TAX SIMPLIFICATION

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-SIXTH CONGRESS

FIRST SESSION

ON

S. 1062

A BILL TO SIMPLIFY CERTAIN PROVISIONS OF SUBTITLE F OF THE INTERNAL REVENUE CODE OF 1954

S. 1063

A BILL TO AMEND SECTION 453(b) OF THE INTERNAL REVENUE CODE OF 1954 TO SIMPLIFY THE RULES RELATING TO CERTAIN INSTALLMENT SALES

JUNE 22, 1979

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FRIDAY, JUNE 22, 1979

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

The subcommittee met, pursuant to notice, at 2 p.m., in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr., presiding.

Present: Senator Byrd.

[The press releases announcing this hearing and the bills S. 1062 and S. 1063 follow:]

[Press release No. H-27]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARING ON CERTAIN TAX SIMPLIFICATION PROPOSALS

Senator Harry F. Byrd, Jr. (I., Va.), Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance announced today that the Subcommittee will hold a hearing on June 22, 1979 on certain proposals for structural simplification of the Internal Revenue Code.

The hearing will begin at 9:30 a.m. in room 2221 of the Dirksen Senate Office Building.

Senator Byrd said, "Each year the tax laws seem to become more and more complex. Not only is the average citizen having trouble understanding the tax law, so also are professional tax advisors."

"Congress should reverse this trend."

In announcing the hearing, Senator Byrd cautioned that the problem of complexity in the Code does not lend itself to easy or quick solutions, since each provision has been added for a specific purpose.

"Nevertheless, the time has come to stand back and see how the provisions fit together, and whether they can be made easier for the tax community to understand."

Senator Byrd noted that a systematic review of the tax code is being conducted at a staff level, which is expected to generate a series of specific recommendations to simplify and improve the present law. The present hearing is intended both to advance discussion as to the general direction and form of structural simplification and to consider certain initial specific bills and proposals. It is anticipated that a series of additional hearings will be held as further recommendations are developed.

In addition to general comments concerning structural simplification, testimony will be sought on:

(1) Installment sales.—Senators Long and Dole have introduced S. 1063, a bill which will simplify the rules of section 453, dealing with installment sales. The proposal is of general application.

In addition to testimony on the specific provisions of the bill, testimony as to the broader questions of the tax treatment of deferred payment sales, contingent payments, and the distinction between open and closed transactions will also be considered relevant to the hearing.

(2) Procedure and administration.—Senators Long and Dole have introduced S. 1062, which would amend several Code provisions on procedure and administration, including a change in the scheduling of gift tax returns designed to facilitiate

voluntary compliance. Many of the proposed amendments were contained in H.R. 12578 in the 95th Congress. The proposal is of general application.

Generally, the revenue effect of S. 1062 and S. 1063 is expected to be negligible. However, due to the litigious nature of the issue relating to installment sales to related parties, the revenue effect of that provision is indeterminant.

(3) Stock attribution.—The American Bar Association House of Delegates has recommended a proposal for consolidating and simplifying the Code provisions on the attribution of stock ownership. The proposal is of general application.

Witnesses who desire to testify at the hearing should submit a written request 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 June 4, 1979.

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) A copy of the statement must be filed by noon the day before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on lettersize paper (not legal size) and at least 100 copies must be submitted by the close of business the day before the witness is scheduled to testify.

(4) 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 testimony.—Senator Byrd stated that the Subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length and mailed with five (5) copies by July 6, 1979, to Michael Stern, Staff Director, Committee on Finance, room 2227 Dirksen Senate Office Building, Washington, D.C. 20510.

[Press release No. H-37]

FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEEMNT RESCHEDULES HEARING ON CERTAIN TAX SIMPLIFICATION PROPOSALS

Senator Harry F. Byrd, Jr. (I., Va.), Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance announced today that the Subcommittee has rescheduled the hearing on June 22, 1979 on certain proposals for structural simplification of the Internal Revenue Code to 2 p.m. The hearing was previously set for 9:30 a.m. on that same date.

The hearing will now begin a 2 p.m. in room 2221 of the Dirksen Senate Office Building. Further information regarding this hearing may be obtained by referring to the Subcommittee's prior press release No. H-27 dated May 11, 1979.

II

96TH CONGRESS
1ST SESSION

S. 1062

To simplify certain provisions of subtitle F of the Internal Revenue Code of 1954.

IN THE SENATE OF THE UNITED STATES

MAY 2 (legislative day, APRIL 9), 1979

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

A BILL

To simplify certain provisions of subtitle F of the Internal Revenue Code of 1954.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; ETC.

(a) SHORT TITLE.—This Act may be cited as the "Subtitle F Revision Act of 1979".

(b) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. PAYMENT OF INTEREST WHERE LEVY HAS BEEN WRONGFULLY MADE AND MONEY RECEIVED BY UNITED STATES.

(a) IN GENERAL.—Section 6343 (relating to release of levy and return of property) is amended by adding at the end thereof the following new subsection:

"(c) INTEREST.—Interest shall be allowed and paid at an annual rate established under section 6621—

"(1) in a case described in subsection (b)(2), from the date the Secretary receives the money to the date of return, or

"(2) in a case described in subsection (b)(3), from the date of the sale of the property to the date of return."

(b) TECHNICAL AMENDMENT.—Subsection (a) of section 6621 is amended to read as follows:

"(a) IN GENERAL.—The annual rate established under this section shall be such adjusted rate as is established by the Secretary under subsection (b)."

(c) EFFECTIVE DATES.—

(1) The amendment made by subsection (a) shall apply to levies made after the date of the enactment of this Act.

(2) The amendment made by subsection (b) shall take effect on the date of the enactment of this Act.

SEC. 3. REPEAL OF REQUIREMENT THAT TRANSFERORS OF CERTAIN PROPERTY TO EXEMPT ORGANIZATIONS MUST FILE RETURNS.

(a) GENERAL RULE.—Section 6050 (relating to returns relating to certain transfers to exempt organizations) is hereby repealed.

(b) CLERICAL AMENDMENT.—The table of sections for subpart B of part III of subchapter A of chapter 61 is amended by striking out the item relating to section 6050.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to transfers after the date of the enactment of this Act.

SEC. 4. SIMPLIFICATION OF PRIVATE FOUNDATION RETURN AND REPORTING REQUIREMENTS.

(a) AMENDMENT OF SECTION 6033.—Section 6033 (relating to returns by exempt organizations) is amended by redesignating subsection (c) as subsection (e) and by inserting after subsection (b) the following new subsections:

"(c) ADDITIONAL PROVISIONS RELATING TO PRIVATE FOUNDATIONS.—In the case of an organization which is a private foundation (within the meaning of section 509(a))—

"(1) the Secretary shall by regulations provide that the private foundation shall include in its annual return under this section such information (not required to be furnished by subsection (b) or the forms or regulations prescribed thereunder) as would have been required to be furnished under section 6056 (relating to annual reports by private foundations) as such section 6056 was in effect before the enactment of this subsection,

"(2) a copy of the notice required by section 6104(d) (relating to public inspection of private foundation's annual returns), together with proof of publication thereof, shall be filed by the foundation together with the annual return under this section, and

"(3) the foundation managers shall furnish copies of the annual return under this section to such State officials and other persons, at such times, and under such conditions, as the Secretary may by regulations prescribe.

Nothing in paragraph (1) shall require the inclusion of the name and address of any recipient (other than a disqualified person within the meaning of section 4946) of any charitable gift or grant made by the foundation to such recipient as an indigent or needy person if the aggregate of the charitable gifts and grants made by the foundation to such recipient during the year does not exceed $1,000.

"(d) SECTION TO APPLY TO NONEXEMPT CHARITABLE TRUSTS AND NONEXEMPT PRIVATE FOUNDATIONS.—The following organizations shall comply with the requirements of this section in the same manner as organizations described in 501(c)(3) which are exempt from tax under section 501(a):

"(1) NONEXEMPT CHARITABLE TRUSTS.—A trust described in section 4947(a)(1) (relating to nonexempt charitable trusts).

"(2) NONEXEMPT PRIVATE FOUNDATIONS.—A private foundation which is not exempt from tax under section 501(a)."

(b) PUBLIC INSPECTION OF PRIVATE FOUNDATIONS' ANNUAL RETURNS.—

(1) IN GENERAL.—The first sentence of subsection (d) of section 6104 (relating to public inspection of private foundations' annual reports) is amended to reads as follows: "The annual return required to be filed under section 6033 (relating to returns by exempt organizations) by any organization which is a private foundation within the meaning of section 509(a) shall be made available by the foundation managers for inspection at the principal office of the foundation during regular business hours by any citizen on request made

within 180 days after the date of the publication of notice of its availability."

(2) CONFORMING AMENDMENTS.—Such subsection (d) is amended—

(A) by striking out "ANNUAL REPORTS" in the heading and inserting in lieu thereof "ANNUAL RETURNS"; and

(B) by striking out "annual report" each place it appears in the second and third sentences and inserting in lieu thereof "annual return".

(c) REPEAL OF PRIVATE FOUNDATION ANNUAL REPORTING REQUIREMENTS.—Subpart D of part III of subchapter A of chapter 61 (relating to information concerning private foundations) is hereby repealed.

(d) TECHNICAL AMENDMENTS.—

(1) Section 6034 (relating to returns by trust described in section 4947(a) or claiming charitable deductions under section 642(c)) is amended—

(A) by striking out "section 4947(a)" in subsection (a) and inserting in lieu thereof "section 4947(a)(2)";

(B) by adding at the end of subsection (b) the following new sentence: "This section shall not apply in the case of a trust described in section 4947(a)(1).";

(C) by striking out "EXCEPTION" in the heading of subsection (b) and inserting in lieu thereof "EXCEPTIONS"; and

(D) by striking out "SECTION 4947(a)" in the section heading and inserting in lieu thereof "SECTION 4947(a)(2)".

(2)(A) The first sentence of section 6652(d)(3) (relating to annual reports) is amended to read as follows: "In the case of a failure to comply with the requirements of section 6104(d) (relating to public inspection of private foundations' annual returns), on the date and in the manner prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause, there shall be paid (on notice and demand by the Secretary and in the same manner as tax) by the person failing to meet such requirements, $10 for each day during which such failure continues, but the total amount imposed hereunder on all such persons for such failure with respect to any one annual return shall not exceed $5,000."

(B) The heading of paragraph (3) of section 6652(d) is amended by striking out "REPORTS" and inserting in lieu thereof "RETURNS".

(3) Subsection (b) of section 6104 (relating to inspection of annual information returns) is amended by striking out "6056,".

(4) Section 6685 (relating to assessable penalties with respect to private foundation annual reports) is amended to read as follows:

"SEC. 6685. ASSESSABLE PENALTIES WITH RESPECT TO PRIVATE FOUNDATION ANNUAL RETURNS.

"In addition to the penalty imposed by section 7207 (relating to fraudulent returns, statements, or other documents), any person who is required to comply with the requirements of section 6104(d) (relating to private foundations' annual returns) and who fails to so comply with respect to any return, if such failure is willful, shall pay a penalty of $1,000 with respect to each such return."

(5) Section 7207 (relating to fraudulent returns, statements, or other documents) is amended by striking out "sections 6047 (b) or (c), 6056, or 6104(d)" and inserting in lieu thereof "subsection (b) or (c) of section 6047 or pursuant to subsection (d) of section 6104".

(e) CLERICAL AMENDMENTS.—

(1) The table of sections for subpart A of part III of subchapter A of chapter 61 is amended by striking out "4947(a)" in the item relating to section 6034 and inserting in lieu thereof "4947(a)(2)".

(2) The table of subparts for part III of subchapter A of chapter 61 is amended by striking out the item relating to subpart D.

(3) The table of sections for subchapter B of chapter 68 is amended by striking out "reports" in the item relating to section 6685 and inserting in lieu thereof "returns".

(f) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1979.

SEC. 5. REPEAL OF ADDITION TO TAX IN CASE OF JEOPARDY.

(a) GENERAL RULE.—Section 6658 (relating to addition to tax in case of jeopardy) is hereby repealed.

(b) CLERICAL AMENDMENT.—The table of sections for subchapter A of chapter 68 is amended by striking out the item relating to section 6658.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to violations (or attempted violations) occurring after the date of the enactment of this Act.

SEC. 6. REPEAL OF REQUIREMENT THAT INFORMATION BE FURNISHED TO THE SERVICE IN CONNECTION WITH CERTAIN OPTIONS.

(a) GENERAL RULE.—Section 6039 (relating to information required in connection with certain options) is amended to read as follows:

"SEC. 6039. INFORMATION REQUIRED IN CONNECTION WITH CERTAIN OPTIONS.

"(a) FURNISHING OF INFORMATION.—Every corporation—

"(1) which in any calendar year transfers a share of stock to any person pursuant to such person's exercise of a qualified stock option, or

"(2) which in any calendar year records (or has by its agent recorded) a transfer of the legal title of a share of stock—

"(A) acquired by the transferor pursuant to his exercise of an option described in section 423(c) (relating to special rule where option price is between 85 percent and 100 percent of value of stock), or

"(B) acquired by the transferor pursuant to his exercise of a restricted stock option described in section 424(c)(1) (relating to options under which option price is between 85 percent and 95 percent of value of stock),

shall (on or before January 31 of the following calendar year) furnish to such person a written statement in such manner and setting forth such information as the Secretary may by regulations prescribe.

"(b) SPECIAL RULES.—For purposes of this section—

"(1) TREATMENT BY EMPLOYER TO BE DETERMINATIVE.—Any option which the corporation treats as a qualified stock option, a restricted stock option, or an option granted under an employee stock purchase plan shall be deemed to be such an option.

"(2) SUBSECTION (a)(2) APPLIES ONLY TO FIRST TRANSFER DESCRIBED THEREIN.—A statement is required by reason of a transfer described in subsection (a)(2) of a share only with respect to the first transfer of such share by the person who exercised the option.

"(3) IDENTIFICATION OF STOCK.—Any corporation which transfers any share of stock pursuant to the exercise of any option described in subsection (a)(2) shall identify such stock in a manner adequate to carry out the purposes of this section.

"(c) CROSS REFERENCES.—

"For definition of—

"(1) The term 'qualified stock option', see section 422(b).

"(2) The term 'employee stock purchase plan', see section 423(b).

"(3) The term 'restricted stock option', see section 424(b)."

(b) TECHNICAL AMENDMENTS.—

(1) Subsection (a) of section 6652 is amended—

(A) by inserting "or" at the end of paragraph (1),

(B) by striking out paragraph (2) and redesignating paragraph (3) as paragraph (2), and

(C) by striking out "return referred to in paragraph (2) or (3)" and inserting in lieu thereof "return referred to in paragraph (2)".

(2) Section 6678 (relating to penalty for failure to furnish certain statements) is amended to read as follows:

"SEC. 6678. FAILURE TO FURNISH CERTAIN STATEMENTS.

"In the case of each failure—

"(1) to furnish a statement under section 6042(c), 6044(e), 6049(c), or 6052(b) on the date prescribed therefor to a person with respect to whom a return has been made under section 6042(a)(1), 6044(a)(1), 6049(a)(1), or 6052(a), respectively, or

"(2) to furnish a statement under section 6039(a) on the date prescribed therefor to a person with respect to whom such a statement is required,

unless it is shown that such failure is due to reasonable cause and not to willful neglect, there shall be paid (upon notice and demand by the Secretary and in the same manner as tax) by the person failing to so furnish the statement $10 for each such statement not so furnished, but the total amount imposed on the delinquent person for all such failures during any calendar year shall not exceed $25,000."

(c) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to calendar years beginning after 1979.

SEC. 7. EXTENSION OF TIME FOR FILING GIFT TAX RETURN FOR FOURTH CALENDAR QUARTER.

(a) GENERAL RULE.—Paragraph (1) of section 6075(b) (relating to due date for gift tax returns) is amended to read as follows:

"(1) GENERAL RULE.—Except as provided in paragraph (2), returns made under section 6019 (relating to gift taxes) shall be filed on or before—

"(A) in the case of a return for the first, second, or third calendar quarter of any calendar year, the 15th day of the second month following the close of the calendar quarter, or

"(B) in the case of a return for the fourth calendar quarter of any calendar year, the 15th day of the fourth month following the close of the calendar quarter."

(b) EXTENSION OF DATE FOR FILING INCOME TAX RETURN TREATED AS EXTENSION OF DATE FOR FILING GIFT TAX RETURN.—Subsection (b) of section 6075 is amended by redesignating paragraph (3) as paragraph (4) and by inserting after paragraph (2) the following new paragraph:

"(3) EXTENSION WHERE TAXPAYER GRANTED EXTENSION FOR FILING INCOME TAX RETURN.—Any extension of time granted the taxpayer for filing the return of income taxes imposed by subtitle A for any taxable year which is a calendar year shall be deemed to be also an extension of time granted the taxpayer for filing the return under section 6019 for the fourth calendar quarter of such taxable year."

(c) TECHNICAL AMENDMENTS.—Paragraph (2) of section 6075(b) is amended—

(1) by striking out "the 15th day of the second month after" and inserting in lieu thereof "the date prescribed by paragraph (1) for filing the return for", and

(2) by striking out "the close of" in subparagraphs (A) and (B).

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to returns for gifts made in calendar years ending after the date of the enactment of this Act.

SEC. 8. DISCLOSURE TO STATE TAX OFFICIALS.

(a) GENERAL RULE.—Subsection (d) of section 6103 (relating to disclosure to State tax officials) is amended by inserting "32," after "31,".

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall take effect on the date of the enactment of this Act.

II

96TH CONGRESS
1ST SESSION

S. 1063

To amend section 453(b) of the Internal Revenue Code of 1954 to simplify the rules relating to certain installment sales.

IN THE SENATE OF THE UNITED STATES

MAY 2 (legislative day, APRIL 9), 1979

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

---

A BILL

To amend section 453(b) of the Internal Revenue Code of 1954 to simplify the rules relating to certain installment sales.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SIMPLIFICATION OF INSTALLMENT SALES RULES.

Subsection (b) of section 453 of the Internal Revenue Code of 1954 (relating to installment method for sales of realty and casual sales of personalty) is amended to read as follows:

"(b) DISPOSITIONS OF REALTY AND CASUAL DISPOSITIONS OF PERSONAL PROPERTY.—

"(1) General rule.—Income from—

"(A) a disposition of real property, or

"(B) a casual disposition of personal property for a price exceeding $3,000,

may (under regulations prescribed by the Secretary) be returned on the installment method.

"(2) Installment method defined.—For purposes of this subsection, the term 'installment method' means a method in which the income for any taxable year from a disposition is that proportion of the payments actually received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

"(3) Subsection does not apply to disposition to related persons.—

"(A) In general.—This subsection shall not apply to a disposition directly or indirectly to a related person.

"(B) Related person defined.—For purposes of this subsection, the term 'related person' means a person bearing a relationship to the person disposing of the property which is set forth in section 267(b) or 707(b)(1).

"(C) Exception for certain redemptions.—Subparagraph (A) shall not apply to any redemption to which section 302(a) (relating to distributions in redemption of stock) or 303(a) (relating to distributions in redemption of stock to pay death taxes) applies.

"(4) OTHER RULES.—

"(A) SUBSECTION DOES NOT APPLY TO DISPOSITIONS OF INVENTORY.—This subsection shall not apply to property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

"(B) PURCHASER EVIDENCES OF INDEBTEDNESS PAYABLE ON DEMAND OR READILY TRADABLE.—For purposes of this subsection, receipt of a bond or other evidence of indebtedness which—

"(i) is payable on demand, or

"(ii) is issued by a corporation or a government or political subdivision thereof and is readily tradable,

shall be treated as receipt of payment.

"(C) READILY TRADABLE DEFINED.—For purposes of subparagraph (B), the term 'readily tradable' means a bond or other evidence of indebtedness which is issued—

"(i) with interest coupons attached or in registered form (other than one in registered form which the taxpayer establishes will not be readily tradable in an established securities market), or

"(ii) in any other form designed to render such bond or other evidence of indebtedness readily tradable in an established securities market.".

SEC. 2. COORDINATION WITH SECTION 691.

The second sentence of section 691(a)(2) of the Internal Revenue Code of 1954 (relating to income in respect of decedents) is amended by inserting "(other than the obligor)" after "or a transfer to a person".

SEC. 3. EFFECTIVE DATES.

(a) FOR SECTION 1.—The amendment made by section 1 shall apply to dispositions made after the date of the enactment of this Act in taxable years ending after such date.

(b) FOR SECTION 2.—The amendment made by section 2 shall apply in the case of decedents dying after the date of the enactment of this Act.

Senator BYRD. The hour of 2 having arrived, the committee will come to order. The subcommittee today will consider proposals designed to simplify the tax code.

Two specific measures, S. 1062 and S. 1063, cosponsered by Senators Long and Dole, will be reviewed.

In addition, the subcommittee will hear general comments on the topic of tax simplification and will consider comments on proposals dealing with stock attribution rules.

The hearing today indicate a desire by the subcommittee to look at current tax laws and develop and review proposals in a systematic manner which will make these laws more workable, more understandable and more logically consistent. These efforts, hopefully, will make the tax law easier to understand, encourage voluntary compliance and improve administration.

The simplification program is not intended as "tax reform" in the sense in which that phrase has often been used in recent years. Also, although individual changes may increase or decrease revenues, it is not the purpose of the overall program to raise taxes or to lower taxes or to change basic tax polices. Instead, it is intended to make the existing tax system and ~~tax~~ policies work better.

The present program will consist of a systematic review of specific proposals for revising particular section or topics.

It should be remembered that provisions which have been in the tax laws for many years are often familiar territory for many taxpayers and their counsel. These provisions were put into the code for a specific reason, which often continues to be valid.

Instead of change involving comprehensive revision of the code, this subcommittee will, in a systematic manner, look at limited revisions which will add precision and certainty to the tax law.

Given the intellectual and practical difficulty of the task before the subcommittee, I particularly welcome the representatives of the legal and accounting community and hope that they will work jointly with the Congress and the Treasury in developing practical and workable solutions to the problems of tax complexity.

The first panel today will consist of two, Mr. Lipman Redman, chairman, tax section, American Bar Association and Mr. Charles R. Lees, vice chairman, Federal tax division, AICPA.

Gentlemen, welcome to the committee this afternoon. We are pleased to have you, and you may proceed as you wish.

STATEMENT OF LIPMAN REDMAN, CHAIRMAN, TAX SECTION, AMERICAN BAR ASSOCIATION

Mr. REDMAN. Thank you, Mr. Chairman. It is my privilege to lead off and I do so with a truism—namely, simplification is like God, motherhood and apple pie. We all are in favor of it, but we do not always agree as to what it really is and how we get there.

But certainly the activities of the Finance Committee and this subcommittee, Mr. Chairman, under your leadership are certainly a step forward, down that road toward simplification and represent an effort to find whether we can agree on at least what we are looking for, and I think we can.

