder due to his very low basis. The Bill, H.R. 6883, would appear in all respects to equitably tax the gain without the punitive taxation that presently exists in our law. We sincerely urge that the committee report favorably on this pending legislation and hope that the same can be implemented shortly.

Very truly yours,

CHAPIN, SHEDD & MARIANO

By:



FWS/jb

American Farm Bureau Federation

WASHINGTON OFFICE
425 13TH STREET, N.W.
WASHINGTON, D.C. 20004
AREA CODE 202 - 637 - 0500
CABLE ADDRESS: AMFARMBUR

September 12, 1980

The Honorable Harry F. Byrd, Chairman
Subcommittee on Taxation and Debt Management
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Senator Byrd:

Your Subcommittee recently held a hearing on miscellaneous tax bills, including H.R. 6883 and S. 2916. H.R. 6883 revises the reporting rules for gains from installment sales under Section 453 of the Internal Revenue Code. S. 2916 is a bill introduced by Senator Dole and Senator Talmadge to allow the use of the investment tax credit against the alternative minimum tax.

The American Farm Bureau Federation, the nation's largest general farm organization representing over three million member families in forty-nine states and Puerto Rico, supports both bills.

Farm Bureau testified last summer before the House Ways and Means Subcommittee on Select Revenue Measures concerning H.R. 3899, an installment sales bill similar to H.R. 6883. In an effort to discourage abuse of the installment sales method, H.R. 3899 included a provision to prohibit the use of installment sales between related parties. Farm Bureau opposed this restriction because the installment method is widely used by farm families in the transfer of farm properties from one generation of a family to the next.

H.R. 6883 corrects the shortcoming of the earlier bill by allowing sales between related parties subject to a restriction on resale of the property within two years. The bill also accommodates situations involving involuntary conversions and makes other technical changes that would simplify the use of Section 453.

S. 2916 makes another important change in income tax law that is supported by Farm Bureau. In the absence of complete repeal of the alternative minimum tax provisions, we support legislation such as S. 2916 that would lessen the effect of the tax by allowing the use of the investment tax credit--a provision that is used widely in the agricultural community. Present law does not permit the alternative minimum tax to be reduced currently by the investment credit.

Thank you for favorable consideration of our comments. We ask that they be inserted in the hearing record.

Sincerely,

Vernie R. Glasson, Director
National Affairs Division

cc: Members of Subcommittee

STATEMENT

OF THE

NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

COMMITTEE ON FINANCE

UNITED STATES SENATE

ON

S. 2512

SERVICE LIABILITY PARTIAL SELF-INSURANCE ACT OF 1980

ON

SEPTEMBER 10, 1980

Mr. Chairman, we appreciate the opportunity to express our views on S.2512.

The National Association of Independent Insurers (NAII) opposes S.2512 for several reasons. First, we do not believe the proponents of this bill have demonstrated the need for this legislation. Second, we believe the proposal will not accomplish its stated purpose. Third, we believe the bill could be counterproductive in resolving the issues sought to be addressed by this legislation.

NAII is a voluntary trade association of over 460 insurers representing a cross-section of the property and casualty insurance business in America. While our companies write basically personal lines, several member companies write product and professional liability insurance, including a substantial amount of the design professional market.

S.2512 would amend the federal tax laws to permit deductions from income for amounts paid either into a reserve fund or to a captive insurer to cover professional liability for design professionals, architects and engineers. Interest paid on such funds would not be subject to taxation.

It is our view that the need for this legislation has not been established. We believe the insurance needs of design professionals, architects and engineers are being adequately met by the insurance industry. According to our information, availability of insurance is not a problem in this market.

To provide support for this legislation, its proponents have offered statistics of rising premium rates and percentage increases over the past two decades. Based on data supplied from member companies, we believe some of these figures are highly inflated and of questionable validity. In addition, while coverage costs have indeed risen over the past 20 years in this industry, the cost of virtually every product and service used by the American consumer has doubled and, in some cases, tripled because of inflation during that time. It is therefore inappropriate for this industry to be singled out for special treatment.

Furthermore, we believe recent information provides a more realistic picture of the situation as it presently exists in this market. In the past three years, the market has become much more competitive with three new entrants,* along with broadened coverages and higher policy limits. In many instances, we understand premium rates are actually declining despite inflationary trends present in the economy generally.