I think it is relevant in this connection to note that the tax section of the American Bar Association had an interest in simplification many years ago in a variety of ways, both informal and unofficial as well as on a more official basis. Indeed, as the chairman has heard me say before, as I sat before his subcommittee, I must explain that I do not speak officially for the tax section today because the nature of the topic being what it is, we have been unable to comply with our own internal rules and those of the American Bar Association so as to entitle us to speak in any representative capacity. With the one exception of the discussion of attribution which we went through many years ago, those of us tax section people here today are here in our individual capacities.

That does not distract, however, from the fact that all of us received our simplification training, if you will, in our tax section settings. Indeed, we started our work many years ago when we organized our special committee on simplification which started with a relatively important then but now lesser important function as that committee's role has increased and expanded.

The committee initially started with a program of reviewing every proposal which came through the tax section and we have some 40-odd committees which constantly look at ways of improving and reforming the code to evaluate every such recommendation from the point of view of simplification.

Our function really was to bring to everyone's attention the fact that as we attempted to improve the code, we should not ignore the effect of such election improvement on simplification, with the result that when the council of the tax section and the members sitting in plenary session reviewed the merits of these various proposals over the years, they had in mind, their attention was brought to the matter of, whether or not that proposal would complicate the code or provide simplification, and that added an important element to the equation.

Indeed, we have been looking at this for some time in that context as our committee proceeded with its work. It had its function of meeting from time to time with various government representatives at the joint committee staff, at Treasury and at the Internal Revenue Service. I remember one such meeting that I attended when Dr. Laurence Woodworth was Chief of Staff, in response to our expression of concern with regard to complexity, Larry said: "It took us about 50 years to make the Internal Revenue Code the mess it is today. We had better plan on taking just about as long in order to simplify it."

Perhaps the best way to do that is as the chairman has indicated, namely, on a step-by-step basis, picking particular areas and particular subject matters which can be separately treated and brought to a head in one place and dealt with in that fashion.

When the Treasury issued its Blueprint in January 1977 there, too, we were involved and took off from that and proceeded with our further activity. We like to think that we had a hand in that, because the others primarily were Messers. Walker and Goldstein, running the Assistant Secretary of the Treasury's Office for Tax Policy at that time. They were on our Simplification Committee before their Treasury service, and they returned to it afterwards.

Thereafter, we extended the scope of our activity and played an important role in the organization in 1978 of the Arlie House Conference on Simplification. From that has given rise over the last year during the Committee on Tax Simplification, a joint effort of the tax section, the American Law Institute, the AICPA and the National Society of Public Accountants.

This committee has organized a number of simplification conferences around the country and the program continues.

I am glad to note that the American Bar Association has made funds available for an expansion of that program.

Thank you, Mr. Chairman.

Senator BYRD. Thank you, sir.

STATEMENT OF CHARLES R. LEES, CPA, VICE CHAIRMAN, FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. LEES. My name is Charles R. Lees. I am pleased to testify today in my capacity as vice chairman of the Federal tax division of the American Institute of Certified Public Accountants.

The AICPA has over 145,000 members, many of whom advise clients on tax matters, prepare tax returns, and work generally with the tax provisions which you help write. We heartily endorse congressional efforts to simplify the Internal Revenue Code.

The Internal Revenue Code has become more voluminous, complex and rapidly changing in recent years. As intimate observers of the effect of our tax system on the public and the Nation, we are extremely concerned.

The Internal Revenue Code is growing in length at a rapid rate. In 1953, the income, estate and gift tax provisions of the code were 670 pages long. By 1963, these had grown to 1,038 pages and by 1973 to 1,728 pages.

Today, these provisions of the code had blossomed into a full 1,091 pages and we have no indication that this rate of growth will slow. The related Treasury regulations have also expanded, increasing in weight from 4.5 pounds in 1968 to nearly 8 pounds today.

The language of the code is extremely complex in many areas. A popular example of almost indecipherable English is a sentence in section 341(e)(1) which contains 457 words, 18 commas, 5 parentheticals, 3 subparagraphs, 2 sub-subparagraphs, and 7 references to other parts of the code. Although there may be some considerations which must override simplicity in some cases, there is all too much complex language in the code.

In addition to the size and complexity of the code, there is an alarming rate of change in its provisions. The Internal Revenue Service has indicated that it has a 3-year backlog of regulations projects in some areas. A list of the statutes which have changed the Internal Revenue Code in the last 10 years requires seven full pages of fine print. Although most of the amending acts are minor, a growing number are quite significant—and even minor changes can be important to a significant group of taxpayers. These changes, in and of themselves, are a major complexity in our system.

As a result of these complexities, CPA's are observing a serious phenomenon. Even our most sophisticated clients are beginning to despair understanding the tax system and how it affects them and their businesses. This inability to understand how one is being taxed is the ultimate in unfairness to the taxpayer and is an unhealthy influence in a self-assessment system of taxation.

The AICPA has been working towards simplification of the Internal Revenue Code for many years. We have sent copies of several of our publications in which we recommend simplification measures to all members of the subcommittee and would be pleased to send copies to others who might be interested.

In 1978, we published a "Proposal for Complete Revision of Subchapter S Corporation Provisions," and we are about to publish a similar series of recommendations for partnership tax law changes. The 1979 edition of our biennial publication, "Recommended Tax Law Changes," will be available shortly and we will send copies to you. Much of the other work of the Federal tax division has been directed at making the tax law as simple and equitable as possible.

We applaud Congress for its current efforts toward simplification. We believe that these hearings should be the beginning of a series of hearings on simplifications measures, and we wish to indicate the full support of the CPA profession for such a program.

Two other speakers from the AICPA will address the specific issues of the two important bills which the subcommittee will consider today. Mr. Herbert J. Lerner, the chairman of the tax accounting subcommittee of the Federal tax division will address the installment sales bill, S. 1063, and Mr. Martin L. Kamerow, a member of the Tax Administration Subcommittee, will discuss the procedures and administration simplification bill, S. 1062.

We appreciate this opportunity to testify at these important hearings and offer our assistance in any way possible in efforts to simplify the Internal Revenue Code. In that regard, we believe that cooperation among the Congress, the Treasury Department, the Bar Associations and the AICPA is very constructive. We are eager to see it continue, and are confident that we will each make important contributions to the process.

Thank you.

Senator BYRD. Thank you, Mr. Lees. Both you and Mr. Redman have brought out interesting information in regard to the tax code.

Let me refresh my memory. Did you say the present code now weighs 8 pounds?

Mr. LEES. Yes. The regulations weigh 8 pounds.

Senator BYRD. Regulations, yes.

Mr. LEES. They weighed 4.5 pounds in 1968; now they are up to 8 pounds. The code is 2,092 pages and it was only 1,038 in 1963 and 670 back in 1953. So in 25 years it has increased approximatey 1,400 pages.

Senator BYRD. And gained a great deal of weight in the process.

Mr. LEES. That is right.

Mr. REDMAN. Either weight or water.

Senator BYRD. Do you feel that the current level of complexity discourages tax compliance?

Mr. REDMAN. I think it makes it very difficult for the uninformed taxpayer to comply to the fullest extent and provides opportunities for the very well-informed taxpayer to avoid full compliance, not necessarily in the illegal sense but in the sense of too many transactions being gerrymandered in particular ways because of the complexity of the code, to produce a given result, whereas, really, taxes should only be an incidental aspect of structuring a sound business transaction.

Senator BYRD. You two speak, of course, as professionals. Do you feel that the tax code is now too complex, even for professional tax practitioners?

Mr. LEES. We feel that it is becoming more difficult to interpret. I would not say that it is too complex for a professional to interpret. It just becomes more difficult.

I think that difficulty and complexity makes compliance more difficult. Whether you come right out and say discourage, is one thing, but it does make it more difficult.

Senator BYRD. The more complex it is, I suppose, and the more difficult for the professionals to interpret it, the more time the interpretation takes. The more time it takes, the more costly it is to the clients who are being served by the professionals.

Mr. LEES. That certainly is true.

Mr. REDMAN. That is true, Mr. Chairman. In the case of the small taxpayer it becomes difficult to create situations where perhaps he needs professional advice when he should not.

For the sophisticated taxpayers, as I said before, the biggest consideration becomes taxes and many transactions, and that should not be so.

Senator BYRD. Thank you, Mr. Redman and Mr. Lees.

Mr. LEES. Thank you, sir.

Mr. REDMAN. Thank you.

[The prepared statements of Messrs. Redman and Lees follow:]

STATEMENT OF LIPMAN REDMAN

Simplification is like "God, Motherhood, and Apple Pie": everybody is for it but not everybody agrees on what it is or how to get there. Yet everybody agrees also it is worth the effort—or perhaps more precisely, an effort.

The subject matter of today's hearing represents such an effort and we Tax Section members here today are very pleased to join the subcommittee and the chairman and our accountant friends in an effort to find at least a little of what we are looking for.

The Tax Section started its looking many years ago in a variety of informal and unofficial ways—and indeed the rules of the Section and of the American Bar Association require me to state that the Tax Section has not taken the type of formal action required in order for us to offer our comments today as official Tax Section position. Accordingly although all of us have received our simplification training, as it were, in our Tax Section activities, we speak today only in our individual capacities.

But some of the things we have done over the years clearly reflect Tax Section policy. Perhaps the most significant was our recognition of the need to formalize our interest and concern in the form of appointing a Special Committee on Simplification. We did that some 8-10 years ago and charged that committee with the responsibility of reviewing each proposal by a Tax Section committee for a legislative or administration recommendation and evaluating it from the point of view of simplification. As a means of focusing attention on the need for simplification, our Simplification Committee rated each proposal, and when the Council of the Section and the members in plenary session voted on a proposal, they added to the equation the then novel factor of simplification.

We are all the more pleased to note now that simplification, or at least the articulation of interest in simplification, is no longer a novelty.

Indeed the Chairman's remarks in the Congressional Record of June 11 is an excellent example of such articulation; awareness of the problem is the first step toward its solution.

The approach to the solution suggested by the chairman in his remarks eleven days ago is, we think, the only viable approach: a step by step attack, picking particular subject matters one at a time, in an effort to eat away at the problem.

This approach was also the one we have suggested from time to time in our meetings over the years with our equally concerned friends on the Joint Committee Staff, at the Treasury and at the Internal Revenue Service. In fact I recall one of our meetings with Dr. Laurence Woodworth when he was Chief of Staff of the Joint Committee Staff. Larry said something to the effect that it took 50 years to make the Internal Revenue Code "the complex mess it is today", and we better plan on taking just about as long to restore some semblance of simplification to it—step by step.

One specific step we urged on our colleagues in the government was a move similar to the original function of our Special Committee on Simplification, namely the assignment of one or more persons with the sole or at least the principal responsibility of isolating and attacking simplification targets, both at the administrative and the legislative levels.

The Tax Section's interest and involvement in that function provided the perfect setting, from our point of view, for the Treasury's tax reform studies which culminated in the publication in January, 1977 of Blueprints for Basic Tax Reform. The study was undertaken while Charles M. Walker and William M. Goldstein were Assistant Secretary and Deputy Assistant Secretary of the Treasury for Tax Policy. We like to think that Messrs. Walker and Goldstein received their simplification training as members of our Special Committee prior to joining the Treasury. We know that the committee benefited when they returned after their retirement from Treasury.

With the publication of Blueprints, our Special Committee entered a new phase of activity. We doubled its size—without any sacrifice of quality or dedication—and undertook a two-year study of the simplification aspects of broad-based tax reform. This activity produced a series of detailed study papers on certain major segments of the Code. They have now been published in the Spring issue of The Tax Lawyer, the Section's official publication and we hope and expect that they will be of significant help in any simplification effort.

Obviously the Section was now deeply committed to simplification and we determined to expand the scope of our activity. That took the form of our involvement in the Airlie House Conference on Simplification in January, 1978. The Special Committee served as a catalyst in bringing together tax experts from government, professional ranks and private practice in a three-day conference on simplification of the tax laws. This conference in turn was a catalyst in the formation of the Steering Committee on Tax Simplification, which is a joint effort of the Tax Section, American Law Institute, American Institute of Certified Public Accountants and the National Society of Public Accountants. This steering committee has sponsored conferences in several cities on tax simplification and has plans for enlarging that activity. Indeed the American Bar Association has recently allocated a significant sum of money to the Tax Section for its use in connection with these programs. I should note that the Tax Section had little difficulty in convincing S. Shepherd Tate, President of the American Bar Association, of the importance of this effort.

The Tax Section people here today have long been active in the Section on the subjects scheduled for discussion. Messrs. Calkins, Dunn and Nolan have served the Section in a variety of important functions, and particularly in the area of simplification; each chairs an important committee in this regard, Mr. Calkins on the Steering Committee on Simplification, Mr. Dunn on the Section's Special Committee, and Mr. Nolan on the Section's Committee on Implementing Legislative Recommendations. They have all participated actively on our Special Committee and have written and talked extensively across the country on various phases of simplification.

One of the specific topics on today's agenda is installment sales. Our activity in this area illustrates the Section's current internal approach to simplification. We have different members of our Special Committee working with our different substantive committees with jurisdiction over particular sections of the Code. Thus, Mr. Ginsburg, Vice Chairman of our Special Committee, has been working with James Jeanblanc, Chairman of our Committee on Tax Accounting Problems. While Mr. Jeanblanc's committee continues to work on Section 453 and other tax accounting matters, Mr. Jeanblanc has been coordinating with Mr. Ginsburg as the representative of the simplification committee on the simplification aspects of this subject, and more particularly at the moment on S. 1063 and H.R. 3899.

Similar liaison is about to be instituted as we reopen our consideration of the rules of attribution. That is being undertaken by Sheldon Bonovitz who is currently Chairman of the Section's Committee on Affiliated and Related Corporations. Mr. Bonovitz and others from his committee will be working closely with members of the Special Committee on Simplification in this effort. It is of course noteworthy that the starting point for the Subcommittee's review of this topic is the Tax

Section's proposal which we adopted and the American Bar Association House of Delegates approved over 10 years ago.

With regard to S. 1062 which would amend various sections of Subtitle F in the area of procedure and administration, we plan on similar coordination. The Section's two committees on administrative and procedural matters and the Simplification Committee have prepared analyses of the bill and we will be prepared shortly to submit their combined statement for the record.

We are grateful indeed to all of these hardworking and dedicated experts and the others who are working on various aspects of simplification for their fine work. We are grateful too to the Finance Committee, the Subcommittee, and to the Chairman for the convening of these hearings and for the opportunity to participate in this clearly appropriate attack on a matter of critical concern.

With the Chairman's permission I would like to acknowledge our particular gratitude to Edward J. Hawkins, Chief Tax Counsel of the Finance Committee and a prime mover with the Chairman in connection with these hearings. Mr. Hawkins' long and distinguished service in the Tax Section makes it no surprise to us that he is performing so well in this setting.

Mr. Chairman, we Tax Section people are really quite pleased to join you in your significant effort to focus attention on the need for simplification and your attempt to start the process with these hearings. We hope you will allow us to continue to work with you and the staff as the process develops.

Statement of Charles R. Lees, CPA, Vice Chairman of the Federal Tax Division, American Institute of Certified Public Accountants

My name is Charles R. Lees, and I am pleased to testify before you today in my capacity as Vice-Chairman of the Federal Tax Division of the American Institute of Certified Public Accountants.

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The language of the Code is extremely complex in many areas. A popular example of almost indecipherable English is a sentence in Section 341(e)(1) which contains 457 words, 18 commas, 5 parentheticals, 3 subparagraphs, 2 sub-subparagraphs, and 7 references to other parts of the Code! Although there may be some considerations which must override simplicity in some cases, there is all too much complex language in the Code.

In addition to the size and complexity of the Code, there is an alarming rate of change in its provisions. The Internal Revenue Service has indicated that it has a 3-year backlog of regulations projects in some areas! A list of the statutes which have changed the Internal Revenue Code in the last 10 years requires 7 full pages of fine print! Although most of the amending acts are minor, a growing number are quite significant—and even the minor changes can be important to a significant group of taxpayers. These changes, in and of themselves, are a major complexity in our system.

As a result of these complexities, CPAs are observing a serious phenomenon. Even our most sophisticated clients are beginning to despair understanding the tax system and how it affects them and their businesses. This inability to understand how one is being taxed is the ultimate in unfairness to the taxpayer and is an unhealthy influence in a self-assessment system of taxation.

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We appreciate this opportunity to testify at these important hearings and offer our assistance in any way possible in efforts to simplify the Internal Revenue Code. In that regard, we believe that cooperation among the Congress, the Treasury Department, the Bar Associations, and the AICPA is very constructive. We are eager to see it continue, and are confident that we will each make important contributions to the process.

Senator BYRD. The next panel will be a panel of three: Mr. Hugh Calkins, Cleveland, Ohio; Mr. H. Stewart Dunn, of Washington, D.C.; and Mr. John S. Nolan of Washington, D.C.

Mr. Nolan has been associated with this committee for many years.

Welcome, all of you.

Mr. Calkins, will you lead off?

STATEMENT OF HUGH CALKINS, CLEVELAND, OHIO

Mr. CALKINS. Thank you, Senator. I am glad to do so.

I am the chairman of the Steering Committee on Income Tax Simplification which Mr. Redman mentioned. That committee is in the business of encouraging study and discussion of simplification and does not take positions and I, like him, am therefore here in an individual capacity.

I appreciate very much the opportunity to open up this panel by responding directly to the question, why is it that simplification is sufficiently important to attract the attention of a legislative body with all of the numerous and heavy responsibilities of the U.S. Senate?

There are many reasons. I have time to state three of them.

The first is that while the enormous complexity and length of the code which Mr. Lees referred to are often justified as an effort to achieve equity, the fact of the matter is that it frequently does not work out that way, and the complexity defeats equity.

Subchapter S, for example, the provision that permits corporations to be taxed somewhat like partnerships, ought to be simple enough for general business lawyers to advise their clients on. The fact of the matter is that it is not.

The retirement income credit and the medical deduction ought to be simple enough that people who are not accountants can compute them, but the fact of the matter is that many such people cannot.

Taxpayers who sell property for a deferred purchase price ought not to have to remember that if any portion of that deferred price is a contingent price, they are going to lose the benefit of being able to pay their tax as they receive the proceeds from the sale.

In all of these instances, and scores more, the complexity of the system defeats the equity of the system.

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Second, the complexity of our system irritates and frustrates a substantial number of our citizens. The lengthy and involved instructions that are represented by the 192-page volume that purports to tell taxpayers how to fill out their tax returns, the quantities of schedules and complicated exhibits that are included in it, the alternative tax computations, all of these things are a real irritation and frustration to the substantial number of citizens who still struggle with filling out their own returns.

The many more who seek professional help are not much better off because all of the complexities translate themselves into the information that they have to supply to the tax return preparer. There is really nothing that the U.S. Government does that more deeply intrudes into the personal lives of millions of citizens, and when one asks why is it that there is a general opinion in this country that government is not very skillful and not very effective, I suggest that the annual April ordeal with the tax returns has a good deal to do with the public impression.

Third, I do believe that the complexity of the code does contribute to declining enforcement. As the Senator knows from the TCMP figures that the Internal Revenue Service assembles the proportion of errors and the dollar volume of the errors are alarmingly high. Unless the trend has recently changed, they are increasing.

It is hard to document to what extent complexity contributes to that result, but it seems clear to practitioners that if there are multiple attribution rules, it is easy for taxpayers to forget which one is applicable in a certain case. When rules produce unexpected results, it is easy for taxpayers to ignore them.

The minimum tax, the recapture of negative basis, are matters that the taxpayer can find easy to forget. ADR regulations and LIFO regulations are so overwhelmingly complex that, in fact, as we all know, businesses, small businesses in particular, simply claim depreciation and inventory evaluation on some kind of a reasonable basis, despairing of following the complicated rules that are spelled out in the regulations.

Mr. Redman referred to the Airlie House Conference and the subsequent conferences that have been held. There have been about nine of them, attended by about 600 lawyers, accountants and practitioners of various kinds. Those recommendations are embodied in reports which will be furnished to the Senate Finance Committee staff.

Those participants are, I think, not all in agreement. You cannot get agreement among 600 people. However, the consensus of the Airlie House Conference and those regional meetings is that we have reached a point of complexity where it is critically urgent that we turn the corner and begin to move toward greater simplicity.

The participants were well aware of the enormous problems. Many people, it is true, will misuse simplification to try to achieve tax benefits for themselves. It is not practical to silence people who will try to do that, but it is practical to oppose them and to overcome them.

I can assure the committee that there will be representatives from the legal and the accounting professions who are prepared to oppose people who promote simplification measures for tax reduction purposes that do not truly serve the objective of an understandable and equitable code.

Others are going to insist that simplification be so bland that it do absolutely nothing in a particular case, and those people also must, and can be opposed and overcome by those practitioners who feel that simplification is important and will stand up and be heard on the subject.

Thank you.

Senator BYRD. Thank you, sir.

Mr. Dunn?

STATEMENT OF H. STEWART DUNN, WASHINGTON, D.C.

Mr. DUNN. Senator Byrd, I am here as chairman of the Tax Section's Special Committee on Simplification and we who have been concerned with this field for 10 years want to express our gratitude and our enthusiasm for the undertaking that you have made here.

The committee was intentionally structured by the Tax Section to be a small group, 18 members, and has devoted a substantial amount of time of experienced persons with government background, professional background and private practice in Federal tax matters.

The committee has gone through many of the preliminary thought processes that one must proceed down before you really are able to address the question of simplifying our tax laws.

We have recently completed a study which grew out of the Treasury's January 1977 publication of Blueprints for Tax Reform. Our study, which was published in the spring edition of the Tax Lawyer, a publication of the Tax Section, is now available in reprints. I have some with me, and Mr. Redman will be sending those to you and to others concerned.

As a result of this study, I would say that the work of the Committee on Simplification has shown that it is certainly not simple to simplify our tax laws. What constitutes simplification of the tax laws is itself a complex, and sometimes controversial, issue.

Furthermore, even in the several areas in which there is general agreement that our tax laws are needlessly complex, there has been no constituency to support simplification of the laws. In the give and take of the legislative process, it has seemed that all parties are prepared to accept complexity if that is the price of realizing their substantive goals.

Consequently, I am here to endorse in the most enthusiastic and unequivocal terms, the effort which this committee has initiated and is forwarding through means of today's hearings. While the immediate proposed legislation is limited in scope, it is an important step in the right direction toward simplification.

Even more importantly, the chairman has made it clear that this is the beginning of a continuing process in which other statutory sections and areas of the tax law will be reexamined with the purpose of introducing and passing legislation that will continue this process of simplifying our tax laws.

The Committee on Simplification stands ready, and I believe able, to assist your committee, your staff, and others in Congress, in advancing this program that you have initiated. To illustrate this willingness and ability to assist you, I wish to point out that the proposals which will be discussed by Mr. Martin Ginsburg are the work of our committee.

Mr. Ginsburg is vice chairman of the Special Committee on Simplification and the program was developed under his leadership and based on comments and analyses of the members of the committee.

Our committee has also prepared comments on S. 1062 on the Subtitle F Revision Act of 1979. Further, with regard to Subtitle F, our committee has initiated a broad study of this subject which we believe could be helpful to you and your staff in developing noncontroversial, but productive, items for future legislative proposals to simplify the law. Also, in our study papers, which I referred to at the beginning of my comments, there are a number of specific proposals which we believe would be worthy of future consideration by this committee in its ongoing program to introdue other specific legislative proposals that will simplify our tax laws.

By way of illustration, I refer you to our proposal for determining which parent is entitled to an exemption in the case of divorced or separated parents. We believe that the present rules of section 152(e) are needlessly complicated.

Our proposal appears at page 665 of the tax lawyer.

As stated, we unequivocally support and applaud the actions which you are taking. We recognize, in view of the demands and pressures of the moment, this type of program is the most realistic avenue to simplifying the laws. We further recognize the importance of starting a legislative process which has as its primary goal simplification of our tax laws.

We do urge you, however, to also give very serious consideration and attention to a broader program that seeks to address what we believe is the prime cause of complexity in the tax laws. This is a combination of the very high rates and very numerous exclusions, deductions, exemptions and credits.

We are deeply concerned that the fundamental problem of the complexity of our tax laws cannot be resolved in any significant or permanent degree unless we move toward an income tax system which is based on low rates and a broad base.

My colleague, Mr. John Nolan, who also is a member of our committee, will address this subject in more detail.

Senator BYRD. Thank you, Mr. Dunn.

[The prepared statement of Mr. Dunn follows:]

TESTIMONY OF H. STEWART DUNN, JR.

My name is H. Stewart Dunn, Jr. I am Chairman of the Special Committee on Simplification of the Tax Section of the American Bar Association, and my involvement in this panel is in this capacity. The Committee on Simplification has been structured by the Tax Section to be relatively small. It has only 18 members so that each of the members will devote a substantial amount of time to this activity and will participate actively in the relatively frequent meetings of the committee. The membership includes persons with extensive government, professorial and private practice experience in federal tax matters.

The Committee on Simplification, which has been in operation for almost ten years, is probably the oldest of the continuing organizations that has devoted its primary efforts to the issues and problems growing out of the ever increasing complexity of our federal revenue laws. The committee has recently published in the Spring Edition of the Tax Lawyer its study papers on simplification of the federal income tax laws. These studies were motivated by the Treasury Department's publication in January 1977 of Blueprints for basic tax reform. These study papers are primarily addressed to the simplification benefits to be realized by movement towards a broad-based, low-rate income tax system. The papers, however, also contain a number of detailed ideas and suggestions for simplifying the laws within present policy.

I have with me a few reprints of these articles. Mr. Redman, as Chairman of the Tax Section, will be distributing these reprints to the members of your committee, your staff and several other interested persons.

The work of the Committee on Simplification has shown that it is certainly not simple to simplify our tax laws. What constitutes simplification of the tax law is, itself, a complex and sometimes controversial issue. Furthermore, even in the several areas in which there is general agreement that our tax laws are needlessly complex, there has been no constituency to support simplification of the laws. In the give-and-take of the legislative process, it has seemed that all parties are prepared to accept complexity if that is the price of realizing their substantive goals.

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Senator BYRD. Mr. Nolan?

STATEMENT OF JOHN S. NOLAN, WASHINGTON, D.C.

Mr. NOLAN. Mr. Chairman, I submit to you that the U.S. income tax system must be simplified. Its integrity depends upon a high level of public confidence that it is fair and equitable—that it uniformly imposes tax burdens in relation to ability to pay. Public confidence has been eroded in the past 20 years by widespread publicity that some very wealthy taxpayers bear minimal tax burdens, that an underground economy exists in which large amounts of cash income are not reported, that extensive personal entertainment is subsidized by tax deductions, that some large corporations bear effective tax rates far lower than the statutory corporate tax rates, and that virtually all taxpayers with earnings above the median level must employ an expert tax preparer so that they get the benefit of every possible tax credit, deduction, and income exclusion.

These conditions are attributable to a significant extent to an income tax system which in form imposes high marginal rates and substantial progressivity but then almost of necessity ameliorates the effects in countless ways to achieve equity and economic efficiency.

These escape hatches from unduly heavy nominal tax rates are essential to encourage individual initiative and personal achievement, to encourage risk taking in capital investment, to provide incentives for religious, charitable, educational, and social activity to supplement government, and for other reasons. The result, however, is an unbelievably complex income tax structure which permits tax avoidance, which encourages some taxpayers to play the so-called audit lottery game, which fosters public misunderstanding and distrust because of its complexity, and which thereby undercuts that vital public confidence which must be the foundation for a self-assessment tax system.

The work that this subcommittee begins today is of the greatest importance. It is the first meaningful step in what we all feel is critically needed—an ongoing continuous process of change in our income tax system to achieve simplification. The installment sale rules and subtitle F of the code have widespread application to taxpayers generally and can be greatly simplified and rationalized. Other candidates crying for attention are the charitable contribution deduction, the moving expense deduction, the tax treatment of annuities, the rules for determining dependency exemptions, subchapter S for small business corporations, the tax treatment of qualified pension and profit-sharing plans, the investment credit, the complex technical rules for employment taxes, the technical rules affecting depreciation and inventories, and many others. We unite as professionals in giving your subcommittee the strongest possible encouragement to carry on this process of careful analysis and redevelopment of particular sets of tax rules, with the overriding objective of achieving simplification.

In addition I respectfully suggest consideration of even more fundamental reform. The ultimate simplification of our income tax structure lies in moving toward a comprehensive tax base with substantially lower tax rates while still preserving the appropriate degree of progressivity. In such a system, all taxpayers would be taxed on substantially all their real income, but at rates sufficiently low as not to require a vast array of exclusions, deductions, and credits.

The Treasury Department provided a preliminary model of such a system in January 1977, in Blueprints for Basic Tax Reform. The Blueprint study demonstrates that it is possible to raise roughly the same total revenue as our present income, with the same degree of progressivity in fact, by taxing virtually all forms of economic income and only three rate brackets. After generous personal exemption and dependency allowances, the first $4,600 of income would be taxed at 8 percent. Income from $4,600 to $40,000 would be taxed at 25 percent. All income over $40,000 would be taxed at 38 percent. Nearly all of the existing tax credits, personal deductions, and income exclusions would be eliminated.

This, however, would obviously require a massive change in our existing income tax structure. Such a change could only be achieved over a long period of time in a framework in which all separate classes of taxpayers were assured that their particular escape hatches—exclusions, deductions, and credits—would not be eliminated except as one step in a complete new system in which all other classes were treated the same so that major reduction in tax rates could and would be achieved for everyone.

Congress could accomplish such a change by committing itself to a long-range master plan of a major overhaul of the system pursuant to a set of general objectives set out in enabling legislation. The objectives so stated would be broad goals, not specific proposals. The enabling legislation would provide a schedule for major segments in the overall plan and stages over an extended period, perhaps 6 to 10 years. A major staff of economists, lawyers, accountants, and other public finance experts would be created and isolated from other responsibilities to focus solely on development pursuant to the legislative schedule of comprehensive recommendations for major revisions to achieve basic simlification. This staff could be a Treasury Department staff, a Joint Committee on Taxation staff, a divided staff from both sources, or even the staff of an independent commission modeled after the Hoover Commission in the 1930's.

The taxwriting committees of Congress would be committed in the enabling legislation to consider and act upon recommendations for major changes pursuant to the legislative schedule, accepting, rejecting, or modifying them as they saw fit. Recommendations would be acted on in the framework of the master plan in the enabling legislation, with assurance to all taxpayers that all segments of the master plan would be considered with equal care over the extended life of the process.

In general, major changes would provide for deferred effective dates, to take effect at the conclusion of the extended process so that the tax reductions would become assured trade-offs for the tax increases resulting from the comprehensive tax base. This would tend to minimize opposition by particular taxpayer groups or classes; opposition tends to focus on the immediate effects of the tax changes. Even with delayed effective dates, the specific changes should include generous transition provisions to allow for gradual adjustment to the new rules after they take effect. The vision would be directed at the forest, not the trees.

Something must be done, Mr. Chairman. We must adopt a strategy for developing a much simpler, fairer, more neutral, and more efficient tax system in the United States. This subcommittee has embarked on that process, and your actions in studying and revising the treatment of specific provisions of the tax system should go forward vigorously and continuously in all events. It would not interfere, however, to give thought to a much broader process of complete change in the existing system. I respectfully urge that you consider both processes.

Senator BYRD. Thank you, Mr. Nolan.

Let me say, at this point, that I want to commend the legal profession and the accounting profession for the great interest both groups are showing in this question of simplifying a very complex tax code. I suppose it would be reasonable to say that both groups are really acting contrary to their own economic interest, because the more complex the Tax Code is, the more the average citizen, like myself and others, need to seek out lawyers and accountants to handle our tax returns and matters dealing therewith.

I usually carry around in my pocket—but I changed suits today, and I do not have it—the original 1913 tax return form. It is on one page; nine lines. The tax is 1 percent on the first $50,000 and after that it goes into what it calls a supertax, and the supertax goes as high as 5 percent.

That is slightly different from what we have today.

Mr. Dunn mentioned the prime cause of the complexity being the high tax rates. I do not anticipate that we will ever get the rates down to the point of where they were in 1913. Incidentally, Virginia has never ratified the constitutional amendment. My grandfather happened to be speaker of the Virginia House of Delegates at that point and he led the fight against it, but I want to say that I personally feel that a progressive income tax is an appropriate tax.

I think it is a proper tax. My problem with it is the extreme level to which the rates have gone and along with that, the complexity. So I want to thank each of you, as well as the professions which you represent, for the time that you are devoting to this problem.

Let me ask this—and you may have touched on it, Mr. Nolan—what specific areas and topics in the Code are in the greatest need of simplification?

Mr. CALKINS. There is a trade-off, Mr. Chairman, between the need and the feasibility and I think that the art of simplification will be to select topics like the installment sales provision which will be presented to the committee very shortly, in which there is both importance in achieving the simplification and fairly easy practicality in the sense that while there are some substantive issues involved and some effect on some taxpayers, the change is not so great as to make the process difficult to achieve.

I think that we should proceed from the most practical toward the most important and the most difficult. And as we achieve successes in making significant improvements in portions of the code, I believe that the effort to achieve simplification will gather momentum and it will be possible gradually to move toward provisions which affect larger economic interests and therefore are somewhat more difficult to change, but where simplification is also important.

Senator BYRD. Let me ask this. As to procedure on the part of this committee, in trying to determine which areas of the code to consider next, over and beyond what is being considered at this hearing, am I correct in assuming that the way to proceed is to get input from the legal profession and the accounting profession?

The Finance Committee has a fine staff. Treasury has a fine staff. The joint committee does; I do. And if the various staffs could work together and work with your committees and come up with recommendations as to the next areas which should be examined by this committee, is that the best approach, do you think?

Mr. DUNN. I think that we would most certainly agree with that. Mr. Nolan has listed in his testimony a number of items that we all feel would be productive in that area. I also referred to some, and I think that the groups that are represented here have already started work along the lines of your suggestion and would be most pleased to be of any assistance.

We agree with your approach.

Senator BYRD. I shuddered when I heard Mr. Nolan read his list. That is about a 24-hour-a-day job for about 3,000 days, I suppose.

Mr. NOLAN. It is possible, Mr. Chairman, to take a discrete area and avoid major policy changes and yet make the provision work a good deal more simply than it does without changing the essential policies which underlie it.

Some of these areas I mentioned are very much in that category and that is what is needed to make these provisions work the way people would expect them to work, without unnecessary fine tuning in the provisions.

Senator BYRD. As a starting point, then, is the committee to understand that what we should do is take the list that Mr. Nolan mentioned today and the list that Mr. Dunn had in mind and then the staffs could attempt to assign priority to those items in working with all of you and with your counterparts?

Mr. CALKINS. If it were possible to indicate, with some leadtime, that, for example, there would be another hearing comparable to this, say, in the late fall and the topics that were tentatively planned for the agenda for that hearing were two or three or four such items, it would certainly be possible for the professional groups to organize themselves to get their homework done and present testimony which had been coordinated with staff and the Treasury.

If the process can be continued with plenty of advance notice as to what the subjects will be, the enormous amount of homework that needs to get done on these varous topics, I am quite sure, can be done.

Senator BYRD. I suppose that the committee and the staff should be careful in trying to simplify, that we do not actually create more complexity. I think we have done that in some cases in the past.

Thank you, gentlemen, very much.

The next witness is Mr. Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy.

Mr. Secretary, we welcome you. Normally, of course, you would be the first witness, but I understand that you kindly agreed that you would let others present their views, and then you would comment on it.

It seems to me that that is a very good approach and I appreciate your cooperation.

STATEMENT OF DONALD C. LUBICK, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. LUBICK. I always find myself well educated by the distinguished gentlemen who preceded me, I do not know that I have much to add to what they had to say.

With your permission, I will submit my written statement for the record and just give a few comments from the point of view of the Treasury Department.

We certainly do share everyone's concern as to the importance of simplification. The cost to us in enforcement of the complex provisions of the code is enormous; not only the cost of maintaining agents but the intangible costs involved with the difficulties taxpayers have in compliance.

We do agree with the approach to take incremental steps. We welcome the action of the committee in bringing Mr. Hawkins aboard to undertake this project and we salute him for making the sacrifice he has made to undertake this project for nothing more than his personal concern that the Internal Revenue Code be workable for all the people.

It is a very great sacrifice for him. We commend him for that, and the record should so indicate.

Senator BYRD. The Chair will join in that statement.

Mr. LUBICK. I might point out that complexity, like cancer, is not a single disease.

First, we have some special problems that involve low-income taxpayers. Their difficulty in the preparation of returns has already been alluded to. There have been some steps which the Congress has taken in the last couple of years to simplify this and we now have a short form that 40 percent of the filers are able to use. We reduced it from 25 lines to 15. We have not gotten down to your nine lines yet, back to 1913, but at least we are moving in the right direction.

When it comes to transactions involving business and investment, one of the serious problems is that the Internal Revenue Code has been employed to do many things. Originally its task was simply to raise revenue by applying a schedule of rates to a tax base of net income. There have been introduced over the years numerous deductions and credits and exclusions designed to run Federal subsidy programs through the tax system.

I need only refer to provisions that you have been considering recently in respect to energy, housing, export trade, health, product liability and handling of the aged. When you try to run all of these problems through the tax system you have an Internal Revenue Service that is not designed to handle these problems efficiently and an Internal Revenue Service that is faced with difficult decisions that it is not equipped to make in implementing these programs.

So one of the great difficulties leading to complexity is this attempt to use the tax system to regulate all manner of Federal spending programs.

I think you have started appropriately in those areas where we can work closely with the professional groups and streamline the code. And I think you have already mentioned that simplification ought not to be used as a cloak for special interest provisions, but that it must be used to achieve genuine simplification to make the system work better.

I might point out to you that last year we proposed a rather comprehensive tax reform bill which, indeed, had a major tax simplification thrust. In many cases, complexity that we were seeking to attack did not seem objectionable, at least to those persons who benefited by a number of the special provisions that we felt could well be eliminated.

We made some significant proposals with respect to the simplification of real estate depreciation, medical deductions, to mention a few.

Sometimes, we ourselves have to propose complex solutions because if we do not propose those complex solutions, we are going to have some very serious problems caused by other provisions of the Internal Revenue Code.

An illustration of such a problem area that you will be faced with very shortly is the problem of the use of tax-exempt bonds to finance single-family mortgages. That is an area where perhaps a complex solution is going to have to be arrived at, because if we allow the proliferation of those bond issues, we estimate by 1984 we might have a revenue loss of some $11 billion to the Treasury to finance this device.

Senator BYRD. May I interrupt and ask you this? When was the tax code first utilized for that particular purpose? It has been fairly recently, has it not?

Mr. LUBICK. Fairly recent, to a great extent.

In 1968, the Congress saw the proliferation of the use of tax-exempt financing for private, industrial purposes. Traditionally, State housing agencies had used tax-exempt bonds to provide low and moderate multifamily housing and in the list of permissible uses of tax-exempt bonds in 1968, housing was listed, with a distinction between the single family mortgage and the traditional multifamily.

Congress simply did not have in mind the use for single-family financing. Our records indicate that there was some use in minute proportions in 1970. It continued very slowly until 1978 and then it took off. It has grown drastically in 1978, until the recent legislation was proposed in the House of Representatives and it threatened to grow at phenomenal proportions.

In some areas, as much as 80 to 90 percent of all mortgages were financed through this device.

Senator BYRD. The city of Chicago, I believe, issued a large bond issue.

Mr. LUBICK. Chicago was perhaps the first and most widely publicized municipality to use it. Some of the State agencies have been using it in great measure. Originally the State agencies were using it 100 percent for multifamily housing but last year the percentage moved. Now 62 percent of the State housing ventures are to finance single-family housing.

That does not only bring up problems of revenue, but the threat to the continuation of the private sector as the means of financing this traditional form of investment.

Senator BYRD. Is it widespread throughout the Nation, or is it concentrated in a few areas?

Mr. LUBICK. It is in a number of areas, because a number of States do not allow it. There are about 13 States that allow it, but many others are moving to as they should. There is no particular reason why those that do not allow it should not, through the tax system, be paid for the benefits which are available to the others.

Senator BYRD. I can understand that in many parts of the Tax Code, you cannot have complete simplicity because, as you indicated a little while ago, if you do that you open up other areas which could cause the individuals to take undue advantage of their fellow taxpayers.

It cannot be totally simple; no doubt about that.

Mr. LUBICK. That is an illustration of such an area. We do think that your initiation of the handling of deferred payment sales is a good place to start in a move toward simplification. I think that is an area where we have worked closely with the professional groups. We believe we will be able to come up with a solution that will satisfy us, as far as the protection of the revenues concerned, and satisfy taxpayers as far as giving them a fair method of payment of their taxes on installment sales. A solution will make life for the IRS and the practitioners easy in an area in which there has been astounding complexity.

One of the witnesses, Mr. Ginsburg, is perhaps the outstanding authority on this. He has written an extensive text if you want to try to understand the complexity. Perhaps his talents explaining this simply, weigh almost the 8 pounds of the Internal Revenue Code. And if he is on board with these provisions, then the changes will indeed rectify the situation.

In summation, I would like to say that we are very pleased to work with you and Mr. Hawkins and the professional groups. We want to point out that we think that a serious congressional concern to take these products of the professional groups and us, and to enact them in areas that are not so exciting to the general public and to the headlines because they do not involve fine-line issues, will be a signal to the professional groups that the time and effort that they and persons like Mr. Hawkins have spent, at no compensation to themselves, has been time well spent. We urge you to move forward in this direction.

Senator BYRD. Thank you, Mr. Lubick.

I assume that you probably agree that the areas outlined by Mr. Nolan and Mr. Dunn are the areas that should be tackled next by the committee.

Mr. LUBICK. Certainly everything they mentioned is worthy of consideration.

Senator BYRD. If you could assign an order of priority from your point of view, it would be helpful to us. I will ask the professional groups to do the same thing.

Mr. LUBICK. Our door is always open to them. We will be very pleased and look forward to sitting down with them. We have been working with them over the past couple of years.

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

Mr. LUBICK. Thank you very much. I appreciate the opportunity to be here.

[The prepared statement of Mr. Lubick follows:]

STATEMENT OF HON. DONALD C. LUBICK, ASSISTANT SECRETARY OF THE TREASURY—TAX POLICY

Mr. Chairman and members of the subcommittee, we are pleased to participate in this hearing on tax simplification.

The Treasury Department views simplification as a fundamental policy objective, for the cost of tax complexity is enormous. A portion of the cost is tangible; taxpayers and the Government devote billions of dollars to the effort to decipher the tax Code. But a more significant cost is intangible; if we permit the Byzantine tax complexity to grow, we erode the foundation of our tax structure. A self-assessment system is severely impaired when the tax treatment of even routine transactions can be incomprehensible to most taxpayers and professional advisors.

Occasionally, sweeping reforms have been proposed as antidotes to tax complexity. Some persons have advocated a fresh start in developing a new income tax system, coupling lower tax rates with a substantial reduction in complicating provisions that refine the concept of taxable income. Others have offered a new kind of tax—perhaps on consumption or value added—as an alternative that might be simpler in operation than the current income tax. Such proposals should continue to be developed and debated, but drastic simplification along these lines is at best a long-term objective. In the short run, incremental simplification steps must be pursued.

We have made some progress in recent years. During This Administration, significant steps have been taken to simplify return prepration for average taxpayers. As a result of the Tax Reduction and Simplification Act of 1977, about 40 percent of all individual taxpayers can now use a Short Form 1040A, with the number of lines on that form being reduced from 25 to 15. The Internal Revenue Service also redesigned the basic 1040 long form and worked to make the taxpayer instructions more readable. These changes were largely responsible for a dramatic decrease in taxpayer mathematical errors in returns filed since 1977—the error rate has been reduced by over 50 percent on Form 1040A and by about 30 percent on Form 1040.

Simplification for average taxpayers was continued in the Revenue Act of 1978. The earned income credit will now be easier to compute. Taxpayers will no longer have to contend with the confusing combination of a general tax credit and a personal exemption. Itemized deductions will be streamlined somewhat.

The hearing today enters another arena—simplification of those rules affecting business and investment transactions. The rules involved are not those applied by a typical individual poring over their IRS instructions on April 15; the provisions being examined are, for the most part, interpreted and applied by tax practitioners with varying degrees of expertise and experience. However, even though relatively few taxpayers may be affected directly by these proposals, simplification in this area is important for several reasons:

Clearer application of the tax law will facilitate sound business and financial planning.

If the rules are simpler and more certain, taxpayers and the Government can devote less time and expense to construing and arguing about the proper application of the Code to specific situations.

With streamlined tax rules, there will be fewer instances where tax savings are dependent upon a practitioner's knowledge of arcane wrinkles in the tax law, and where tax penalties are imposed on businesses with less knowledgeable tax counsel.

Simplification will also reduce the benefits enjoyed by some aggressive taxpayers and practitioners who play the "tax lottery"—the game of calling uncertain rules in your favor in the hope, if not the expectation, that the transaction will not be audited.

In recent years, most persons have acknowledged the need for simplification of the tax rules relating to business and investment activities. A start was made in the 1978 Act when Congress adopted the Administration's recommendations to simplify the tax treatment for small business losses and for corporations that elect the quasi-partnership treatment of Subchapter S. The American Bar Association, the American Institute of Certified Public Accountants and the American Law Institute have recently conducted seminars for simplification in such areas as depreciation, inventory accounting, farming and pensions. Your decision to conduct these hearings, Mr. Chairman, is in itself a very significant indication of Congressional interest in the simplification effort.