Another reason for rising insurance costs over the past two decades was explained by Senator Mathias in his statement introducing the bill: "Over the past 20 years, product liability laws have changed substantially, making it easier for the consumer to recover damages for injuries attributable to defective products. These changes have exposed the suppliers of

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*Insurance Company of North America, Allianz and a company in the American International Group

products to potentially ruinous liability and, in turn, have increased the cost of insurance that these suppliers must pay to protect themselves from such liability."

Thus, a significant reason for rising costs is the fact that product makers and professionals are being held more accountable to consumers than ever before for the quality of their work. If controls are needed to improve the quality of products and services, or to limit the scope of this responsibility and to set outer limits on recoveries in product or professional liability cases, tort reform or other legislative approaches at the state level would be the proper method to achieve these goals.

We also do not believe that this bill will adequately address the insurance concerns of firms of design professionals, architects and engineers. This proposal does not provide for traditional insurance services for the businesses involved, such as claims services, claims handling or legal services which would be necessary in handling such claims. The proposal merely provides a means of tax-free savings for a business which on any given day may be confronted with a liability claim. The plan does not even offer insurance protection, in the traditional sense, to businesses or to the public. Both would be gambling on whether such a fund would be adequate enough at a given time to pay any and all claims.

The amounts to be retained in such funds may also be inadequate as a result of the ceiling set forth in the bill

which limits contributions to no more than $25,000 per year ($100,000 for firms with severe problems). At that low rate, it would take many years to accumulate enough in any such fund to pay off a sizeable claim. Senator Mathias' statement accompanying the bill suggests that in practice, most design professionals would choose to use the fund only to cover their insurance policy deductibles and would purchase conventional insurance to cover additional exposure. However, the bill is not drafted in such a way as to require that the funds be used only in that manner.

Even if adequate amounts were paid into such a fund, without proper regulation and monitoring of reserves and investment practices, as well as claims and settlement practices (the way insurance companies are supervised by state regulatory authorities), there would be little assurance a particular company would be in a position to respond to legitimate claims the way a commercial carrier would.

This tax deduction program would thus encourage firms to pursue actuarially unsound self-insurance programs merely to gain apparent tax advantages. It would also place firms with no insurance expertise, skills or disciplines in the business of insurance since they would have to assume responsibility for all traditional claims services.

Finally, we believe this bill could actually be counterproductive to efforts that are underway between the insurance industry and the states to control costs. Since it is the

frequency and severity of liability awards which will prompt insurers to raise rates, efforts to control costs (in addition to inflation-control measures) must be centered around tort reform and delivery of better quality products and services. The insurance industry currently is working with the National Association of Insurance Commissioners (NAIC) in developing new product and new rating methods, as well as state tort reforms, to meet this challenge of expanding liability awards.

In conclusion, NAII opposes S.2512 because: (1) the need for such legislation has not been demonstrated, (2) the proposal will not accomplish its stated purpose, and (3) the legislation could be counterproductive.

****

68-906 O - 81 - 29

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September 10, 1980

Honorable Harry F. Byrd, Jr.
Chairman, Subcommittee on
Taxation and Debt Management
Committee on Finance
United States Senate
Washington, D.C.

Dear Senator Byrd:

I respectfully submit the following comments for consideration by the Subcommittee on Taxation and Debt Management in connection with your hearings on H.R. 6883, The Installment Sales Revision Act of 1980.

I appreciate the fact that this legislation is intended, among other things, to simplify the often-confusing rules pertaining to installment sales; however, it is my belief that the provisions pertaining to installment sales between related parties, if enacted, would greatly complicate this area and would impose substantial hardship on taxpayers who enter into legitimate installment sale transactions. It is my opinion that existing law effectively prevents the tax abuse which this legislation is intended to eliminate.

Over the past several months, I have written letters to both you and Representative Al Ullman, Chairman of the House Committee on Ways and Means, expressing my concerns about both the subject legislation as well as its predecessor, S.1063. I am enclosing, for your reference, copies of those letters.

In the event some legislation such as the proposed legislation is to be enacted, the following is a summary of the issues which I have previously raised, and which I believe must be dealt with by the proposed legislation:

1. The proposed provision which would cause the recognition of the entire amount of the unrealized gain from an installment sale upon the testamentary transfer of an installment obligation to the maker of such obligation should be deleted because it is inequitable and would create a terrible tax trap.