Yet, in spite of the apparent consensus for simplification, enactment of specific proposals will not be easy. Our mission will surely fail if the cloak of "simplification" is used to disguise other motives. For some practitioners, simplicity seems to be a code word for eliminating any impediments to the tax results sought for particular clients. Discussions at simplification conferences sometimes suggest that no law reducing taxes is too complex and no law increasing taxes is simple enough. Of course, on the other hand, many would accuse the Treasury of seeking revenue-raising tax reform be calling it "tax simplification."

In this endeavor, we must all strive to avoid our natural biases. With the proper exercise of good will, this simplification effort can succeed. If either side refuses to compromise, it is doomed to failure.

Sometimes, the search for equity can also be an obstacle to simplicity. Simplicity is impossible if we become too preoccupied with avoiding unwarranted advantages or disadvantages that may result from peculiar fact situations. Equity is of paramount importance, but a ton of complexity is a high price to pay for an ounce of equity. Treasury and taxpayers must be willing to suppress the drive for complete equity, submerging this goal to simplicity when the additional equity comes at too high a cost.

In this regard, S. 1063—the bill to revise the tax treatment of sales for deferred payment—will be an important barometer of the fortunes of the simplification effort. Deferred payment sales is generally recognized to be an area where complexity, and in particular diversity of treatment, exists beyond any reasonable needs of tax policy. Nevertheless, even here there will be trade offs; no simple rule for treatment of sales for contingent payments can possibly satisfy everyone as being equitable in all circumstances.

Looking beyond today's hearing, the avoidance of new complications is as important as affirmative steps to simplify existing law. A proper balance of simplicity and equity should discourage much legislation, particularly tax measures affecting only a handful of taxpayers. Because of the broad application of the tax laws to diverse personal, charitable and business sectors of our society, it is important that a vehicle exist to consider whether an unintended tax liability has arisen. But regardless of how we resolve the equitable merits of particular legislation, we must recognize that ad hoc solutions inevitably increase the complexity of the Code, invite other taxpayers to seek similar relief and, unless scrupulously drafted, create new potentials for abuse.

Complications caused by special interest bills must be weighed against the equity in the claim for relief. Unless the equitable argument is extremely strong, the claim should be rejected. We certainly do not feel that taxpayers should be encouraged to view the legislative process as a forum of first, rather than last, resort. Often it is possible, with minor changes of behavior, to accommodate taxpayer activities to the current provisions of the Code. If this can be done, legislative relief is not needed. We hope the professional tax community can join with the Treasury in opposing the proliferation of special interest tax legislation, which in itself complicates the law and takes time away from more far-reaching and important efforts.

Code complications also result from the Government's desire to prevent taxpayers from using provisions in unintended ways. Over the years, we have developed the habit of drafting tax provisions with great particularity in an attempt to curb abuses. Such detailed drafting has often proved to be unavailing, given the vast wealth of energy, imagination and intelligence devoted to tax avoidance. We need to pause and ask questions:

Would the tax system be improved if we established more general rules, with the understanding that testing the boundary will not succeed as long as the purpose of the provision is violated? Will the tax community accept the greater IRS discretion inherent in this approach?

Code section 305(c), dealing with stock dividends, provides essentially that certain transactions will be taxed no matter how a taxpayer may contrive to avoid Congressional intent. Has this provision worked? Should we model other rules on it? Should we consider this method in connection with deferred payment sales legislation?

Although these questions and my other remarks today have dealt principally with simplification of the mechanics of the tax law, I must, in closing, touch upon a more fundamental cause of concern. A discussion of tax simplification should not overlook the prime source of complexity: the tax system is being used to perform far too many Government functions. Its basic purpose is to raise revenue by applying a rate structure to a tax base consisting of "net income." But it is also used to implement nearly 100 Federal programs, ranging from welfare assistance to promotion of certain forms of investment. These so-called "tax expenditures" are nearly one-third as large as direct budget outlays. As long as we insist upon combining the basic revenue-raising function with a plethora of tax expenditures, we cannot expect the tax Code to be simple.

Nevertheless, technical tax simplification is important, and I would like to express again our endorsement of the simplification process this Subcommittee has set out to implement. Dramatic improvements cannot be achieved overnight. Time will be needed for Congressional and Treasury staffs and for tax practitioners to develop and to analyze additional proposals. Unless serious Congressional consideration is relatively assured, we cannot expect the professional tax community or the staffs to expend the necessary resources. For this reason, the Subcommittee's expression of interest and suport for simplification is most welcome. Mr. Chairman, we are grateful for the leadership you have taken in this effort.

Senator BYRD. Now we come to Mr. Martin Ginsburg, New York State Bar Association; Mr. Herbert Lerner, Federal tax division, AICPA; and Mr. James Jeanblanc, tax section, American Bar Association.

Welcome, gentlemen.

Mr. Ginsburg, will you lead off?

STATEMENT OF MARTIN GINSBURG, NEW YORK STATE BAR ASSOCIATION, ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

Mr. GINSBURG. Thank you, Mr. Chairman.

I am happy to be here to testify on S. 1063 to simplify the rules relating to certain installment sales by nondealers. I am here in various capacities, on behalf of the Committee on Taxation of the Association of the Bar of the City of New York of which I am currently chairman; on behalf of the tax section of the New York State Bar Association, of which I am past chairman; and, in an individual capacity based upon Mr. Redmon's instruction, on behalf of the Committee on Simplification of the Section on Taxation of the American Bar Association, of which committee I am currently vice chairman.

The various bar association groups on whose behalf I am here today jointly have adopted a report entitled "Simplification of Installment Sales Reporting" for submission to this hearing. The joint report extends the testimony I will give today and, with the chairman's permission, I ask that the report be included in the record.

Senator BYRD. It will be included in the record.

Mr. GINSBURG. Thank you, Mr. Chairman.

When Senate bill 1063 was introduced last month, it was announced that the legislation is intended as one of a number of discrete bills to be introduced over the next several years designed to clarify and simplify the tax law. We, all three bar groups, highly commend both the contemplated process of selected amendment of provisions that unduly complicate the tax law and the choice of the installment sale provision as an initial focus of the legislative process.

The current tax treatment of sales for future payment is extraordinarily and unnecessarily complex and confusing. Unfortunately, this does not distinguish future payment sales from quite a number of other subjects as to which current tax law is complex and confusing.

The sale of property for deferred payment belongs, we believe, on the front burner, ahead of such arcane mysteries as corporate reorganizations, for a compelling reason. 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.

Because it is peculiarly complex, present law operates inappropriately in two major ways. First, all too often it imposes an undue and never-intended burden on taxpayers who, through inability, inadvertence or inadequate advice, fail to take the steps that are now necessary to qualify their deferred payment sales for deferral of tax liability.

Second, present law incorporates disparities which the well-to-do taxpayer, guided by very sophisticated counsel, embraces to undue, and very clearly unintended, advantage.

Mr. Chairman, in the discussions among the witnesses before this hearing began and in examining the written testimony that has been submitted, I made a very happy discovery. It appears that we, today, are participating in a rather amazing piece of business.

We are out to clarify and simplify an important, and vastly confused, area of the tax law and it appears that every institutional participant, as far as I can tell—the Treasury Department, the American Bar Association, the New York City Bar Association, the New York State Bar Association, AICPA—are in agreement as to the general nature of the problems; and, while each organization has taken its work in its own meetings to different levels, to the extent that each one has gone into these matters, there seems to be substantial agreement on the solution as well.

I find this an almost miraculous occurrence in the tax law.

In very broad terms, the following is the position of the organizations that I represent here: The taxation of sales for future payment is woefully confused, and we ought to grasp the opportunity uniquely afforded by the subcommittee's newly commenced process of legislative simplification to straighten out this rather frightening area in a coordinated way, by dealing in a tightly focused manner with each of the major factors that contributes significantly to the current problem.

We believe that to do this, it is necessary to observe this paramount reality. When property is sold for payment deferred, the statutory installment method is only one of the ways that the seller, if a tax-sophisticated seller, may claim deferral of tax liability.

Other ways, for example, are the cash equivalent rule, and the open transaction doctrine. These are especially attractive because they provide not only tax deferral, but greater tax deferral than is allowed currently under the installment method of reporting.

Given this state of affairs, the only way to rationalize and simplify this area of the tax law is to bring these various tax deferral methods into balance and harmony. If that is not done, it is somewhere between extremely difficult and totally impossible to straighten this field out.

It is a field worth straightening out, because it does affect so many people.

With respect to the specifics of our recommendations, I will pause at only a couple of them in the interests of time. The first, identical to S. 1063, to eliminate the 30-percent initial payment limitation.

I would like to spend a couple of minutes on that, if I may, because it is more mysterious an area than first appears. Under present law, the election to report on the installment method is not available if the year of sale payment exceeds 30 percent of the selling price.

The bill's proposal to do away with the 30 percent initial payment limitation merits unrestrained applause—applause it strongly receives from the ABA tax section and the tax section of the AICPA. Both organizations adopted a resolution to the same effect in the past year.

Mr. Chairman, no other segment of the installment method provision has occasioned so much confusion, outright error and court dispute over a period of nearly half a century.

No one but litigators will mourn its passing.

At first look, I think this conclusion appears a little strange. Is it really all that difficult to multiply the selling price by 30 percent to figure out the maximum payment the seller may receive in the year that the property is sold?

In fact, the multiplication is suspiciosly easy. Unfortunately, encrusted with 50 years of administration and judicial history, it is not a mastery of arithmetic that is required under the statute; it is a mastery of some of the tax law's most arcane minutiae that is required.

I would like to take that minute or two to hazard a couple of examples. I would ask that they be considered in the context of a relatively small taxpayer who, if he or she has consulted anyone, it is a small city general practitioner, a lawyer or an accountant, who is not a full-time tax specialist, although he or she may be a fine practitioner in other respects.

My first case is Mr. A whose sole asset of significant value, accumulated over a lifetime, is a small office building leased to unrelated tenants. It is currently worth $300,000.

Mr. A has a very low basis. The property is not mortgaged. Mr. A exchanges the rental building for a smaller rental building that is worth only $100,000. Evidencing the $200,000 difference, the buyer—the other party to the exchange—issues to Mr. A a series of interest-bearing negotiable promissory notes that will come due in the future.

Claiming installment treatment, Mr. A reports no taxable gain in the year of the transaction. In this, he is advised by his lawyer or accountant that the exchange of the buildings is tax-free under section 1031 as a like-kind exchange of property, and since Mr. A initially has received only the building and notes and no cash, installment treatment and current nonrecognition is proper.

That advice is entirely reasonable. Unfortunately, it is also entirely wrong.

Installment treatment is unavailable under present law. The reason is that the receipt of the $100,000 rental building, although in all other circumstances free of tax under section 1031, constitutes a year of sale payment under the installment sale statute.

Therefore, the total selling price being $300,000 and the $100,000 value of that building being more than 30 percent of it, Mr. A is now currently taxable on the full value of the amount that he has received. Including the notes.

Unfortunately, Mr. A has not received not 1 penny of cash with which to pay the tax. I think it is fair to say that he is grumpy, and not without reason.

Let me try Mr. B. Mr. B owns a building, gross value $300,000, encumbererd by a very old mortgage in the principal amount of $150,000.

Mr. B's basis has been depreciated down to $50,000. Now he is going to get rid of the building. Representing himself to avoid expenses of sale, Mr. B sells the building for no downpayment and notes of the buyer, fully secured, bearing an adequate rate of interest, in the total principal amount of $150,000.

The notes come due in future years and the buyer will take subject to the mortgage. Once again, installment treatment is not available. Mr. B is fully taxed in the year of sale on gain of $250,000.

The reason is that $100,000, the amount by which the $150,000 mortgage exceeded the $50,000 basis of the building, is treated as payment in the year of sale, $100,000 is more than 30 percent of $300,000. Once again, Mr. B slides down into the bog.

It is amusing to consider what would have happened in the same transaction—the same Mr. B, the same $300,000 building, the same sale—if this time Mr. B retains a lawyer. The lawyer renders absolutely no valuable tax advice, but usually charges a fee which, when added to the other expenses of Mr. B's sale, totals $10,000.

This is a true marvel of the tax law. If Mr. B resides in California or anywhere else in the ninth circuit, installment treatment now is available. If Mr. B lives somewhere else, New York, Virginia, or almost any other place, neither he nor his lawyer nor anyone else in the world knows whether installment treatment is available on this set of facts.

The reason is that the $10,000 selling expense, if it is added to Mr. B's basis of $50,000, results in his basis aggregating $60,000. The amount of the mortgage was $150,000. That is $90,000 more than $60,000. Mortgage in excess of basis is treated as a year of sale payment under the installment sale provision. But $90,000 is exactly 30 percent of $300,000. Thirty percent payment in the year of sale is permitted; 30 percent, not more.

With respect to expenses of sale, addition to basis is the rule in the ninth-circuit. According to the Commissioner, the ninth circuit is wrong. In the history of the Republic, no court outside of the ninth circuit has spoken to this point. Total confusion, after 50 years this provision has been in the tax law.

I will hazard just one more example, because it is delightful. I will take up Ms. C who owns a building, gross value $300,000, mortgage $100,000. She has a basis of $100,000 and thus no mortgage in excess of basis problems. She sells the building for $20,000 cash and notes of the buyer of $180,000. The buyer is to worry about the mortgage.

The arrangements that her lawyer negotiated contemplated that the buyer would assume the mortgage; very reasonable.

At the closing, however, the buyer turns up with the mortgagee and they propose, not merely an assumption of the mortgage which would leave Ms. C contingently liable on the mortgage, but rather they propose a novation which will release her from any contingent liability.

Not surprisingly, Ms. C is delighted and her attorney is delighted. They agree to the novation. Bad news. The transaction as originally negotiated was fine. No problem, because there was no mortgage liability in excess of basis of property. Therefore, year of sale payment would be only the $20,000 cash received; $20,000 is a lot less than 30 percent of $300,000.

Unfortunately, the rules that apply to the assumption of a mortgage do not apply to the novation of a mortgage. Under what appears to be a rather clear weight of current authority, the $100,000 principal amount of the novated mortgage, by reason of that novation, will be treated as a payment to Ms. C in the year of sale.

Now, year of sale payments aggregate $120,000. This is more than 30 percent of $300,000. Suddenly, although she gets very little cash, Ms. C attracts all kinds of tax liability.

The disaster catalog replicates itself throughout the present installment sale rules. One thing should be clear from it. Under current law, the ability to multiply absolutely does not carry with it the ability to qualify for installment reporting.

The 30 percent initial payment limitation is a terrible trap for the unwary and the inadequately advised. This is why we wholeheartedly endorse the proposed elimination of it.

Senator BYRD. You would eliminate any figure at all?

Mr. GINSBURG. Any maximum limitation, yes, we would, Mr. Chairman.

Senator BYRD. How would you distinguish then, between an installment sale and a normal sale?

Mr. GINSBURG. I think this is the place to focus what is perhaps the central point. We are dealing here only with nondealer transactions.

Senator BYRD. What do you mean by nondealer transactions?

Mr. GINSBURG. Casual sales. I sell my home, office building, corporate stock, what have you. If someone simply sells for cash, he will be taxed on that cash, normally, when he receives it. This is proper under the cash method of tax accounting. If you sell for notes and you get 50-percent cash and 50-percent notes, under what we propose and under what S. 1063 proposes, you would be taxed on half on your gain up front and the other half as you collect the notes.

Mr. Chairman, most people are very used to that concept. Perhaps rather than going through my long laundry list, I will leave it to the Bar report and just finish it this way.

Most individuals, if they own stocks, for example, trade the shares on the stock market. Assume a profitable sale at the end of December. Settlement is not going to be for 7 days. Payment thus will be made in January.

They all know that, although they sell at the end of December, the gain is not recognized—is not taxed—until January. That is not installment reporting; technically, it is the cash equivalent method reporting.

We are all used to the notion of paying taxes when we get the cash. It is not a bad notion.

Thank you.

Senator BYRD. Thank you. Your testimony is very interesting.

I must say I thought installment sales for tax purposes was reasonably simple. I have always thought that what people did was instead of taking 30 percent, just to protect themselves, they usually would take 29 percent and that would cure all of the problems, but apparently that does not do it.

Mr. GINSBURG. I wish it did.

Senator BYRD. Thank you, sir. Very interesting.

Mr. Lerner?

STATEMENT OF HERBERT LERNER, FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. LERNER. Thank you, Mr. Chairman. My name is Herbert J. Lerner. I appear today on behalf of the American Institute of AICPA in my capacity as chairman of the Federal tax division's tax accounting subcommittee.

The AICPA is pleased to have this opportunity to testify on S. 1063. We have submitted a detailed statement which we respectfully request be included in the record at this hearing.

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

Mr. LERNER. Thank you.

At this time, I would like to summarize our views on the bill.

The AICPA has adopted five legislative recommendations concerning the installment method of reporting income, and we are pleased to see that two of those recommendations are included in the draft bill. While we generally support the changes contained in S. 1063, certain comments and suggestions, we feel, should be offered with respect to each change.

First, as to the elimination of the 30-percent downpayment limit. This amendment is identical to one of the division's legislative recommendations, so obviously, it has our wholehearted support.

The elimination of the requirement that payments received in the year of sale not exceed 30 percent of the sales price to qualify for the installment method will remove, as Mr. Ginsburg so well described, a trap for the unwary taxpayer and thus should result in tax simplification.

It should eliminate controversy or uncertainty, perhaps both in some cases, where the property sold is subject to indebtedness, where indebtedness is assumed by the buyer or where the buyer pays all or part of the indebtedness in the year of sale, among other things.

Some other complexities also relate to the application of the imputed interest provision where there are sales price adjustments as a result of those provisions which would, if that provision were modified or eliminated, would not cause a disqualification of an otherwise valid installment election.

The bill also would amend present law to permit installment reporting for single-payment sales where no payment is received on the year of sale. This amendment also has our full support.

It is the second recommendation that we have included now for several years in our compendium of legislative recommendations.

Senator BYRD. What is that recommendation?

Mr. LERNER. A single payment sale to eliminate the requirement that there be more than one payment for installment election privileges.

We believe elimination of the two-payment rule will simplify the operation of the tax law. It may do this in a backhand way.

This will not only provide sellers an opportunity to consummate single-payment sales with assurance about the resulting tax treatment, but it may also eliminate some of the controversy that arises from the attempted use of the alternative deferred payment method of reporting income from certain sales of real property.

The single payment that I have in mind here is a payment in a subsequent year, no payment in the year of sale.

The bill would preclude the use of the installment manner of reporting except for certain redemptions of stock. While this is not a proposal based on simplification, we feel that the amendment would eliminate controversy over related-party sales where the gain is deferred by the initial seller and the property is sold by the related purchaser shortly thereafter, so that the related group, considered as one economic unit, has the proceeds of the sale in hand, as well as deferral of the gain.

That generally seems to be an inappropriate result.

While we agree with that provision for reasons of tax equity and perceived failure of the system, installment reporting for sales between related parties, while in need of restriction, should not be as rigid as is proposed in the bill.

Outright prohibition of installment reporting for all sales between related parties would prevent the number of nontax motivated sales from being consummated. For example, the bill would effectively eliminate the sale of a family-run business or farm from father to son where the son does not have sufficient resources to make an outright purchase and cannot obtain alternative financing.

So we would recommend that the bill be fine tuned to accomplish only the abuse cases where the related party buyer disposes of the property prior to the installment election outside of the related group for cash or its equivalent within a short period; we would recommend 2 years.

Then if the disposition for cash or its equivalent does take place within that period of time, the original seller would be treated as having made a disproportionate disposition of the installment obligation.

In addition, we would support an outright prohibition against installment reporting for related party sales and marketable securities. However, we do not support an across-the-board prohibition against installment sales reporting for marketable securities where the seller and the buyer are unrelated.

In applying these related party rules, we would urge that the test for determining related parties by code section 318 rather than section 267 so as not to embrace brothers and sisters within this restriction on installment election for sales within a family group.

The bill would increase the minimum sales price of $1,000 to $3,000 for an election provision privilege. While we do not object to this amendment if it is considered as leading to simplification, we would question whether any simplification gains are more perceived than real. Perhaps the best form of simplification would just be elimination of that threshold amount.

If the scope of S. 1063 is expanded, we would respectfully request that serious consideration be given to our other legislative recommendations, that the installment method of reporting be extended to the gain attributable to the receipt of an installment obligation originally received by a corporation in the sale of its property under section 337.

There are a number of problems in the area of open versus closed transactions, rather open transactions and contingent price arrangements in the installment area, and we think these require further addressing.

While we agree that this problem is in need of a legislative solution, we feel that many of the questions that must be answered to solve the contingent sale problem also will have to be resolved adequately to deal with this open transaction problem.

In that connection, we support Mr. Ginsburg's plea for some harmony of treatment in all deferred payment sales and we are quite prepared and would offer to work with the staff of this committee, with other professional groups and with the Treasury to develop such solutions.

That concludes my oral testimony, Mr. Chairman. I thank you for your consideration.

Senator BYRD. Thank you, sir.

The committee has received a great deal of mail in opposition to the bill as it now stands with respect to installment sales to related parties. I take it that you agree that the bill, as it now stands, goes too far?

Mr. LERNER. I think that it certainly has a worthwhile purpose in the terms of its intention to restrict abusive installment sales, or what might be considered abusive sales, but it is too broad.

Senator BYRD. At this point, I will insert in the record telegrams which the committee has received in opposition to this. They seem to be in opposition to the entire bill, but I think they are in opposition only to this part of the bill.

One is from the president of the California Farm Bureau Federation, one from the president of the Georgia Farm Bureau Federation, and one from the president of the Illinois Farm Bureau Federation.

[The material referred to follows:]

CALIFORNIA FARM BUREAU FEDERATION,
Berkeley, Calif., June 15, 1979.

Hon. HARRY FLOOD BYRD, Jr.,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BYRD: We have been informed that your subcommittee on taxation and debt management will soon be considering S. 1063 which is a bill designed to "simplify" the use of section 453, "installment sales", of the Internal Revenue Code. One purpose of the bill is to prohibit the use of the installment sales provision between related parties.

If S. 1063 is successful, farmers would no longer be able to exercise their option to sell their farms to their children. We hope that the impact of eliminating section 453, which keeps family farm units intact, will be recognized by the subcommittee when it considers S. 1063.

Sincerely,

FREDERICK J. HERINGER, *President.*

GEORGIA FARM BUREAU FEDERATION,
Macon, Ga., June 19, 1979.

Hon. HARRY FLOOD BYRD, Jr.,
U.S. Senate,
Washington, D.C.

DEAR HARRY: Request you oppose S. 1063 as it applies to section 453. The stated reason for legislative action—to simplify the law—strikes Farm Bureau members as being a misnomer. The change would merely work a hardship on overburdened farmers who are trying to keep family farms in the family. If a parent chooses to sell to his child, he should not be penalized by a law that would deny him capital gains tax exemptions that would apply if he sold to a stranger. Farm Bureau decidedly opposes changing the law.

Sincerely,

ROBERT L. NASH, *President.*

ILLINOIS FARM BUREAU,
Bloomington, Ill., June 20, 1979.

Hon. HARRY FLOOD BYRD, Jr.,
U.S. Senate,
Washington, D.C.

DEAR HARRY: We understand that S. 1063—a bill to simplify the use of section 453 installment sales—has been introduced in the Senate and will be before the Senate Finance Subcommittee on Taxation and Debt Management in the next couple of weeks.

Under present law the gain (but not the loss) from a sale of real property involving deferred payments may be reported on the installment basis (1) there is no payment in the year of sale or (2) the payments in the year of sale do not exceed 30 percent of the selling price, even if only two payments are made. The advantage of using section 453 is that the entire capital gain does not have to be reported in the year of sale. Otherwise, the tax on the gain could be substantial.

In an effort to simplify section 453 and prevent abuse of the section, the bill prohibits the use of the installment sales provision between related parties. This would eliminate the option that farmers have been able to use to sell their farms to their children and could create a substantial economic burden on the orderly transfer of the family farm operation from one generation to the next.

We urge you to oppose S. 1063.

Sincerely,

HAROLD B. STEELE, *President.*

Senator BYRD. Mr. Jeanblanc?

STATEMENT OF JAMES K. JEANBLANC, MILLER & CHEVALIER, WASHINGTON, D.C., TAX SECTION, AMERICAN BAR ASSOCIATION

Mr. JEANBLANC. Thank you, Mr. Chairman. I appreciate this opportunity to discuss S. 1063. I will summarize my statement, which I hope can be included in the record.

Senator BYRD. Yes, your statement will be.

Mr. JEANBLANC. In my judgment, the area of deferred payment sales is ripe for review, and the bill provides for a good start in the needed review of the entire code.

In the case of deferred payment sales and other areas of the tax law, many tax rules are scattered among various code provisions, regulations and cases. Much time and expense is consumed in research to find the answers, or likely answers, to what should be simple questions. There are many inconsistencies and uncertainties in this area and a climate of tax gimmickry exists.

In the tax section, we have devoted substantial attention over the past 3 years to the deferred-payment sale area and have adopted several legislative recommendations. One would be to eliminate the 30-percent limitation in section 453(b). And a second would be to reverse the installment election in the case of a cash-basis taxpayer so that section 453(b) will apply unless a taxpayer elects not to have it apply.

The committee on tax accounting problems, of which I am the chairman, has developed a legislative recommendation with respect to contingent price installment sales which will be voted upon by the tax section. Under this proposal, installment sale treatment would be expanded to contingent price installment sales if the contract provides for a maximum price.

This maximum price could either be stated in the contract or could be determinable from the conditions or formulas within the contract.

This maximum price would be the selling price for purposes of determining the gross profit ratio and how much gain is recognized with respect to each installment payment. If, in a later taxable year, the maximum price is reduced because the contingency is not satisfied, appropriate adjustments would be made in that taxable year to reflect the reduced gain from the sale.

With this brief background, Mr. Chairman, I would like to turn to S. 1063, noting, as Mr. Redman pointed out, that at the moment I appear in my individual capacity and not as chairman of the committee on tax accounting problems. As Mr. Redman pointed out, we have worked with the tax section's special committee on simplification, and our views coincide in many respects.

S. 1063 would eliminate the 30-percent limitation. This limitation is an excellent example of the special rule with marginal policy justification which has fostered much litigation and has contributed to unnecessary complexity. It should be eliminated as Mr. Ginsburg and Mr. Lerner have urged.

S. 1063 would bring further simplification by eliminating the two-payments rule, and we support this change.

S. 1063 would raise the $1,000 floor to $3,000. This change should not be made. The objective of simplification would be better served, in my judgment, if the $1,000 floor, rather than being increased, were eliminated.

Presently, there is no floor amount for installment sales of real property, and the same rule should apply to personal property. I do not believe that elimination of the floor in the case of personal property will materially increase the administrative burdens of the Internal Revenue Service. Small-dollar deferred payment sales are not very common.

The bill would deal with one area of tax gimmickry centering around the type of situation involved in the *Rushing* case which Mr. Lerner discussed. This is a problem requiring some type of resolution, but the bill does go too far in disallowing installment sale treatment in all cases where the installment sale is to a person related to a taxpayer within the meaning of section 267(b) or section 707(b)(1).

No tax gimmickry is present, as you have noted, Mr Chairman, where a farmer sells the family farm to his son on the installment basis and the son continues with the farm. Disallowance of the installment method should be limited to those cases where the installment sale is made to a related party who makes a resale thereafter which was presumably anticipated when the original installment sale occurred.

In this regard, it seems reasonable to adopt a rule treating any sale or exchange as anticipatory if it occurs within 2 years after the installment sale. A disposition by reason of death should not be subject to this 2-year rule.

Some alternative to sections 267(b) and 707(b)(1) should be used to define who is the related party. For example, a sale by the taxpayer to a trust established by his spouse would not be reached. There also will exist some possibility for continued tax gimmickry in other areas. Section 267(b) and 707(b)(1) go too far in treating brothers and sisters as related for this purpose.

S. 1063 would deal with testamentary dispositions of installment obligations, which we believe would be a necessary change to clarify existing law.

I see that my time has expired, but there are other areas, Mr. Chairman, where I believe 1063 should be expanded, as my written statement points out. Contingent sale transactions should be covered. In the case of maximum price contingent sales, the legislation proposal on which we have been working and which I have discussed earlier is essentially the same proposal that Mr. Ginsburg is making and the Treasury will be making. This proposal should be included.

Mr. Chairman, that concludes my remarks.

Thank you, Mr. Chairman.

Senator BYRD. Thank you very much.

Let me see if I understand this generally. As I understand it, each of you supports the provision in the legislation before the committee, would do away with the 30-percent rule. It would permit each buyer and seller to determine how much should be paid down, if we use the example, Mr. Ginsburg, that you gave of the exchange of a building worth $300,000 for one worth $100,000 with a series of notes for the additional $200,000 over a period of time.

Then the tax would be paid on the $100,000, would it?

Mr. GINSBURG. Well, Mr. Chairman, you have picked a very good question in terms of where we are in current law. If you apply current law without the 30-percent limitation, a portion of the total gain would be taxed in the year of sale, but not all of the gain. That is a doubtful rule, where the taxpayer receives no cash at all in the year of sale.

It seems to me that the proper answer is that you ought not to tax anything in the year of sale. You ought to ratably allocate the seller's basis over the property he receives, first to the new rental property; and as notes are collected, there should be gain recognized and taxed at that time.

Senator BYRD. In the year that the individual receives the $100,000 building, there would be no tax to him at that point?

Mr. GINSBURG. That, I think, would be the correct answer; if all he did was exchange one building for another, under section 1031 there would be no tax.

Senator BYRD. If the other $200,000 was to be paid over 10 years in equal installments, then he would pay a tax on $20,000 each year?

Mr. GINSBURG. Less the portion of basis, if any, allocable to the notes. In a better world, usually you would not allocate basis to the notes, and just have him pay tax on $20,000 a year as notes are collected.

That is a part of the broader problem of allocation of basis. As to when is the taxable event, it is exactly as you stated: when the cash comes in.

Senator BYRD. So from the Treasury Department's point of view, it does not make a great deal of difference. If a person gets cash equal to 40 percent of the contract price of a piece of property, that person pays a tax on 40 percent of the gain at that point, and the next year pays tax based on whatever percent he gets that year.

On the other hand, if he gets 70 percent of the contract price in the first year, he pays tax on 70 percent of the gain that year.

Mr. GINSBURG. That is correct.

Senator BYRD. Thank you gentlemen very much. It was a very interesting discussion.

[The prepared statements of the preceeding panel follow:]

JOINT REPORT OF THE 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

SIMPLIFICATION OF INSTALLMENT SALE REPORTING

On May 2, 1979, the Chairman and ranking minority members of the Senate Finance Committee and the House Ways and Means Committee introduced a bill (S. 1063, H.R. 3899) to simplify the rules relating to certain installment sales. As proposed, the bill would amend section 453(b) of the Internal Revenue Code in two significant ways, and would effect a single, narrowly focused, change in section 691(a)(2).

In speaking for himself and Senator Dole in introducing the corrective legislation, Chairman Long announced that S. 1063 is intended as one of a series of bills, to be introduced over the next several years, designed to clarify and simplify the tax law. We highly commend both the contemplated process of selective amendment of provisions that unduly complicate the tax law, and the choice of the installment sale provision as an initial focus of the legislative project.

The current tax rules governing sales of real property and casual sales of personal property, when payment is deferred, are inordinately complex and confusing. Because sales for future payment are made by persons at virtually all economic levels, and are not solely the province of the wealthy and well-advised, present law too often imposes an undue and unintended burden on taxpayers who, through inability or inadvertence, fail to take the steps necessary to qualify their deferred payment sales for equivalent deferral of tax liability. Conversely, present law incorporates disparities which the well-to-do taxpayer, guided by sophisticated counsel, may embrace to undue advantage.

The bill identifies three areas of specific concern. One, the 30 percent initial payment limitation, is a major source of confusion, uncertainty, and outright error in practice, and properly qualifies as the rule most in need of change. A second, installment sale to a related person, typifies undue, unintended advantage and unquestionably merits reform. The third, a narrow clarification of section 691(a)(2), responds to an avoidance potential that may be more theoretical than real, and while a cautionary change should not be faulted on that account, it can be argued that the problem is broader in nature than the bill's tailored remedy suggests and that legislative change, if change is to be made, should be broader in scope.

Both in its general intent and principal focus, if not in all respects in the specific changes formulated, the bill merits commendation. While this report will comment on and suggest improvements to certain of the bill's specific remedial features, our main purpose in submitting this report is a larger one.

A congressional determination to rationalize, clarify and simplify this important, pervasive area of tax law should, we strongly believe, be reflected in a more encompassing legislative proposal. Eliminating the 30 percent limitation and sensibly restricting the installment sale advantage when the buyer is related are important, desirable changes properly to be included in any sensible reform of the installment reporting provision. But there reside in present law other major incongruities unintended by Congress. Some unduly burden inadequately advised taxpayers. Others unduly benefit well advised taxpayers. All of these disparities qualify as fruitful subjects of legislative clarification and simplification. We do not recomment that Congress now react to every anomaly in the present tax treatment of sales for future payment. We do urge that Congress sensibly expand the present bill's very restricted catalog to encompass, clarify, and simplify the other major elements of uncertainty, confusion, and disparate treatment.

I. THE INSTALLMENT SALE IN CONTEXT

The pending bill by design treats only the installment sale of realty and the casual installment sale of personal property. It does not affect installment sales by dealers in inventory and proposes no change in subsections (a), (c), or (e) of section 453. We fully concur in the underlying judgment. Consistent with it, in this report references to installment sales are to transactions cognizable under section 453(b), governing sales of real property and casual (non-inventory) sales of personal property.

Under present law, the taxpayer who sells property for payment deferred may also defer gain recognition, wholly or partly, in any of a number of quite different ways. The installment sale election under section 453(b), available in the particular case, is but one of these ways. The resulting opportunity to select among various methods, and to achieve different quantities, of tax deferral is, in our view, the single most important, and arguably the single most pernicious, concept informing present law's unsatisfactory tax treatment of deferred payment sales. No sensible simplification of the installment sale provision can be formulated unless the legislation reacts to the broader context in which the installment election operates.

The analysis that follows assumes a common fact situation. Mr. S, a cash method calendar year taxpayer, owns long-held capital gain property (closely held corporate stock) at an adjusted basis of $5,000. On June 1, 1979, S sells the property to B in exchange for B's unsecured promise of future payments. In each case, assume the specified payments will be made together with interest at 6 percent per annum.

1. Installment election. The selling price is $10,000. B agrees to pay $5,000 on the fourth anniversary of the date of sale and $5,000 on the fifth anniversary. B's obligation is embodied in a promissory note that may or may not be in negotiable form. On his 1979 income tax return, S properly elects to report the transaction on the installment method under section 453(b).

The installment method requires ratable recovery of basis and ratable recognition of gain. The gross profit percentage is 50 percent. S recognizes no gain in the year of sale and in any of the next three years. In each of years 4 and 5, he will recognize long-term capital gain of $2,500, one-half the cash received.

2. Open transaction—cash method. The facts are the same, but B's promise to pay is embodied in a mere contractual obligation the rights of S under which are neither assignable nor transferable (except by operation of law at his death). S does not elect installment treatment under section 453(b).

Despite a contrary position long held by the Internal Revenue Service, under the substantial weight of authority S is not taxable in the year of sale: S is a cash method seller and B's unsecured mere contractual obligation is not the equivalent of cash. In year 4, when he received $5,000 from B, S will claim the right to full cost recovery. Since his adjusted basis in the property sold was $5,000, in year 4 S will apply that amount in full against the payment received, reporting no taxable gain. In year 5, when S receives a final $5,000 payment from B, S will report that entire amount as long-term capital gain. Thus, under cost recovery S enjoys a better tax result than installment reporting would have permitted. Under cost recovery, S has deflected $2,500 of gain from year 4 to year 5.

3. Closed transaction—cash method. The facts are the same—mere contractual obligation and no installment election—but the Internal Revenue Service successfully asserts that B's promise must be valued and taken into tax account in the year of sale. In light of the comparatively low interest rate and any other relevant factors, it is determined that B's obligation has a present value of $8,000

S must recognize $3,000 of long-term capital gain in 1979, the year of sale. Present value, $8,000, now becomes S' basis in the payment obligation. Basis must be allocated to each of the payment components; assume $4,000 of basis is allocated to year 4 and $4,000 to year 5. In each of those years, receiving from B $5,000 S will have a reportable profit of $1,000. Under current law, section 1232(a) of the Code, in each year the $1,000 is long-term capital gain if B is a corporation or a governmental entity, and is ordinary income if B is neither. An ordinary income result obtains, when B is an individual, because a "collection gain" is not gain from a "sale or exchange" of property absent a contrary Code directive. Section 1232(a) directs sale or exchange treatment, but applies only when the obligor is a corporation or governmental entity.

Finally, note that if S were accrual method seller failing to elect installment treatment under section 453(b), in the year of sale S would take into account the face amount, rather than the fair value, of B's promise. Thus, in 1979 accrual method S would report the full gain of $5,000 as long-term capital gain. S' basis in the payment obligation then would be $10,000 and S would report no collection gain in years 4 and 5.

4. Open transaction—contingent payments. S sells to B for contingent payments. Assume the stock sold is 10 percent of the outstanding shares of X corporation. B agrees to pay to S, each year during the five consecutive years 1980-1984, an amount equal to 1 percent of the after-tax profits earned by X during the preceding calendar year (plus adequate interest on each payment). The contingent payment obligation is embodied in the written agreement between S and B. Assume the obligation is not currently capable of valuation.

This is a classic open transaction. Under present law, S recognizes no gain in the year of sale and is permitted front-end recovery of basis. If S receives $4,000 (exclusive of interest) from B in 1980, S will recognize no gain and will absorb $4,000 of his aggregate $5,000 basis. If S again receives $4,000 (exclusive of interest) in 1981, his reportable long-term capital gain will be $3,000. In subsequent years, S will report payments in full as long-term capital gain. These very favorable results will obtain whether S is a cash method or an accrual method taxpayer.

The foregoing does not exhaust the possibilities. Special and diverse treatment is accorded certain real estate sales that do not qualify for the installment election, sale for a commercial annuity, and sale for a private annuity. But the essential point is clear enough without further exemplification. The installment sale rules do not function in isolation. Those rules can not be sensibly clarified and simplified in isolation. The system, the revenue primarily but taxpayers as well, is far better served by a legislative reform that coordinates what is now almost totally disparate. The complexity of present law resides in the opportunity to blunder and the opportunity to obtain undue advantage, to miss installment treatment when it is sought, to obtain installment treatment when it ought not be allowed, intentionally to forego installment treatment's ratable recognition in order to claim the inappropriately greater benefits of costs recovery. A system of penalties and premiums in which the unsophisticated taxpayer suffers the penalties and the sophisticated enjoys a premium Congress did not intend to convey.

If, as we believe, responsible simplication of this area of tax law calls for a substantial reduction in the level of unintended benefits as well as unintended burdens, reforming legislation should treat the problems in their wider context and should not focus narrowly and exclusively upon section 453(b).

II. THE SPECIFIC COVERAGE OF THE PENDING BILL

Section 453(b), under current law and as it would be amended by the bill, provides for installment method reporting (ratable return of the seller's basis and ratable recognition of gain), at the sellers election, of income from a sale or other disposition of real property and a casual sale or other casual disposition of personal property (other than inventory) for a price exceeding a specified amount. Under current law, that amount is $1,000. Current law specifically requires that year-of-sale payment not exceed 30 percent of the selling price, and as interpreted to date by the courts also requires that the agreement call for at least two payments. Internal Revenue Service published hostile rulings to the side, current law does not in terms forbid, and a number of courts have approved, installment sale to a related person even though the purchaser, shortly thereafter, chooses to resell the property to a third party for cash.

A. *Floor amount*

On a casual sale of personal property for installment payment, the bill proposes to raise the current floor amount from $1,000 to $3,000. The presumed, although not stated, justification is to ease a perceived administrative burden on the Internal Revenue Service. For the reasons set out below, we oppose this change. We strongly believe the change is pointed in the wrong direction, in practice will complicate rather than simplify, and cannot fairly be justified on grounds of administrative convenience. We also believe the proposed floor amount increase reflects a failure to consider the installment election provision in the broader context of deferred payment sales in general.

1. Reversing the installment election. Later in this report, for the reasons there stated, we recommend that the elective provision relating to installment sales be reversed. If that recommendation is adopted, a qualifying transaction will be reportable on the installment method unless the taxpayer affirmatively elects non-installment treatment. In that world, simplification obviously would require elimination of any floor amount.

2. Maintaining the current election. If our recommendation to reverse the installment election is not adopted, increasing the floor amount nonetheless functions counter to the simplification objective. In our inflationary world, a casual sale of personal property for $3,000 or less, payable in installments over time, is a small transaction undertaken, normally, by a small taxpayer. Ordinarily the the sale will not stand the weight in legal costs of a pledge instrument or other arrangement for security and the buyer's obligation, if more than oral, may be evidenced by an informal writing, a simple contract, or a note that may or may not be negotiable. Whatever the form and whatever amended section 453(b) may provide, the likelihood is that the untutored seller will report gain when he or she received cash, and not before.

If the floor amount is raised, increasing the number of sellers and number of transactions to which the installment election is denied, complexity is compounded. In almost every case the seller will be on the cash method. If the buyer's promise is not the equivalent of cash, in failing to report gain until cash is received the seller will be correct without regard to the availability of an installment election. But the seller will be at risk in the audit process, a revenue agent may claim the obligation should have been reported at value (rather than at face) at the time of sale and that future collections above that amount are converted from capital gain to ordinary income; the seller, right or wrong, on the amount involved likely cannot afford the cost of proper representation. Raising the floor amount may generate additional revenue, much of it inappropriately exacted, but there is little reason to believe raising the floor amount will ease the administrative burden of the Service.

In our view, the only simplifying change to be made in the floor amount provision of section 453(b)(1)(B) is to eliminate it. Not to raise it.

B. 30 percent limitation

The bill's proposal to do away with the 30 percent initial payment limitation, contained in present section 453(b)(2)(B), merits unrestrained applause.[1] No other segment of the installment method provision has occasioned so much confusion, outright error, and court dispute. None but litigators should mourn it passing.

C. Sale to a related person

The bill's proposed section 453(b)(3) would deny installment sale treatment to a dispostion directly or indirectly to a related person. That term is defined by reference to sections 267(b) and 707(b)(1).

The current law abuse to which the proposed rule is directed may be illustrated simply.

Example 1. F owns at an adjusted basis of $10,000 all the stock of X. P, an unrelated person, offers to purchase the stock of X for $1 million in cash. F does not accept the offer. Instead, F establishes and modestly funds a trust for the benefit of his children and grandchildren, B Bank as trustee. F then sells the X stock to the Trust, aggregate sale price $1 million, a small amount of cash paid at the closing with the balance of the purchase price evidenced by 10-year maturity notes bearing interest at an annual rate of not less than 6 percent and probably a few points higher. F elects to report the sale on the installment method, thereby deferring recognition of nearly all of his $990,000 gain for 10 years. Some weeks following its purchase of the X stock, B as trustee negotiates and concludes a sale of the X stock to P for $1 million cash. Because the basis of the X stock in the hands of B is $1 million, there is no gain on this sale. B invests the proceeds during the ensuing 10 years at a high yield.

Viewed as a unit, the family group has turned the X stock into immediate cash but has deferred for 10 years its liability to the fisc. That tax result is indefensible.

[1] It will receive that applause from, among others, the Section of Taxation of the American Bar Association, which adopted a resolution (No. 1978-17) to the same effect last year. The resolution is reproduced in 32 Tax Lawyer 231 (Fall 1978). The Federal Tax Division of the AICPA, in May, 1979, also approved a legislative recommendation to the same effect.

While the problem addressed unquestionably is real, the bill's proposed solution in some respects casts too wide a net.

Example 2. A owns all of the stock of Y corporation, basis $10,000 and value $1 million. To induce B and C to enter the business with both a stake in the venture's future and a financial commitment to that future, A sells 10 percent of the stock of X to B and 10 percent to C for a fair value purchase price of $100,000 each. No risk of forfeiture tied to continued employment is imposed. Because B and C lack cash, each of them issues to A an 8 percent interest bearing installment note requiring principal payments of $20,000 per year for five years commencing next January. B is unrelated to A. C is A's half-brother. Neither B nor C subsequently disposes of the shares purchased from A.

Under the bill, the sale to B qualifies for installment treatment, but the sale to C does not. See section 267(b)(1), (c)(4).

Denial of installment treatment on the sale to half-brother C, in the circumstances described, seems clearly inappropriate. In an installment sale to a related person, the potential of tax abuse resides, not in that transaction standing alone, but rather in the purchaser's near-term disposition of the property which, in the purchaser's hands, enjoys a high basis. In introducing S. 1063, Chairman Long stated the problem with exactness:

Under present law, a tax-planning technique involves selling appreciated property on the installment basis to a related party, such as a family trust, and then having the property sold by the related party at little or no taxable gain because the cost basis for the second sale would reflect the entire purchase price under the installment sale. In this situation, the appreciation has been realized within the related party group but gain is recognized for tax purposes only as the related party purchaser makes installment payments to the original seller.