2. The use of the phrase "the total amount realized" in the proposed Subsection 453(c)(3), must be clarified because it implies that the total sales price to be received upon a "second disposition" is to be treated as having been received by the person making the "first disposition." Under this interpretation, acceleration of the recognition of the gain relating to the "first disposition" would result even if the person making the "second disposition" receives no cash or other "nonqualifying" property. The effect of such acceleration would be to cause the person who made the "first disposition" to recognize gain sooner than if such person had made the "second disposition" directly.

3. The proposed legislation is unclear and must be clarified as to what constitutes a "second disposition." For example, the legislation does not deal with situations in which an installment sale of either stock of a corporation or a partnership interest to a related person is followed, within two (2) years, by either (i) a sale of all or some of the assets of such corporation or partnership to an unrelated third party, (ii) a termination of the partnership or liquidation of the corporation, or (iii) a gift to charity of the stock or partnership interest.

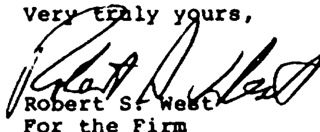
4. The proposed legislation should clarify the treatment of an installment sale of an asset to a related party which is followed, within two (2) years, by either (i) a resale of such asset to another related party, (ii) a gift to charity of such asset, or (iii) a transfer of such asset to a trust followed by a disposition of the beneficial interest in the trust.

5. The proposed legislation should clarify precisely to what extent the party making the "first disposition" must hold an interest in an installment purchaser entity for the two parties to be considered related.

In order for the proposed legislation to effectively treat all of the above issues, I respectfully submit that the objectives of "tax simplification" would have to be abandoned. The resulting statute would be incredibly complex and would still fail to deal with every type of installment sale transaction. In light of this fact, I urge that the related-party provisions of the proposed legislation not be enacted. Existing judicial standards effectively determine when a legitimate related party sale qualifies for the installment method of reporting. Such standards should not be abandoned in favor of new and incredibly complex tax legislation.

Thank you for your consideration of my comments.

Very truly yours,



Robert S. West
For the Firm

RSW/lb

Enclosures

NATIONAL ASSOCIATION OF REALTORS
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September 12, 1980

Honorable Harry F. Byrd, Jr.
Chairman
Subcommittee on Taxation and
Debt Management
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Byrd:

The NATIONAL ASSOCIATION OF REALTORS® is pleased to submit this statement in support of H.R. 6883, the Installment Sales Revision Act of 1980, and commends the Congress for continuing its efforts to further simplify some of the more complex provisions of the Internal Revenue Code. H.R. 6883 would make much needed changes to a Code section of particular value to transferors of real property and would offer buyers and sellers a simplified alternative method of transferring property rather than the complex rules that presently exist.

The Association particularly supports the revisions made by H.R. 6883 with respect to the tax treatment of sales for a contingent selling price, the method of obtaining installment sales treatment and the receipt of like kind property. Each of these changes is necessary in order to allow the installment sale provision to operate free of the complexities inherent in the present provision, but in recognition of the practices in the marketplace. Certainly, as practitioners in the real estate industry we have long sought recognition of the fact that contingent

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selling prices are common and often necessary.

While we support the revised bill, we do have some concerns and will proceed with a section by section discussion of the major revisions made by the bill.

Election of Installment Sale Treatment

The NATIONAL ASSOCIATION OF REALTORS® supports this bill's revision of the method of obtaining installment sales treatment. In many cases, taxpayers under current law are unaware of the benefits accorded by the installment sale method, even if the transaction would clearly be a qualifying sale. Further, we support this provision because it would reduce the paperwork burden for the many taxpayers who do elect installment sale treatment every year.

Sales for a Contingent Selling Price

Sales of real property based on a contingent selling price have long been commonplace in the real estate industry. Typical examples include sales of commercial space based in part on the amount of future leasehold income from property, sales of retail space based in part on the amount of sales volume, and so on. In many cases, sales of these types of property must be made on the basis of a contingent selling price since the value of the property is derived entirely from future income that cannot be determined on the date of the sale. Unfortunately, such sales have not qualified for the installment method despite the obvious need for the contingency.

We support the bill for making this much needed change and trust that the regulations that would be promulgated would recog-

nize the many types of contingencies on which a selling price may be based.