When resale is neither contemplated nor in fact consummated, there is no special potential of tax avoidance, and this is so whether the installment purchaser is a half-brother, a full-brother or even a child or a parent of the seller.[2]

1. One Solution. A "pure" solution to the avoidance problem would concentrate on the resale.

If the installment purchaser is related to the seller, installment treatment would be allowed if, but only if, in his year-of-sale return the seller files a consent (in such form and detail as the regulations may prescribe) identifying the purchaser, the relationship and the transaction, and agreeing promptly to notify the Internal Revenue Service of any subsequent disposition (within a specified period of time) of the property by the purchaser. Appropriately, the statute or regulations should require that the purchaser also execute the consent and agree to be bound to its notification requirement. With an eye to the recent resolution by Congress of a somewhat analogous problem in section 644 of the Code, an appropriate period might be two years following the date of sale.

If within the two year term the purchaser disposes of the property, that disposition would be treated as a disposition of the installment obligations by the original seller, giving rise to taxable gain under section 453(d) to the original seller in the year of disposition. Thus, the original seller would be neither required nor permitted to amend the tax return filed by him for the year of sale.

Relationship should be defined in a manner appropriate to the problem. For the reasons indicated below, we do not believe sections 267(b) and 707(b)(1) supply the best available definition.

2. Alternate solution. In its concentration on resale by the installment purchaser, the "pure" solution is equitable. In the tax arena, too often, equity is the antonym of simplicity, and there is a belief on the part of some that a resale-focused solution illustrates the dichotomy. While analogous notification provisions exist in present law, e.g., section 302(c)(2), and seem to function in an acceptable way, it is facially simpler to deal with the problem by forbidding the installment election at the threshold. Whether this "simpler" solution will be fully effective remains unclear,

[2] Even absent resale, the installment purchaser (whether related to the seller or not) may benefit currently from the purchase price basis advantage. The property may be depreciable; however, the likelihood of depreciation recapture burdening the installment seller normally may be expected to provide a fair offset. If the property sold is all of the stock of a target corporation and the buyer, using a corporate purchasing vehicle, liquidates target under section 334(b)(2), again there may be a current depreciation advantage although one that would not, ordinarily, benefit a related buyer. See section 334(b)(3)(C). When basis is stepped up, the immediate recapture cost at the target corporation level may furnish a reasonable offset. Denial of installment treatment solely because the related purchaser directly or indirectly may enjoy a depreciation or amortization benefit over time, seems inappropriate. An unrelated buyer would enjoy the same benefit and the case cannot fairly be equated to the prompt cash resale which epitomizes the tax avoidance potential.

however, since the likely reaction of the well advised cash method seller will be to avoid the necessity of an installment election by accepting the related buyer's unsecured, non-assignable contractual promise and treating that promise as other than the equivalent of cash.[3]

Should it be concluded that simplification will be measurably advanced by adhering to the bill's approach of barring installment treatment, we recommend that related person be defined, not in terms of sections 267(b) and 707(b)(1), but rather by adoption of the relevant concepts embodied in section 318(a) extended, perhaps, to encompass the spouse of a related individual. The bill's exception for certain redemptions, proposed section 453(b)(3)(C), should be retained. Unlike section 267, section 318 would not bar installment sale to a brother or sister.

D. Two payment rule

In introducing S. 1063, Chairman Long stated:

[P]resent law has been interpreted so that installment reporting is not available unless the sales contract requires two or more payments. As a result, for example, a sale would qualify where the seller receives a very small downpayment in the year of sale with the balance due in another taxable year but would not qualify if no downpayment was received with the entire amount payable in another taxable year. In this case, the tax treatment turns on the form of the transaction rather than its true substance. In practice, this requirement has been another trap for the unwary. The bill would eliminate the requirement that there must be two or more payments to qualify for installment reporting.

We fully concur in the decision to eliminate the two payment rule. We are concerned, however, that S. 1063 as drafted does not clearly accomplish the intended result. The present two payment rule reflects a line of lexicographical court decisions holding that the term "installment" means one of a series, not one alone.[4] While the bill, in proposed section 453(b)(2), newly defines the term "installment method," it does not do so in a way specifically to negate the multiple payment concept, and it continues to employ the word that attracted the problem to begin with. We recommend, therefore, that the legislative proposal clearly negate the two payment rule.

E. Bequest of installment obligation to the maker

The pending bill, in section 2, would amend the second sentence of section 691(a)(2) to make it clear that the testamentary transfer of an installment obligation to the maker of that obligation will trigger recognition of the deferred gain. It is quite possible this result obtains under present law. However, present law being less than crystalline on the point and the described result unquestionably qualifying as the correct one, we think the change appropriate.

If this change is to be made, we think a similar but in practice more serious issue merits no less attention. In general, when an installment obligation is transferred or otherwise disposed of, other than by reason of the holder's death, section 453(d)(1) triggers recognition. In measuring gain (or loss), that provision looks to the amount realized in the case of a sale or exchange or a satisfaction at other than face value, and looks to the fair market value of the obligation in the case of a distribution, transmission, or disposition otherwise than by sale or exchange. Among other concerns, the articulated concepts do not with absolute certainty encompass every conceivable event.

A perceived problem is the installment note holder, donatively inclined, who simply writes "cancelled" across the face of the note. While an outright gift of the note to the maker would have triggered gain recognition under section 453(d)(1) measured by the difference between fair market value and the holder's basis, cancellation unaccompanied by distribution or transmission has been held tax-free.[5] The result is absurd. The risk of other taxpayers relying upon that singular holding, and the audit lottery, provide reason for concern. An uncomplicated solution would

[3] This problem exists under the "pure" solution as well. One cure is to require that any sale to a related party, not properly reported on the installment method, must be reported as if the seller were on the accrual method. Forced accrual to curb feared abuse is hardly unknown in the tax law. See, e.g., sections 305(c) (difference between redemption price and issue price of stock) and 1232(a)(3)(A), (ratable inclusion of original issue discount). Under the "pure" solution the seller should be required, in the consent filed with the Service, to treat the related buyer's promise of future payment as an installment obligation for purposes of section 453(d) whether or not the buyer's promise otherwise would so qualify.

[4] See, for example, 10-42 Corp., 55 T.C. 593 (1971); *Baltimore Baseball Club, Inc.* v. *United States*, 481 F. 2d 1283 (Ct. Cl. 1973).

[5] *Miller* v. *Usry*, 160 F. Supp. 368 (W.D. La. 1958). A similar problem is the holder who simply fails to enforce collection and the statute of limitations expires. Reasonably, that event should be treated as a "cancellation."

be insertion of the word "cancellation" in section 453(d)(1)(B) after the word "transmission" at the two places that word now appears.

III. IMPORTANT SIMPLIFICATIONS NOT COVERED BY THE BILL

A. Reversing the election

An extended history of litigation confirms that, year after year, an extraordinary number of unsophisticated taxpayers fail properly to elect installment treatment under section 453(b) and thereby forego the tax deferral to which they are otherwise entitled. As often as not, the disadvantaged sellers are economically ill-positioned to pay tax in advance of receiving sale proceeds.

It would greatly simplify the tax law, in its practical application, if Congress were to reverse the election. A sale of property otherwise qualifying for installment treatment under section 453(b) should be returnable on the installment method unless the taxpayer elects (under regulations to be prescribed by the Treasury) to forego installment treatment.

1. Seller's regular accounting method. Section 453(b) does not encompass sales of inventory. Thus, designating installment reporting as the general rule creates no obvious problem of inconsistent accounting methods. We believe automatic installment treatment under section 453(b) would be appropriate whether the seller is otherwise on the cash method or the accrual method of tax accounting. Recognizing that unsophisticated casual sellers almost always are cash method taxpayers, however, we believe the simplification objective will be adequately achieved if section 453(b) is amended to provide automatic installment treatment only to cash method taxpayers.[6]

2. *The election out.* If installment treatment is made the rule under section 453(b), there are circumstances in which a seller may wish to elect out and to report his gain under the method of tax accounting otherwise applicable to him. This obvious, and appropriate, case is a sale for future payment, evidenced by a negotiable promissory note, in a year in which the seller has a loss carryforward that shortly will expire.

The method of "electing out" of otherwise automatic installment treatment should, we believe, be specified in regulations and should not encumber the amended statute. Appropriately, however, the Congressional committee reports might furnish guidance to the Treasury. The regulations, we would hope, would further the cause of simplification in at least two respects. First, election out of installment treatment should be irrevocable and will be valid either if made by formal statement in the tax return or if made "informally" simply by reporting the gain in the tax return in accordance with the taxpayer's normal accounting method. Second, to be valid the election out should be made in the seller's timely filed tax return for the year of sale. Much of the complexity in present law has derived from uncertainty whether and in what circumstances irregular elections—in a late return for the year of sale, in an amended return for the year of sale, in a return for the later year of first payment—are to be given effect.

B. Ratable recognition of gain

The statutory installment method requires ratable recovery of basis and ratable recognition of gain. If the seller's basis is $5,000 and the selling price $10,000 (plus adequate interest), of each dollar of principal payment received 50 cents is tax-free recovery of basis and 50 cents is taxable gain.

Under current law, sophisticated sellers tailor transactions, and avoid installment reporting when it is otherwise available, in order to recover basis first and in full, deflecting taxable gain to later years. The tax law relevant to future payment sales cannot be simplified effectively unless the current pressure to avoid installment treatment is relieved. The effect of that change, in simplification terms, will be great indeed since there lies in the solution to the avoidance potential a desirable resolution of a number of related complexities that now plague the revenue and taxpayers alike.

The solution, quite simply stated, is to require ratable recovery of basis, and thus ratable recognition of gain, in every deferred payment sale.

Example 3. S, a cash method taxpayer, owns all of the stock of X corporation at an adjusted basius of $100,000. S sells the stock of X to unrelated B for $1 million payable $100,000 in cash at closing and $900,000 five years hence (plus adequate

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[6] In this circumstance, the accrual method seller would, as now, be required affirmatively to elect installment treatment in the tax return filed for the year-of-sale. Affording automatic installment treatment to the cash method seller, while continuing to require an affirmative installment election by the accrual method seller, was recommended last year by the Section of Taxation of the American Bar Association (Resolution No. 1978-15). See 32 Tax Lawyer 231 (Fall 1978).

interest). B's promise to pay the $900,000 balance is an unsecured mere contractual obligation that is not the equivalent of cash. S elects out of installment treatment.

Under current law, S would recover his $100,000 basis in full against the $100,000 cash received in the year of sale, thereby deferring for five years any recognition of gain. If, as we urge, the law is changed to require ratable recognition, in the year of sale S will offset against the $100,000 cash receipt (10 percent of the total selling price) only $10,000 (10 percent of his aggregate basis) and will recognize year of sale gain of $90,000. Since this is exactly the tax result that would have obtained had S not elected out of installment treatment, the election out has availed S nothing. Having no reason to avoid installment treatment in a ratable recognition world, S would not elect out of section 453(b).

Example 4. The facts are the same as in Example 3, but S is an accrual method taxpayer.

Having chosen to avoid statutory installment treatment, in the year of sale S must accrue the full $900,000 face amount of B's obligation. S thus must account for $1 million in the year of sale (incuding the $100,000 cash downpayment) and, as this is the full amount of the selling price, S will offset his entire $100,000 basis and will report year of sale gain of $900,000. Unless this is the result S validly seeks, perhaps to offset an expiring loss carryforward, S will have no incentive to avoid section 453(b).

C. Contingent payment sales

Under present law a sale for contingent payments ordinarily is reportable as an open transaction, allowing front end basis recovery to both cash method and accrual method sellers. Present law artifically encourages the designing of contingent payment sales.

The ratable recognition concept can, and in our view should, be applied to sales for sales for contingent payments. In one important respect current law furnishes a useful blueprint.

1. Payments limited in time.

Example 5. S owns all of the stock of X corporation at an adjusted basis of $100,000. S sells to unrelated B for payments equal to 5 percent of the net after tax income of X for each of the next 10 years (payment to be made each year). The agreement may call for adequate interest "added on," for "built in" interest calculated at 6 percent per annum, or for no interest in which event section 483 will apply.

Under the ratable recognition concept, S' total basis of $100,000 should be allocated $10,000 to each of the ten payment years, subject to one necessary revenue protective rule. If in any year prior to the final payment year the amount of principal (as distinguished from interest stated or unstated) paid to S is less than $10,000, S will not recognize a loss in that year. Instead, the unrecouped basis will be spread forward ratably over the balance of the payment term.[7] If, at the close of the final payment year, S has not recouped his entire $100,000 basis, the unrecouped portion will be allowed as a loss in that year (capital loss if the property originally sold was capital gain property).

2. Payments limited in amount.

Example 6. S sells the stock of X corporation, adjusted basis $100,000, to unrelated B for annual contingent payments (5 percent of corporate net income) which are to continue without limitation in time until S has received a total of $1 million. Either no interest is stated (section 483 applies) or interest is "built in" (each payment when received is deemed to include an interest element calculated at 6 percent per annum from date of sale to date of payment).

Application of the ratable recognition concept focuses on the maximum payment, $1 million. Since S' basis of $100,000 is 10 percent of that amount, 10 percent of each payment received will be in recovery of basis. For purposes of determining the basis recovery percentage, here 10 percent, the maximum payment amount ($1 million) is determined without regard to section 483 and without regard to any "built in" interest formulation. This treatment is necessary since, at the date of sale, it is impossible to know what portion of the $1 million maximum payment amount will constitute interest and what portion will constitute proceeds of sale. Of course, when payments actually are received, section 483 (of the "built-in" interest directive) will apply. As in the case of a time limitation, in no year prior to the final payment year will S be allowed a loss.

3. Dual limitation.

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[7] This is the rule under present law when renegotiation of an installment obligation results in reduction of the aggregate selling price.

Example 7. The facts are the same as in the preceding two examples, but the limitation on B's obligation is two-fold. B will pay for a maximum of 10 years, but in no event more than a total (including unstated or "built in" interest) of $1 million.

Appropriate application of the ratable recognition concept focuses on the maximum dollar amount of $1 million. An appropriate portion of each payment received is interest, 10 percent of the gross amount of each payment received (including the interest portion) is return of basis, and the balance is capital gain (if the property sold was capital gain property). No loss is allowed prior to the final year. If by the end of year 10 S has received aggregate payments totaling only $600,000, unrecouped basis is $40,000 and that amount then will constitute a capital loss.

In the dual limitation case, concentration upon the maximum dollar amount fosters transactional simplification. S is encouraged to fix a realistic sum, and discouraged from artifically inflating the maximum figure, because the higher that maximum figure is set, the lower will be the percentage of each payment received that qualifies as tax-free recovery of basis.

4. Unlimited contingent payments.

Example 8. S sells property, not a wasting asset, adjusted basis $100,000, to B for annual contingent payments limited neither in maximum amount nor in time.

The transaction described is commercially unusual.[8] It can well be argued that S has not sold the property. On that analysis, payments received by S would be ordinary income, perhaps in the nature of rent or royalty, and S may recoup basis only in accordance with the rules appropriate to an owner of property as distinguished from a seller.

If, however, the facts of the particular case confirm sale rather than retention, basis recovery should be afforded S under a bright line rule reasonably protective of the revenue. Present section 1253(d)(2) provides some analogy. We recommend that basis is recovered ratably over a period of 20 years, subject to the proviso that no loss be allowed in any year unless and until the contingent payment obligation has become wholly worthless or is otherwise abandoned by S.

D. Mixture of fixed and contingent payments

Example 9. S. owns all of the stock of X corporation at an adjusted basis of $100,000. S sells to unrelated B for a mixture of fixed and contingent future payments. Fixed payments are specified as $100,000 per year at the end of each of the next 10 years (plus adequate interest). Contingent payments (to be made annually) equal 5% of the net after tax income of X for each of the next 5 years, the maximum contingent payments to aggregate not more than $1 million. No interest is stated on the contingent payments.

S has sold for a mixture of 10 year installment payments and 5 year contingent payments. Under present law's weight of authority,[9] he is not permitted to report the fixed payment component (or the sale transaction as a whole) on the installment method. Under present law, in the year of sale S is not taxable on the contingent payment component of the sale price; in the year of sale he will be taxed, or not, with respect to the fixed payment component depending upon his regular method of tax accounting (cash or accrual) and (if cash method) whether the obligation is or is not deemed the equivalent of cash.

This is an entirely unsatisfactory state of affairs. Current law's denial of installment treatment entraps the unwary and forces the well-advised taxpayer, seeking to defer tax liability until payments are received, either to accept the commercial disadvantage of the buyer's unsecured non-negotiable promise or to forego the contingent payment element for which the seller legitimately has bargained. Tax simplification will be significantly enhanced through reversal of the present rule.

Consistent with our paramount recommendation in favor of ratable recovery of basis and ratable recognition of gain in all cases, we urge that (1) installment treatment be allowed to the fixed future payment component of the sale price, and (2) to protect the revenue and discourage the tailoring of sale transactions for special tax advantage, the seller's basis should be allocated against all payments, fixed or contingent, that may be received under the sale agreement.

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[8] Compare the open transaction sale of a wasting asset such as a mineral property, payments to be made equal to a specified sum per ton mined. By estimating in the year of sale the total mineral reserves, a maximum dollar limitation on aggregate contingent payments may be forecast. Thus, under the rules outlined above, the seller's basis should be recovered over the life of the arrangement, so many cents per dollar of payment received, until either payments cease too early (seller's unrecouped basis is then a loss) or seller's total basis has been recouped.

[9] 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).

In Example 9, under the sale agreement taken as a whole payments will be received over 10 years and the maximum amount payable (inclusive of unstated interest) is $2 million ($1 million fixed and $1 million contingent). Appropriate application of the ratable recognition concept focuses on the maximum dollar amount of $2 million. Since the seller's basis is $100,000 (5 percent of $2 million), of each payment received (including as "payment" for this purpose unstated interest but excluding "add on" stated interest) 5 percent is return of basis. If basis has not been recouped in full when all payments cease at the end of year 10 (because contingent payments did not aggregate $1 million), unrecouped basis is a loss in that year.

An additional illustration may be useful.

Example 10. The facts are the same as in Example 9 except that the limitation on contingent payments is not stated in dollar terms but rather is stated in time: contingent payments will be made for eight years and then cease. As before, fixed payments of $100,000 per year will be made for 10 years.

Since the described arrangement does not supply a maximum dollar amount, but does furnish an overall limitation in time, in the first instance it is appropriate to look to that factor. All payments will cease at the end of 10 years. The seller's $100,000 basis thus may be allocated over those 10 years, $10,000 per year. If, in any year for any reason, principal payments (as distinguished from payments of interest stated or unstated) are less than $10,000, there is no current loss and the excess basis will be reallocated over the balance of the 10 year term.

Fairly to protect the revenue and discourage inappropriate tax tailoring of sale agreements, one additional rule is required. In no event may the existence of a contingent payment component, in a mixed fixed and contingent payment sale, accelerate basis recovery. Thus, if the sale arrangement called for fixed payments of $200,000 per year (plus adequate interest) in each of years 6 through 10, plus contingent payments in years 1 through 8, the seller's $100,000 basis would not be allocated $10,000 to each of years 1 through 10. Instead, the seller's $100,000 basis would be allocated solely to the fixed component, $20,000 per year in each of years 6 through 10.

The basis recovery and ratable recognition concepts set out above will, we believe, significantly clarify and greatly simplify current tax law. In all cases, gain recognition is deferred when payment is deferred. In all cases, basis is recovered ratably and not at the front end. In no case is the taxpayer or the auditing revenue agent required or permitted to "value" a future contingent payment obligation or (unless the cash method seller timely elects out of installment treatment) to determine whether the buyer's future fixed payment obligation is the equivalent of cash. Most importantly, the unsophisticated deferred payment seller is protected from the inappropriate exaction of immediate tax liability and the too sophisticated deferred payment seller is required to pay appropriate tax as payments are received. Fairly equating the tax burdens of the unwary and the clever, by protecting the former from blunder and discouraging baroque transactions by the latter, constitutes tax simplification at its commendable best.

E. Section 337 transactions

Example 11. S owns all 100 outstanding shares of X corporation at an adjusted basis of $100,000 ($1,000 per share). The assets of X consist of $200,000 cash and a long-held tract of undeveloped land currently worth $800,000. X has no liabilities. B, an unrelated person, wishes to acquire the tract and is prepared to pay $100,000 cash plus a 5 year maturing $700,000 negotiable promissory note bearing interest at 10% per annum. S finds the proposal attractive. His objective is to receive a total of $300,000 cash plus B's $700,000 negotiable note, and to recognize in the year of sale capital gain of $270,000 ($300,000 cash less $30,000 of S' total $100,000 basis). S is prepared to pay tax on the balance of his $630,000 capital gain in year 5, when he receives payment on B's note.

His objective is to receive a total of $300,000 cash plus B's $700,000 negotiable note, and to recognize in the year of sale capital gain of $270,000 ($300,000 cash less $30,000 of S' total $100,000 basis). S is prepared to pay tax on the balance of his $630,000 capital gain in year 5, when he receives payment on B's note.

Under current law, S can achieve his desired and entirely reasonable tax result by selling the X stock to B for $300,000 cash plus B's $700,000 negotiable note, and electing installment treatment under section 453(b). B, prepared to pay currently only $100,000 out of his own cash, will obtain the additional $200,000 by promptly liquidating X corporation. B will recognize no gain on that liquidation since his basis in the X shares is the $1 million purchase price.

Fearing unknown or contingent X corporation liabilities, however, B may be unwilling to purchase shares. In this circumstance, X may adopt a plan of complete liquidation, sell the land to B for $100,000 cash and B's $700,000 note, and promptly distribute its assets (now consisting of $300,000 cash and B's $700,000 note) to S. The X shares held by S would be cancelled and X then would dissolve under state law. Under section 337 of the Code, X would recognize no gain on the land sale. Under section 331, S has exchanged his X shares for the assets distributed in liquidation and qualifies for capital gain treatment.

But, when the section 337 asset sale and corporate liquidation route is followed, under current law S is not entitled to return his gain on the installment method.[10] Under section 453(b), only the purchaser's evidences of indebtedness qualify for installment treatment. B is a purchaser of assets from X. B is not a purchaser of anything from S.

The present rule, that section 337 at the corporate level and section 453(b) at the shareholder level are mutually exclusive, makes no tax policy sense whatsoever. The form in which an installment sale is cast should not determine eligibility for installment tax reporting. The present rule traps the unwary and forces the tax conscious seller into commercially senseless arrangements.[11] Historically, the only apparent argument is favor of the bar to shareholder installment reporting has been a need to protect the 30 percent limitation of present section 453(b)(2). By eliminating the 30 percent limitation, S. 1063 eliminates any reason for the current rule.

1. Identifying eligible debt obligations. The essential and proper objective is to equate at the shareholder level the tax treatment of two forms of installment sale, sale of the corporation's stock and sale of the corporation's assets incident to a section 337 liquidation. Thus, in the section 337 transaction, the debt obligations distributed in liquidation which ought to qualify for installment treatment in the shareholder's hands are those obligations, and only those obligations, which the corporation has received on the sale of its assets incident to liquidation. Debt obligations received by the corporation in the regular conduct of its business should not qualify.

The line is not always easily drawn. Since the legislative objective is simplification rather than absolute equity, we recommend adoption of an existing standard rather than a newly crafted rule. Section 453(d)(4)(B) identifies in a comprehensible way the class of installemnt obligations generated in a section 337 transaction, which should attract tax deferral at the shareholder level. We recommend, therefore, that identification of the qualifying debt obligations be made by cross-reference to section 453(d)(4)(B) excluding, however, the final sentence of that provision (which deals with a corporate tax matter irrelevant to the present issue).

2. Liquidations spanning two taxable years

Example 12. The facts are the same as in Example 11. On December 31, 1979 X corporation adopts a plan of complete liquidation, sells its tracts of land to B for $100,000 cash and B's $700,000 negotiable note, and immediately distributes its total cash assets of $300,000 to S. On January 6, 1980, X distributes the $700,000 note to S and thereby completes its liquidation. S is a cash method calendar year taxpayer.

In 1979 S has received a liquidating distrubution in cash of $300,000. Under the tax rules currently applicable in corporate liquidations—which rules we presume will continue unchanged—S will recover his entire $100,000 basis (in the X shares) against this first liquidating distribution, and will report 1979 capital gain of $200,000. In 1980 S receives, as a final liquidating distribution, the $700,000 note issued by B. That note, we have urged, should be eligible for installment reporting. If this is the end of the matter, S will have achieved a better tax result (front end recovery of his entire $100,000 basis) in the section 337 transaction than he would have received had he sold the X shares directly to B in exchange for $300,000 cash and a $700,000 note. In reporting that direct transaction on the installment method, S would have offset against the cash only $30,000 of his basis and would have reported capital gain of $270,000. Since an impelling simplification objective, we believe, is to require ratable recovery of basis and ratable recognition of gain whenever tax is deferred, the section 337 transaction taxing plan must accommo-

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[10] See, for example. *Mercedes Frances Freeman Trust* v. *Commissioner*, 303 F.2d 580 (8th Cir. 1962), *West Shore Fuel, Inc.* v. *United States*, 79-1 U.S.T.C. paragraph 9357 (2d Cir. 1979); Rev. Rul. 73-500, 1973-2 Cum. Bull. 113.

[11] See *W.B. Rushing*, 52 T.C. 888, 896 (1969), aff'd, 441 F.2d 593 (5th Cir. 1971). In this case the taxpayer, to avoid the "section 337 bars section 453" problem, sold the stock to a family trust in exchange for installment notes; the corporation then adopted a plan of liquidation, sold its assets to an unrelated buyer in exchange for notes of that buyer, and distributed those notes to the trust. The *Rushing* case, decided in favor of the taxpayer on those sympathetic facts, led to the spate of "installment sale to a relative" cases which were decided in favor of the taxpayer even though the relative thereafter resold for cash. These decisions, in turn, led to the proposal, in S. 1063, to forbid installment reporting of sales to related persons.

date to the achieving of that objecive. Fortunately, current tax law provides an appropriate directive.[11]

As under present law, compute year 1 (1979) standing alone: amount realized by S $300,000, basis recovery $100,000, capital gain $200,000. "Speculation" as to what S will receive from X in 1980 would be inappropriate. X may not distribute until late in 1980 and it may not distribute B's not at all. X might sell the note to a third party and distribute the cash proceeds.

In year 2 (1980) determine the tax consequences to S taking account of what was received by S and what was taxed to S in year 1 (1979). That is, treat S as if all liquidating distributions were made in 1980 but factor out the gain, if any, that was recognized by S in 1979.

If X had distributed everything in 1980, in that year S would have recognized $270,000 of capital gain ($300,000 cash received less $30,000 of S' total $100,000 basis), and S would have held the B $700,000 note (no portion of the principal of which as yet has been paid) at a basis in his hands of $70,000 (equal to S' original $100,000 basis in his X shares less $30,000 allocated to the $300,000 cash receipt). Because S in fact received a $300,000 cash distribution in 1979 and recognized gain of $200,000 in that year, this $200,000 of already recognized gain must be factored out in the 1980 computation. Subtracting $200,000 from the $270,000 gain S would have recognized in 1980 had all distributions been made in that year, there remains $70,000 of capital gain property to be recognized by S in 1980. That recognition of $70,000 gain, in turn, confirms there is now $70,000 of basis that S has not as yet recouped. This $70,000 of unrecouped basis is, therefore, allocated to the $700,000 note.

In the result, S is placed in the correct tax position. He has received cash ($300,000) and an installment obligation ($700,000) totaling $1 million. His basis in the X shares was $100,000, 10 percent of the "selling price." Against $300,000 of cash received, he has recouped $30,000 (10 percent of the cash received) of his basis and has recognized the balance of $270,000 of the cash received as capital gain. He has not been taxed on receipt of the $700,000 note and he holds that note at a basis of $70,000, 10 percent of the face amount. Of every dollar of principal payment received by S on the note, 10 cents will be return of basis and 90 cents will be capital gain.

The described arrangement promotes both tax simplification and administrative convenience in a coordinate way. The shareholder, receiving a partial liquidation distribution in year 1, and the revenue agent who will audit the shareholder's year 1 tax return, will not be required to estimate or value in advance the liquidating distribution the shareholder will receive in year 2. No less important, nothing that occurs in year 2 will require amendment of the tax return that the shareholder filed for year 1.

F. Closed transactions

Example 13. S, a cash method corporation, owns all of the stock of X corporation at an adjusted basis of $100,000. S sells the X shares to B receiving in exchange B's negotiable promissory note in the face amount of $1 million, payable $500,000 on the fourth anniversary date and $500,000 on the fifth anniversary date. The note calls for stated interest at the rate of 6 percent per annum and is secured by a pledge of the X stock. Because S has a large capital loss carryforward that is about to expire, S elects out of installment treatment.

Because the B note is negotiable and well secured, S properly will report the value of the note as an amount realized in the year of sale. Assume that value is determined to be $800,000. That amount is 80 percent of the $1 million face value of the consideration received. In the new ratable recovery of basis world, S will allocate $800,000 (80 percent) of its total $100,000 stock basis to the $800,000 year of sale receipt. S' year of sale capital gain thus will be $720,000 against which S will offset its expiring capital loss carryforward.

S will hold the note at a basis of $820,000 (the sum of (1) $800,000 "amount realized" at the time of sale, plus (2) $20,000 of previously unrecouped basis at which S held the X shares sold). That aggregate basis is allocable, we may assume, $410,000 to the year 4 payment component and $410,000 to the year 5 payment

[11] There are a variety of situations in which a taxpayer, in year 1, receives a refundable deposit or other untaxed amount, and in year 2 sells the subject property for installment notes. Under current law, the untaxed year 1 receipt is treated as if it had been received by the seller in year 2, for purposes of determining installment sale qualification under section 453(b) and ratably apportioning basis among payments received and to be received. See, for example *Daniel Rosenthal*, 32 T.C. 225 (1959), *John F. Westrom*, 25 T.C.M. 1019 (1966); Rev. Rul. 73-369, 1973-2 Cum. Bull. 155. This line of familiar authority offers a comprehensible solution to the section 337 liquidation problem.

component. In each of those years S will collect $500,000 from B. At issue is the tax treatment to S of the $90,000 profit he will receive in each of those years.[13]

As noted earlier in this report, under current law the collection gain is capital gain if B is a corporation or a governmental entity, and is ordinary income to S if B is something else (e.g., an individual). Section 1232(a). It makes no sense to have the tax treatment of the seller turn on the identity of the unrelated buyer. The current rule makes no better sense when illuminated by this reality: Even if B is an individual, S presumably can achieve capital gain by selling the note to a third party (at a modest discount) shortly, but not too shortly, before payment is due.[14] Once again, the sophisticated taxpayer achieves a better tax result than the unwary or unsophisticated taxpayer.

To rationalize and simplify this area of tax law, we recommend that collection be treated as a sale or exchange of the debt obligation in all cases. An expanding amendment of present section 1232(a) would appear an appropriate way to achieve this change. We have considered the unifying alternative of treating all collection gains as ordinary income and have rejected that course for two reasons. First, capital gain treatment, when the obligor is a corporation, is now well embedded in the tax law and, whatever treatment we might have preferred as an original matter, it seems difficult and divisive to attempt to change the corporate obligation rule at this date. Second, we question whether any such change would prove either effective or simplifying. Holders will attempt to avoid ordinary income on collection by selling debt obligations prior to maturity. The audit lottery then will play its usual role. The minority of cases uncovered by revenue agents likely will develop a good deal of litigation, the results of which most probably will turn on distinctions of fact. In that process, tax simplification will not emerge the winner.

G. Property exchanged for an annuity

A taxpayer who exchanges appreciated property for a commercial annuity has entered into a transaction currently taxable. This rule should not be changed.

The transfer of property in exchange for a properly designated private annuity—in general, a non-transferable unsecured annuity contract issued by an individual, or a charity, or a corporation that rarely if ever issues annuity contracts—under present law is not a currently taxable event to the seller-annuitant. Although transactions of this sort have been undertaken with some regularity over many years, there is today a surprising degree of confusion as to exactly how annual payments are to be taxed to the seller-annuitant.[15] The Treasury Department, in section 1.1011-2(c) Example 8 of the regulations, has described tax treatment of the seller-annuitant that appears both correct in terms of current law and consistent with the ratable recognition concept generally recommeded in this report.[16] Hence, we do not believe that any statutory articulation of private annuity transaction tax rules is needed.

We do think, however, the Treasury Department should be urged to clarify this unnecessarily confused area by promoting to greater prominence and more obvious general application the useful pronouncement, cited above, which now rests obscurely in the regulations that govern bargain sales to charities. It also would seem appropriate to expand the regulations' present coverage in two respects. The year of sale tax position of the seller who receives a secured (e.g., benefitted by a pledge of property) noncommercial annuity should be determined, in a manner consistent with the revised legislative scheme, and clearly stated. It also should be made clear that if the seller-annuitant retains and advantageous right to reacquire his property at a later date, the sale may not be a complete sale at all. The case may be viewed as akin to the transfer of property in exchange for contingent payments limited neither in time nor in amount, and the way in which Congress resolves the tax treatment of that arrangement might well inform the regulations' approach to the annuity transaction issue focused here.

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[13] Since neither the X stock nor the B note is readily tradable, there is no original issue discount. See section 1232(b) (1), (2).

[14] The ordinary income result of a collection gain, when the obligor is an individual, derives from the absence of a "sale or exchange." When S sells the note to a third party, provided that purchaser acts for his own account and not as agent for S or B, S is creating the requisite "sale or exchange" through self-help.

[15] Compare Rev. Rul. 69-74, 1969-1 Cum. Bull. 43, with Treas. Reg. Section 1.1011-2(c) Example 8. Amazingly, these two administrative pronouncements, one from the Internal Revenue Service and the other from the Treasury Department, are wholly irreconcilable.

[16] Under the regulations' example, the seller's investment in the annuity contract is the fair market value of that contract at the time it is issued. During the expected return term, an appropriate portion of each exclusion ratio sum payment is return of the seller's basis and the balance of that sum is gain on the sale. The portion of each payment that exceeds the exclusion ratio sum is ordinary income to the seller.

IV. CONCLUSION

Introduction and enactment of a series of bills designed to clarify and simplify discrete segments of the tax law is a process, and perhaps the only process, likely to reduce the proliferating complexity of the Internal Revenue Code. We highly commend the tax writing Committees in their determination to undertake this process.

Equally, we commend the choice of the installment sale provision as an initial focus in the ongoing legislative process. The choice is particularly appropriate both because the area is inordinately complex and confusing, and because the pertinent tax law impacts upon taxpayers at all economic levels.

In this report we have urged that the simplification catalog of S. 1063 be expanded, beyond the three concerns there focused, to encompass the other major simplification issues. In that way, we believe, Congress can accomplish a landmark simplification in a tax area of pervasive significance, to the benefit of taxpayers and the tax administrator alike.

Even if the additional clarifying and simplifying changes we recommended were not adopted, we would nonetheless commend and support S. 1063. We hope, however, that the tailored alterations in the bill's provisions recommended in Part II of this report will be adopted.

STATEMENT OF HERBERT J. LERNER, CPA—CHAIRMAN, TAX ACCOUNTING SUBCOMMITTEE OF THE FEDERAL TAX DIVISION AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

The Federal Tax Division of the American Institue of Certified Public Accountants is pleased to have this opportunity to testify on S. 1063, the bill introduced by Senator Long and Senator Dole to amend Section 453(b) of the Internal Revenue Code of 1954 to simplify the rules concerning the installment method of reporting gain from sales of real property and casual sales of personal property. We were pleased to note that S. 1063 is intended to be one of a series of bills designed to clarify and simplify the tax law. The Federal Tax Division looks forward to the opportunity of making its views known concerning future tax simplification proposals.

The Federal Tax Division has adopted five legislative recommendation concerning the installment method of reporting income.[1] These recommendations were developed in response to problems encountered by the Division's members in their own tax practices. The recommendations are summarized as follows:

(1) Installment sale reporting should be permitted in any single-payment sales of realty or single-payment casual sale of personality, which otherwise qualifies, where payment is not received in the year of sale.

(2) The requirement that payments in the year of sale cannot exceed 30 percent of the selling price should be eliminated.

(3) Installment reporting should be permitted in any open-end sale.

(4) Upon a change from the accural to the installment basis of reporting income from installment sales by dealers in personal property, installment payments actually received during the year on account to 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.

(5) The installment method of reporting gain should be extended to gain attributable to the receipt of an installment obligation originally received by a corporation in a sale of property under section 337.

While the first two recommendations are contained in S. 1063, we request the recommendations (3) and (5) also be given due consideration if the scope of the simplification bill covering § 453(b) is expanded to accomodate other deferred payment sale situations. (Recommendation (4) may appropriately be considered at another time.)

I SPECIFIC COMMENTS ON AMENDMENTS MADE BY THE BILL

The bill makes amendments to simplify the operation of section 453(b) by deleting the present-law requirement that no more than 30 percent of the selling price be received in the year of sale and by permitting installment reporting for single-payment sales where no payment is received in the year of sale. In addition, the bill denies installment reporting for sales between related parties and raises the mini-

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[1] Three of these recommendations are contained in the 1977 AICPA publication "Recommended Tax Law Changes." The other two recommendations were adopted at the Federal Tax Division's meeting in May of this year. The full text of these recommendation are attach as appendices A through E.

mum sales price required to qualify for installment reporting of gain from casual sales of personal property. Finally, the bill would clarify current law by making it clear that the installment obligation disposition rules cannot be avoided by bequeathing an obligation to the obligor.

While the Federal Tax Division generally supports the changes contained in S. 1063 as bringing about much needed improvements in the operation of the installment reporting provisions, certain comments and suggestions are offered with respect to each change.

A. Elimination of the 30-percent initial payment requirement for reporting gain on the installment method

This amendmenmt is identical to one of the Division's legislative recommendations (see Appendix B). Accordingly, it has our whole-hearted endorsement. The elimination of the requirement that payments received in the year of sale not exceed 30-percent of the sales price to qualify for the installment method of reporting gain will remove a trap for the unwary taxpayer and thus result in tax simplification. In additions, 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. It may actually increase revenues to the Treasury to the extent that sellers are able to negotiate downpayments in excess of 30-percent of the sale price.

This amendment also should reduce controversies between taxpayers and the Internal Revenue Service over the proper treatment of selling expenses when property is sold subject to a mortgage in excess of the seller's adjusted basis for the property.

B. Elimination of the two-payment rule

The Division has adopted a recommendation that the two-payment rule be eliminated so that the installment method of reporting gain would be available for any single-payment sale of real property or single-payment casual sale of personal property where payment is not received in the year of sale. (See Appendix A.)

Elimination of the two-payment rule will simplify the operation of the tax law because it will remove a trap for the unwary. In addition, in single payment transactions, it should reduce taxpayer/IRS controversies over valuation of the buyer's obligation to pay the purchase price in the future. (Such valuation is necessary under present law to determine the amount realized in the year of sale where there is an obligation from the buyer to make one payment in a future year.)

Reducing the number of cases where there is a need to value the buyer's obligation will reduce the number of cases in which the seller of a capital asset will have to recognize "collection gain" when the buyer pays his obligation in full at maturity. Reducing the number of cases in which "collection gain" arises, in turn, will result in greater equity in the tax law. This will occur because two sellers of capital assets—one selling to an individual buyer and the other selling to a corporate buyer—will both recognize capital gain when the buyer's obligation is paid in full at maturity instead of one recognizing ordinary income from collection gain (individual obligor) and the other recognizing capital gain (corporate or governmental obligor).

We also see merit in a legislative rule that collection gain be treated in the same manner as the gain on the original transaction.

C. Sales to related parties

The Bill would preclude use of the installment method of reporting for any disposition of property by a taxpayer to a related person except for certain redemptions of stock. For purposes of determining who is a related person, the bill would use the same relationships described in Code sections 267(b) and 707(b)(1) for determining when losses are disallowed on sales of property between related taxpayers.

While not a proposal based on simplification, this amendment would eliminate controversy with respect to "Rushing[1] type" sales whereby gain is deferred by the initial seller and the property is thereafter sold by the related purchaser so that the related group, considered as one economic unit, has available cash as well as deferral of the gain.

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[1] *Rushing v. Commissioner,* 441 F.2d 593 (5th Cir. 1971) aff'g 52 TC 888 (1969). 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), cases which have followed, however, 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 exampled, William D. Pityo, 70 TC — No. 21 (May 15, 1978); Clair E. Roberts, 71 TC — No. 26 (Nov. 30, 1978); and Carl E. Weaver, 71 TC — No. 42 (Dec. 27, 1978).

In general, the Federal Tax Division agrees that for reasons of tax equity and perceived fairness of the tax system, installment reporting for sales between related parties needs to be restricted. However, we feel that the flat prohibition approach (with limited exceptions for certain redemptions of stock) taken by the bill, while defensible as a simple solution, is too rigid. It is felt that outright prohibition of installment reporting for all sales between related parties would prevent a number of nontax-motivated sales from being consummated (e.g., the sale of all, or a portion, of a family-run business or farm by a father to a son, where the son does not have sufficient resources to make an outright purchase and cannot obtain alternative financing). It is also feared that the approach taken by the bill may prevent private annuity transactions between related parties.

We recommend that the bill be "fine tuned" to encompass only the abuse cases where the related party buyer disposes of the property subject to the installment election outside of the related group for cash or its equivalent within two years from the date of the original sale. (A two-year time period is suggested because it is consistent with the period prescribed under Code section 644 for the special treatment for gain on property transferred to a trust at less than fair market value.) If a disposition for cash or its equivalent does take place within two years, the original seller would be treated as having made a proportionate disposition of the installment obligation. This approach will necessitate special reporting and consent requirements.

Moreover, we would support an outright prohibition against installment reporting for related-party sales, if such prohibition was limited to sales of marketable securities (as defined under § 1023(h)(2)(E) by reference to the date of the sale). This approach would have the advantage of simplicity while at the same time permitting favorable treatment for most legitimate related-party sales.

In applying these related-party restrictions on the use of the installment method, we would urge that the test under § 318 be applied rather than § 267, so as not to embrace brothers and sisters within the provision.

D. Minimum sales price for casual sales of personalty

The bill would increase the minimum sale price required to qualify a casual sale of personal property for installment reporting from more than $1,000 to more than $3,000.

While the Federal Tax Division does not object to this amendment if it truly leads to simplification, we wonder if any simplification gains are more perceived than real. We are not aware of the existence of a large number of sales for less than $3,000 that are reported on the installment method under present law. Thus, an increase in the threshold amount for electing installment sales treatment may not lead to much administrative simplification for either taxpayers or the Service. Perhaps simplification would be better served by eliminating any threshold amount.

E. Coordination with section 691

The bill would provide that any previously unreported gain from an installment obligation would be recognized by a deceased seller's estate if the obligation is transferred or transmitted to the obligor.

The Division supports this amendment as a clarification of present law. We believe that the result obtained is the correct one as a matter of tax policy.

II. OTHER INSTALLMENT SALE REPORTING ISSUES

A. Installment obligations distributed in a 12-month liquidation

If the scope of S.1063 is expanded, we request that serious consideration be given to the Federal Tax Division's legislative recommendation that the installment method of reporting gain be extended to the gain attributable to the receipt of an installment obligation originally received by a corporation in a sale of property under Code section 337. (See Appendix E for the full text of the recommendation.)

While our recommendation is based on tax equity and ability-to-pay considerations primarily, it does have a simplification aspect.

Permitting the shareholder-recipient of an installment obligation originally received by a corporation to report his liquidation gain attributable to such obligation under the installment method would alleviate the need for the use of the related-party sale of stock on the installment basis as used by *Rushing*.[3]

It is recognized that a rule would have to be devised to allocate a portion of the shareholder's stock basis to the installment obligation to prevent a recovery of all stock basis against assets received in liquidation in one taxable year of the shareholder with the installment obligation being received in the succeeding taxable year

[3] Footnote 2, *supra*.

with a zero basis. For this purpose. It would seem logical for basis to be allocated to assets received in liquidation in proportion to their respective fair market values.

B. Contingent sales price

The Federal Tax Division has outstanding a legislative recommendation that installment sale reporting be permitted for open-end sales, i.e., those sales where a fixed and determinable selling price does not exist at the time of sale. (See Appendix C for the full text of the recommendation.)

One major problem that must be resolved is how basis should be recovered in a contingent payment sale. Possibilities include: (1) allocating basis ratably over the payment term of the contract if the selling price is not fixed but the number of payments is; (2) recovering basis as a fixed percentage of each payment based on the maximum sales price that may be received; (3) letting the taxpayer choose between the preceding options when both the number of payments to be received and the maximum sales price are known; (4) allocating basis as a fixed percentage of each payment based on the minimum sales price that may be received (with adjustment being made in the profit percentage if contingent payments are received or as contingent amounts are "earned out"); or (5) permitting no basis recovery until the final payment is received when there is neither a maximum sales price nor a limited payment period.

A threshold problem that would seem to require resolution would be defining what constitutes a sale as opposed to a retained profits interest. Answering this question may entail adopting arbitrary limitations on the payment period and/or the percentage of the sales price that can consist of contingent amounts (i.e., force a maximum sales price).

The Division has not adopted a position on these questions yet and thus we are not prepared to support any particular proposal at this time. However, we think it is important and are prepared to work with Congressional staff and the Treasury Department to develop the best possible approach for subsequent hearings on this matter.