Related Party Sales

While we strongly support the concept that installment sales between related parties must be allowed, we remain concerned that, even as revised by H.R. 6883, the related party seller may face serious tax consequences brought about through no fault of his or her own. Specifically, I am referring to the situation where the related party purchaser, as a result of economic circumstances unrelated to the installment sale, finds that the property must be sold within two years of the date of the installment sale. In this event, the related party seller must pay tax even though he may have had no control over the resale of the property by the related party purchaser. We are hard pressed to find any other Code section that imposes tax on one individual solely as a result of an unrelated action by another individual.

To remedy this situation, installment sale treatment should be allowed between related parties unless the transaction is a sham, even if economic circumstances dictate that the property must be resold within the two year period mentioned in the bill.

Nevertheless, we applaud the bill's recognition of the fact that related party transactions should not automatically be disqualified from favorable tax treatment merely because the parties happen to be related. We would welcome such recognition in other areas as well. For example, the so-called "vacation home" rules preclude the owner of <u>any</u> rental unit from deducting expenses related to that unit, even though fair rental is paid, merely

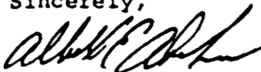
because the renters are related to the owner.

Current law limits the allowable deductions attributable to the rental of any residence if the taxpayer or his relatives personally use the home in excess of a specified minimum period of time during the taxable year. There is no problem when this rule is applied to the vacation home situation envisioned by Congress. But it is a serious problem when applied to a residence owned by the taxpayer and rented to a relative at fair market value even though the property is not a vacation home. For example, if a taxpayer owns rental property which is rented to complete strangers, he is entitled to all appropriate deductions. If the taxpayer rents the same property at the same rent to his or her parents, the same tax rules should apply. Unfortunately, that is not the case.

The NATIONAL ASSOCIATION OF REALTORS® opposes such discrimination and is certainly willing to work with this Subcommittee to remove this onerous provision and begin to deal more equitably with related party transactions, along the lines H.R. 6883 would establish in the installment sales area.

In conclusion, the NATIONAL ASSOCIATION OF REALTORS® strongly supports the Installment Sales Revision Act of 1980 and urges this Subcommittee to favorably report the bill to the Finance Committee. We would also urge the Subcommittee to work to resolve the vacation home rules problem outlined previously.

Sincerely,



Albert E. Abrahams

AEA/jms

HUNTZINGER, MILLER & ASSOCIATES
Certified Public Accountants
637 FREDERICK STREET
HANOVER, PA. 17331
717-637-5915

July 22, 1980

Mr. Herbert Spira, Chief Counsel
Senate Select Committee on
Small Business
Room 424, Russell Building
Washington, D.C. 20510

Dear Herb:

There is an important piece of legislation that was approved by the House Ways and Means Committee, H.R. 6883, that would be beneficial to Small Business. I would like to see your committee put its support behind this measure, which would have a minimal effect on the Federal Budget. Actually, the effect could conceivably be a revenue gain in the short run, because current law forces some potential gains either to be deferred indefinitely or not occur at all. Let me explain.

There are several good provisions in the bill which will ease the filing requirements for reporting gains on installment sales. This in itself is a positive step. The automatic or "mandatory" installment treatment effectively prohibits the IRS from attacking the treatment on "technical" grounds.

It is my opinion that most installment sales are made by individuals (of real estate) and small businesses (of assets and stock). I'm sure a study would prove me to be correct and make the allocation of the "benefits" of this bill quite clear.

One of the more significant provisions of the bill relates to installment sales involving business property. Current law puts the potential seller of a business in a difficult situation. His most favorable tax treatment occurs if he sells his stock of the corporation. The potential buyer normally wants to buy the assets of the corporation so that he can get his appropriate tax basis easily. It is not uncommon for a small businessman to be willing to "let some money in the deal" which can overcome some of the negotiating hurdles. However, if he consents to selling the corporate assets he has no incentive to sell on the installment method, because that method of reporting for tax purposes cannot be passed through to him upon liquidation of the corporation. He normally must liquidate under Sec. 337 since there is no longer any need for the corporation and the tax cost of withdrawing the income from the sale is prohibitive.

So, what happens? No deal! He then decides to just let the business run its course and hopes that all goes well after he dies; or, he continues

to work as hard-as he ever did and digs himself an early grave. Of course, he can seek a buyer from "Big Business."

It must be pointed out that most buyers of small businesses are small business people. Anything that reduces the obstacles that the seller faces inevitably is of benefit to the buyer. Most buyers do not have the personal resources to acquire a business. Commercial lending is an answer, but quite often the terms are less advantageous than the seller would grant on the installment basis.

Currently, I am working on two "deals," (one of which certainly will fall through), that would be easy to put together if H.R. 6883 were part of current tax law. In one case, a widow is desperately trying to sell the family business "before it goes downhill." I hope she can do it.

There are many detailed factors in all of the above which I've not discussed in this letter. If you would like to go over this issue with me, please let me know. In any event, please put your support behind H.R. 6883.

Sincerely,

Thomas E. Huntzinger

TEH:lry

WILFRED WILLIAMS
CHAIRMAN OF THE BOARD

MR. HERB SPIRA
424 RUSSELL BLDG.
WASHINGTON D.C. 20510

AUG. 28, 1980

DEAR MR SPIRA,

AT THE SUGGESTION OF MY BROTHER, HERMAN WILLIAMS, MILWAUKEE WISCONSIN, AND PRES. OF WILLIAMS STEEL & SUPPLY CO. I AM SENDING YOU A COPY OF A LETTER THAT I AM SENDING TO THE MEMBERS OF THE SENATE FINANCE COMMITTEE.

IT IS MY UNDERSTANDING FROM HERMAN, THAT BETWEEN SENATOR GAYLORD NELSON AND YOU, THAT YOU PUT THRU THE "GRADUATED INCOME TAX" THAT HAS BEEN OF SUCH GREAT HELP TO SMALL BUSINESS IN GENERATING AND PRESERVING CAPITAL FOR EXPANSION AND GROWTH. HERMAN SPEAKS HIGHLY OF BOTH OF YOU AND THE TREMENDOUS EFFORT EXPENDED IN REVISING THE TAX LAW TO AID SMALL BUSINESS.

H.R. 6883 IS ANOTHER LAW THAT WILL CORRECT AN UNFORTUNATE INEQUITY IN OUR PRESENT TAX LAWS THAT MAKES SMALL CORPORATIONS PAY TAXES IN ADVANCE, ON INCOME THAT HAS NOT AS YET BEEN COLLECTED.

YOUR EFFORTS TO SEE THAT HR 6883 BECOMES LAW AT AN EARLY DATE WILL BE A REAL AID FOR SMALL BUSINESS. THANKS.

SINCERELY

Wilfred Williams

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WILFRED WILLIAMS
CHAIRMAN OF THE BOARD

Mr. Herb Spira
[illegible] Russell Bldg.
Washington, DC 20510

August 28, 1980

Dear Mr. Spira:

SUBJECT - H.R. 6883 EASED INSTALLMENT SALES RULES

As a former "small business man", age 69, and now retired, I am writing to ask that you use your good office to pass the above bill at an early date.

My interest in this bill lies in the fact that after almost 30 years of hard work in starting and expanding a business that now employs over 100 people, I have run into a problem that is jeopardizing the continuity of this business.

About 4 years ago, I sold the Midwest Stamping Company to 18 of my employees thru an I.R.S. approved E.S.O.T. (Employees Stock Owners Trust) The employees now want to buy the factory building and the real estate, which they now lease, and which is a separate corporation owned by me and my 4 children. The employees can only pay 20% down and want to pay the balance over a 5 year period.

My children and I are willing to sell on this basis because it will guarantee the continuation of the business as well as the the future expansion and the increased employment of this small industry. However, without the passage of H.R. 6883, the payment of 20% along with notes for the balance of the sale would constitute a "complete sale" which calls for the payment of capital gains taxes in excess of the total initial cash payment. My children and I would have to borrow money at present day high interest rates to pay taxes on income that we will not collect for some years to come.

(cont. pg. 2)

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[illegible] sage of H.R.6883 [illegible] this inequity, in that it revises the eligibility rules for reporting sales of real estate from casual or [illegible] sales under the "installment sale" [illegible] permits the seller to avoid paying taxes [illegible] vance on income that has not as yet been collected.

There must be thousands of small family businesses and closely held corporations like Midwest Stamping that are being forced to sell out to large corporations and to conglomerates at sacrifice prices only because these large entities have the "ready cash" usually not redily available to Small Business.

In other instances, Small Businesses are forced to liquidate because they are unable to find small buyers or employees with adequate cash,to buy the business and preserve their jobs. We have too many " archaic" tax laws that work unnecessary hardships that were originally not intended, on the small business man.

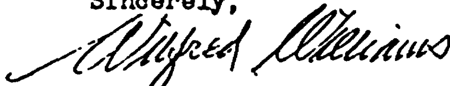
The House Ways and Means Committee approved the bill and the measure had the approval, and was drafted with the assistance of the Treasury Department, the Tax Section of the American Bar Association, and the Federa l Tax Division of the American Institute of Certified Public Accountants, together with several/state associations of these groups. Several trade associations and farm groups have also had a hand in drafting this legislation.

Finally, it is my understanding that H.R.6883 has been passed in the House as of June 17,1980.

Like "Motherhood", it seems as if everyone is for H.R.6883, however unless it is passed into law soon, it willnot and cannot be of help or aid to the small business man who needs help now.

May I hear from you at an early date as to what action you are taking to insure the speedy passage of H.R.6883 which will be of great aid to small business without costing the treasury department any loss of tax money.

Sincerely,



Wilfred Williams

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(Excerpt from the Newsletter of the National Association of Small Business Investment Companies)

The Small Business Authorization bill has gone to the White House to be signed by the President. The legislation has been in various stages of negotiation for over 2 years, largely because of disagreements between the House and Senate regarding the disaster lending programs of the SBA and the Farmers Home Administration. Compromise legislation S. 2698 was finally agreed to by a special House/Senate conference committee (see News 6/12/80) and was passed by both Houses of Congress last week. S. 2698 is a five-title bill which authorizes appropriations for the SBA for fiscal years 1981 and 1982, and which directs the agency to emphasize its Advocacy, Economic Research, Management Assistance, Procurement Assistance and minority small business programs. The legislation authorizes the SBA to guarantee $228 million of SBIC debentures in 1981, and $251 million the following year.

A bill to simplify and improve tax treatment of installment sales was passed by the House on June 17. The legislation would effect several major changes in the rules for reporting gains on the installment method. First, it would eliminate the 30% ceiling on the amount of the selling price that can be received in the taxable year of the sale and be eligible for installment sale reporting. In addition, it would do away with the requirement that a deferred payment sale consist of at least two payments (under the House bill, deferred reporting would be applicable even if the purchaser made a single full payment in a year following that taxable year in which the sale is made). The bill would also eliminate the rule that casual personal property sales be for amounts greater than $1,000 to qualify for installment reporting, and it would make installment sales treatment available to obligations received from liquidating corporations. Finally, the provisions of the bill would automatically apply to a qualified sale, except when the taxpayer elected not to apply it to a deferred payment sale. Advocates of the legislation, H.R. 6883, said that it will "give taxpayers greater flexibility in planning transactions, while containing sufficient safeguards against transactions that lack economic substance." A Senate counterpart, S. 2451, is currently pending in the Senate Finance Committee.

Legislation to alleviate the MESBIC funding problem failed to be reported out by the Senate Small Business Committee. The bill, introduced by Committee Chairman Gaylord Nelson (D-Wis.) would have enabled the SBA to sell MESBIC debentures to the Federal Financing Bank, but to continue paying the 3% interest subsidy. This system would make the MESBIC funding system roughly parallel to that of regular SBICs. Currently, funds to pay for MESBIC debentures come from a direct appropriation for that purpose. Due to the extremely heavy demand for funds by MESBICs in the past two years, the appropriated amounts have not been sufficient and a tremendous backlog in processing requests has developed. Although Congress authorized $38 million for fiscal year '80, only $27 million was actually appropriated, and a portion of that went immediately to fulfill holdover demands for funding. The FY '81 authorization is set at $55 million, but AAMESBIC President Richard Cummings has called that amount insufficient to meet industry needs.

MESBICs are being forced to borrow from the FFB at current rates, which creates a problem since they must then pass the higher interest rates through to their portfolio companies. One 301(d) SBIC executive noted that the shortage of funds and high FFB rates has "put our companies' very existence in jeopardy. MESBICs are forced to make debt financings instead of equity financings in order to cover their own operating costs," he said. An effort is being made to reprogram $11 million of unspent SBA funds into the MESBIC program.

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