C. Open versus closed transactions

Under present law, if the value of the buyer's obligation to make future payments to a cash basis seller cannot be ascertained, the sale is considered to be an open transaction and the seller is entitled to recover the basis of the property sold before any gain is reported.[4] If the buyer's obligation can be valued (and the installment method is not elected or is not available) the transaction is closed and the cash-basis seller recognizes gain in the year of sale equal to the difference between the fair market value of the consideration received (including the seller's obligation to pay) and the basis of the property sold. The seller then takes the fair market value of the buyer's obligation as his basis for determining gain or loss on subsequent disposition or collection of the obligation. Collections on the obligation in excess of the seller's basis constitute "collection gain" which can be either ordinary income or capital gain depending upon whether the obligor-buyer is an individual or a corporation (or a governmental unit).

Controversy frequently arises between taxpayers and the Internal Revenue Service over whether a sale of property for payments to be made in the future is an open or a closed transaction. Because open-transaction treatment is often more favorable than installment reporting, some taxpayers may structure transactions (e.g., elaborate contingent payment arrangements) in an attempt to qualify for basis recovery first.

It has been suggested that the open-versus-closed transaction area of controversy can be resolved legislatively by mandating installment reporting for all such sales and by requiring allocation of basis over payments received.

While the Division agrees that this is a problem area which needs a legislative solution, we feel that many of the question which must be answered to solve the contingent sales problem must also be resolved to adequately deal with the open transaction problem. At the present time, therefore, we are not prepared to support any particular suggested solution. However, as with contingent sales, we are prepared to give further consideration to the problem and to work with the staff and the Treasury to develop such a solution.

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[4] *Burnet v. Logan*, 283 U.S. 404 (1931) is the leading case under the open transaction doctrine.

LEGISLATIVE RECOMMENDATIONS OF THE FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, CONCERNING THE INSTALLMENT METHOD OF REPORTING INCOME

APPENDIX A

SECTION 453—INSTALLMENT METHOD—SINGLE-PAYMENT SALES

Section 453(b) should be amended to permit installment sale reporting in any single-payment sale of realty or single-payment casual sale of personalty, which otherwise qualifies, where payment is not received in the year of sale.

Section 453(b) allows use of the installment sales method, provided payments in the year of sale do not exceed 30 percent of the selling price. No payment is required in the year of sale, and no specific requirement is included as to the minimum number of payments that must be provided for in the sale agreement.

The IRS, in Revenue Ruling 69-462 (1969-2 CB 107), held that income from a sale of real property, where the total sales price is payable in a lump sum, in a year subsequent to the year of sale, may not be reported on the installment method. Revenue Ruling 69-462 has been followed in Baltimore Baseball Club, Inc., 481 F. 2d 1283 (Ct. Cl., 1973), which rejected the concept of a deferred "lump-sum installment."

It should be noted that, in order to use the installment method for sales of real property and casual sales of personalty, it is not necessary that the multiple payments actually be made, only that the sale agreement, by its terms and conditions, provide for them. A sale, once qualified for installment reporting, generally is not disqualified if the terms of the agreement are not followed and only one payment of the full sales price is received. No tax is avoided in such cases, because the entire deferred profit is reported in the year the single payment is received.

We recommend that Section 453 be amended to provide for installment sale reporting where a single payment in a year subsequent to year of sale is provided for in the sale agreement. We believe this provision would be equitable and in accord with the intent of Congress in enacting Section 453—namely, to provide relief from the payment of tax on the full amount of anticipated profits when none, as well as only a small part, of the sales price has been received in cash. Many desirable single-payment sales frequently arise as a result of proper business dealings. Such sales might not be possible without use of installment reporting, because the seller would immediately owe the entire tax on the sale, while having received no payments in the year of the sale. While this circumstance may generally be avoided by arranging for a "token" payment in a year other than the "single-payment" year, such a technique is largely cosmetic and lacking in substance, may not be available to small business owners and to small investors, and should not be necessary.

This amendment would not only provide sellers an opportunity to consummate single-payment sales with assurance about the resulting tax treatment, but would also eliminate much of the controversy that arises from attempted use of the alternative "deferred payment method" of reporting income from certain sales of real property.

APPENDIX B

SECTION 453—INSTALLMENT METHOD—30-PERCENT REQUIREMENT

Section 453(b)(2) should be amended to eliminate the requirement that payments in the year of sale not exceed 30 percent of the selling price.

Section 453(b)(2) presently provides that in order for a sale of real property or a casual sale of personal property to qualify for installment reporting, payments in the year of sale must not exceed 30 percent of the selling price. This 30 percent limit should be eliminated entirely so that any sale which otherwise qualifies for installment reporting under Section 453(b) may be reported on the installment method regardless of the amount realized in the year of sale.

The present 30 percent limit is contrary to Section 453(a) which allows dealers in personal property to report on the installment method without any limitation on the amount of payments which are received in the year of sale.

The 30 percent limit often causes transactions to be altered, sometimes artificially, from their normal business form in order to meet the requirement of Section 453(b)(2). In many instances the requirement of Section 453(b)(2) has been a trap for the unwary.

There does not appear to be any convincing rationale for imposing the 30 percent limit. Why should a transaction where the seller receives 30 percent of the sales price in the year of sale be allowed different tax treatment from a transaction where the seller receives 31 percent or any other percent of the sales price in the year of sale?

APPENDIX C

SECTION 453—OPEN-END SALES

Section 453(b) should be amended to provide for installment sale reporting in any open-end sale where payments in the year of sale do not exceed 30 percent of the minimum sales price.

Section 453(b) allows use of the installment sales method, provided payments in the year of sale do not exceed 30 percent of the selling price. The IRS maintains that to qualify for installment sale reporting, a fixed and determinable selling price must exist at the time of the sale. In Gralapp, CA-10, 458 F2d 1158 (1972), the Tenth Circuit Court of Appeals upheld the Commissioner in deciding that an open-end sale does not qualify for installment sale reporting. However, the court, by dicta, indicated that this decision should not be considered absolute in all situations involving open-end sales. The Ninth Circuit Court of Appeals confirmed this position in Steen, CA-9, 509 F2d 1398 (1975).

We recommend that section 453 be amended to provide for installment sale reporting where payments in the year of sale do not exceed 30 percent of the minimum sales price. Contingent payments received in subsequent years would adjust gross profit to be reported similar to the method approved by the Commissioner in Revenue Ruling 72-570, (1972-2 CB 241). We believe this provision would be equitable and in accord with the intent of Congress in enacting section 453—namely, to provide a relief measure from the payment of tax on the full amount of anticipated profits when only a small part of the sales price has been paid in cash. Open-end sales frequently arise as a result of honest differences of opinion as to the real value of property sold. Where these differences of opinion exist, it may not be possible to complete the sale without use of installment reporting, because the seller would owe more tax on the sale than the amount of payments received in the year of sale.

This amendment would not only provide sellers an opportunity to consummate such sales with assurance about the resulting tax treatment, but would also eliminate much of the controversy that arises from the alternative use of the "deferred payment method" of reporting.

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 installment 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.

APPENDIX E

SECTION 331—INSTALLATION METHOD REPORTING IN SECTION 337 LIQUIDATIONS

The installment method of reporting gain should be extended to gain attributable to the receipt of an installment obligation originally received by a corporation in a sale of property under section 337.

Section 337, which was designed to insure that gain on the sale of corporate property is taxed no more than once, operates in conjunction with the rules under section 331. The provisions of section 331 require that property, including installment obligations originally received by the corporation in conjunction with the sale of assets and, in turn, received by shareholders in exchange for stock of the liquidating corporation, be valued at fair market value in determining gain or loss recognized on the liquidation.

The present law does not allow a shareholder receiving an installment obligation upon a complete liquidation to report his gain on the installment method notwithstanding that the obligation was originally received by the liquidating corporation pursuant to a sale of property under section 337. The only allowance made for the receipt of an installment obligation is consideration given to the terms and maturity date in valuing the obligation. This results in a situation where no gain may be recognized on the corporate level, but a tax will be due at the shareholders' level. Substantial taxes may be payable, although liquid assets may not be received. On the other hand, taxes can be deferred by selling the corporate stock on the installment method.

It is recommended that section 331 be amended to allow a shareholder to report on the installment method that portion of gain on the liquidation of a corporation attributable to receipt of the installment obligation. Satisfaction of the installment reporting rules under section 453 and especially the limitation prescribed in section 453(b)(2) must be maintained through the date of liquidation. It is anticipated that the recapture of depreciation and investment credit would continue to be taken into account at the corporation level. This recommendation is consistent with the purpose of section 337 and is more reflective of the economics of a liquidation in which installment obligations are the principal assets distributed to shareholders.

STATEMENT OF JAMES K. JEANBLANC, MILLER & CHEVALIER, WASHINGTON, D.C.

I appreciate this opportunity to discuss S. 1063, the bill introduced by the Chairman and Senator Dole to simplify the rules under section 453(b) of the Internal Revenue Code for certain installment sales. In my judgment, this is one area ripe for review, and the bill provides a good start in the needed review of the entire Code to simplify and clarify the tax law.

In the case of deferred-payment sales, and other areas of the tax law, many of the tax rules are scattered among various Code provisions, regulations, rulings, and cases. Much time and expense is consumed in research to find the answers, or likely answers, to what should be simple questions. Bringing these scattered rules together will be of substantial benefit to both practitioners and taxpayers. In addition, there are many inconsistencies and uncertainties in how the existing provisions operate and an undesirable climate of tax gimmickry has been created. There exist many special rules and exceptions which have been added to the Code for marginal policy reasons, which breed unnecessary complexity, and which should be eliminated. A review of the Code will provide an opportunity to provide simplicity where possible and provide increased clarity. At the same time, the review should insure that each provision operates reasonably and fairly in all cases. The task will not be easy and will require persistence and patience.

In the Tax Section, we have devoted substantial attention over the past three years to deferred-payment sales and have developed several legislative recommendations. Other recommendations are under development. The following recommendations were adopted by the Tax Section last year and have been approved by the American Bar Association House of Delegates:

1. Under present law there is considerable uncertainty in how the cash-equivalence test is applied under section 1001(b) where a cash-basis taxpayer receives a deferred-payment obligation. In general terms, the recommendation is that the obligation should be treated as equivalent to cash if its fair market value is two-thirds or more of its face amount. ABA Tax Section Recommendation No. 1978-11, 31 Tax Lawyer 1481 (1978).
2. The 30-percent limitation in section 453(b), relating to the maximum amount of payments which may be received in the year of sale, should be eliminated. ABA Tax Section Recommendation No. 1978-15, 31 Tax Lawyer 1507 (1978).

3. The installment sale election should be reversed and the installment method applied to all eligible sales by cash-basis taxpayers, except where they elect not to have the provisions apply. ABA Tax Section Recommendation No. 1978-15, 31 Tax Lawyer 1507 (1978).

The Committee on Tax Accounting Problems has developed a legislative recommendation with respect to contingent-price installment sales, which will be voted upon by the Tax Section. Under this proposal, installment-sale treatment would be extended to contingent-price installment sales if the contract provides for a maximum price. This maximum price could either be stated in the contract or could be determinable from the conditions or formulas within the contract. This maximum price would be the "selling price" for purposes of determining the gross-profit ratio and how much gain is recognized with respect to each installment payment to be received. If, in a later taxable year, the maximum price is reduced because the contingency is not satisfied, appropriate adjustments would be made in that taxable year to reflect the reduced gain from the sale. The taxpayer would not file an amended income tax return for the previous taxable years.

A second project of my Committee is for a recommendation to eliminate the so-called "two-payments" rule under section 453(b). This project, of course, is now moot since S. 1063 would accomplish this result.

Finally, a joint task force has been established within the Tax Section to examine all types of deferred-payment sales, including sales with open-ended contingencies, with the view to developing a single, or perhaps two, simple rules which might be applied to all such sales. This task force has not made any recommendations, but preliminary indications suggest that the simple, easy-to-apply rule for all cases would be the cost-recovery method. Under this method, the taxpayer would fully recover his basis before reporting any gain from such a sale. Naturally, for revenue reasons, we recognize that the Treasury will find such a recommendation unacceptable, at least under the present tax system where we fail to adjust basis for inflation.

With this brief background, I would like to turn to S. 1063, noting as Mr. Redman pointed out, that at the moment, I appear only in my individual capacity and not as Chairman of the Committee on Tax Accounting Problems of the Tax Section. As Mr. Redman pointed out, we have worked with the Tax Section's Special Committee on Simplification and our views coincide in many respects. We thought it nevertheless might be helpful to this Subcommittee to submit this separate statement. In general, the bill would accomplish five things: (1) eliminate the 30-percent limitation, (2) eliminate the "two-payments" rule, (3) raise the $1,000 floor on sales of personal property to $3,000, (4) deal with the *Rushing* problem, and (5) make clear that a testamentary transfer of an installment obligation to the maker will trigger the deferred gain.

1. Elimination of the 30-percent limitation.—This limitation is an excellent example of a special rule with marginal policy justification which has fostered much litigation and has contributed to unnecessary complexity. Taxpayers have molded their transactions around the limitation so that it is not uncommon for a transaction to provide a 29-percent down payment with a substantial additional payment to be made at the beginning of the following taxable year. Under these circumstances, who pays the expenses related to the sale and the amount of the mortgage indebtedness often are critical factors in determining whether the limitation has been exceeded. Elimination of the limitation would be a significant simplification of section 453(b), and is likely to result in a net revenue gain to the Treasury as down payments in excess of the limitation are made.

2. Elimination of the "two-payments" rule.—This change also will result in simplification of section 453(b). Taxpayers wishing deferred-tax treatment where the contract price would otherwise be paid as a single payment in a future taxable year must now negotiate a second payment. The "two-payments" rule has been a trap for the unwary; it has elevated form over substance and should be eliminated.

3. Raising the $1,000 floor to $3,000.—This change should not be made. The objective of simplification would be better served, in my judgment, if the $1,000 floor, rather than being increased, were eliminated. Presently, there is no floor amount for installment sales of real property and the same rule should apply to personal property.

I do not believe that elimination of the floor in the case of personal property will materially increase the administrative burdens of the Service. Small-dollar deferred-payment sales are uncommon. When the sale price is small, taxpayers are inclined to negotiate immediate payment rather than to allow the payments to continue into future taxable years. Nevertheless, where a small taxpayer does make a small deferred-payment sale, deferral of tax to him is as important as deferral of tax is to the large taxpayer who is to receive large deferred payments.

4. The Rushing problem.—The bill would deal with one area of tax gimmickry centering around the type of situation involved in the *Rushing* case, 52 T.C. 888 (1969), aff'd, 441 F.2d 593 (5th Cir. 1971). In the classic case, a father anticipating that a tract of his land will be sold, will sell the land to his son on the installment basis. The son, in turn, will immediately resell the land outside the family for cash. The son has a cost basis equal to his sale price and reports no gain. The father, under the installment method, is entitled to deferred tax treatment even though the son has the cash. (The Service will attempt to reach the blatant case under Rev. Rul. 73-157, 1973-1 C.B. 213, where the installment sale and resale are pursuant to a prearranged plan.) Variations involve installment sales of stock to family trusts in anticipation of liquidation of the corporation.

This is a problem area requiring some type of resolution, but the bill goes too far in disallowing installment sale treatment in all cases (except for certain stock redemptions) where the installment sale is to a person related to the taxpayer within the meaning of section 267(b) or section 707(b)(1). No tax gimmickry is present where, for example, a farmer sells the family farm to his son on installment basis and the son continues with the farm. Disallowance of the installment method should be limited to those cases where it is evident that the installment sale is made to a related person who makes an anticipated disposition. In this regard, it seems reasonable, in line with section 644(a)(1) of the Code, to adopt a rule treating the resale as anticipatory if it occurs within two years after the installment sale. An exception should be made for involuntary dispositions within the two-year period, such as by reason of death.

Some alternative to sections 267(b) and 707(b)(1) should be used to define who is a related party to the taxpayer. For example, a sale by the taxpayer to a trust establishment by his spouse would not be reached. Also, there will exist some possibility for continued tax gimmickry where, for example, three unrelated persons with adjoining tracts of land (which the ultimate purchaser wants) sell these tracts on the installment basis to a corporation the stock of which is one-third owned by each. A childress uncle still would be able to sell to a favored nephew. Finally, while sections 267(b) and 707(b)(1) may not go far enough, they go too far in treating brothers and sisters as related for this purpose.

It is well to keep in mind that the cause of simplication necessarily takes a back seat when provisions are written to deal with avoidance cases. The failure to cover a particular avoidance case will be regarded by many taxpayers as providing a license for avoidance in that situation. To draft vague regulations to attempt to reach these cases will add to complexity and uncertainty in legitimate transactions which this Subcommittee is endeavoring to avoid. Thus, reasonable lines should be drawn in the statute to cover most all of the cases. To allow a few fish to get away is a satisfactory price to pay not to have everyone tangled in a different net of complexity and uncertainty.

5. Testamentary dispositions of installment obligations.—This is necessary to change to clarify existing law.

* * * * * * *

S. 1063 should be expanded to deal with other issues in the deferred payment area. The installment election should be reversed for cash-basis taxpayers. ABA Recommendation No. 1978-15, discussed above, provides for this. The problem here centers on cash-basis taxpayers who are unaware of the requirements for installment-sale treatment and who do not make a proper election. In most all cases, they expect to have installment-sale treatment.

S. 1063 should be expanded to allow installment sale treatment where the corporation makes an installment sale of its property and distributes the intallment obligations to its shareholders in a section 337 liquidation. The shareholders are permitted installment treatment if they sell their stock on the installment basis. This change would be consistent with the underlying purpose of section 337 to provide for essentially the same treatment whether the corporation sells its property and liquidates, or whether the shareholders sell their stock.

Several members of the Tax Section have raised a problem concerning the deferred payments of farmers who sell their crops at the end of the year and arrange to be paid in a following year. There has been much confusion and litigation regarding the application of the constructive receipt doctrine in the year of sale. Farmers do not qualify as dealers so that the deferral provisions applicable to dealers in personal property under section 453(a) are not available to them. Because their crops probably qualify as inventory, the existing provisions in section 453(b) are not available (disregarding the "two-payment" rule in present law). If deferred-payment sales by dealers and casual deferred-payment sales of other taxpayers are to be eligible for deferred tax treatment, then the same treatment should be established in S. 1063 for the in-between case where a taxpayer is not a dealer, but makes casual sales of inventory-type property on a deferred-payment basis.

Another problem involves section 1232(a) and the so-called "collection gain" of a note issued in a closed transaction where a capital asset has been sold and the taxpayer does not elect installment treatment. Presently, section 1232(a) allows this gain to be taxed as a capital gain if the purchaser is a corporation or governmental entity, but not if the purchaser is an individual or other type of taxpayer. The result should not depend upon who is the purchaser; capital gain treatment should also be allowed to individuals and other types of taxpayers.

S. 1063 should be expanded to provide for contingent-price installment sales. The Committee on Tax Accounting Problems has developed a legislative recommendation to deal with the maximum-price contingency case, discussed above. Our proposal is essentially the same proposal as the proposal made by Mr. Ginsburg and the Treasury.

Dealing with the open-ended contingency cases is not an easy task. The theoretical solution is to place a value on the open-ended contingency and treat the sale in the same way as an installment sale with a maximum price would be treated. Naturally, there would be substantial administrative problems with respect to the values set by taxpayers. Also, room would be left for tax gimmickry. The cost-recovery method which I mentioned earlier would be simple to apply, but the Treasury will not accept it.

This brings us to the system of basis allocation which is being proposed. As in the case of the maximum-price contingency case, the cost-recovery or open-transaction method would not be available. Where the contract provides for a specified period over which the open-ended contingency payments are to be made, basis would generally be allocated over that period. Some refinements will be required to deal with the case where the bulk of the contingent payments fall within the first years of the period. Also, a taxpayer under the system should be permitted to deduct his unrecovered basis as a loss in the taxable year in which it is determined he will never recover that basis. He should not have to wait until the end of the period to claim his loss. This is the principle the Committee on Tax Accounting Problems has adopted with respect to its maximum-price contigency proposal. Finally, some refinements will be required where the contingency is open-ended and no period is specified when the payments end.

These rules of basis allocation for the open-ended contingency cases will not be simple. They would provide, however, a well-defined system a basis allocation and certainty to taxpayers. They would reduce the research time I mentioned earlier and reduce tax gimmickry. In making the necessary refinements of these rules, I look forward to working further with the staff and Treasury to insure that they work fairly.

Senator BYRD. The next witness will be C. Murdoch, Esq., Wilmington, Del., Small Business Council of America.

STATEMENT OF C. MURDOCH, WILMINGTON, DEL., SMALL BUSINESS COUNCIL OF AMERICA

Mr. MURDOCH. Mr. Chairman, I am here because I believe small business has a particular interest in two things your subcommittee is considering today.

First, small business has a great interest in the matter of simplifying the installment sales provisions because small businesses are often transferred either within a family or outside of the family by the installment sale route. Anything that complicates that kind of transaction hurts small business.

Small business also has a real interest in the broader subject of simplification generally I can explain that in part by answering a question you asked of one of the other witnesses but did not ask me.

You asked if the witness thought that the complexities in the code were getting too much for the practitioners. I am not too proud to admit that the answer to that, as far as I am concerned, is yes. My clients tell me that they can barely afford a lawyer like me who confesses the code is too complex. I am sure they cannot afford a lawyer who does not yet admit that.

Therefore, our clients cannot stand more complexity and neither can we.

I second what the prior three witnesses have just said about eliminating the 30-percent rule. I applaud that. I cannot see any loophole that is opened up by eliminating the 30-percent rule.

I do not think it costs the Treasury a dime of revenue if a person takes 35 percent rather than 30 percent in the year of sale. The Treasury gets the tax that much faster. It does not delay anything.

I urge the committee to adopt that part of the proposal.

However, I decry the idea of putting in a simplification bill, a provision to close a loophole. You might argue as to whether there is a loophole, but assuming there is a loophole, the bill, under the banner of simplification, proposes to put in very complex provisions about denying installment sales treatment for sales between related parties.

That is a very simple thing to say. Yet, when we look at this section that the subcommittee is today considering, we see that it has cross references to other sections which are terribly complicated and which define related parties. It also has cross references to highly complex provisions of the code, having to do with whether certain corporate distribution should be treated as sales or exchanges or as dividends.

I believe that such complexity is not needed in this area.

I am a fan of country and western music. I even wake up with a clock radio set to a station that plays country and western music. The current favorite on that station is a song entitled "Two Steps Forward and Three Steps Back." I am concerned about a project which is headlined as a project to achieve simplification, but in which the committee recommends a bill which takes one step forward in simplifying the law by eliminating the 30-percent rule and a dozen steps backwards in the area of complications by putting in complicating factors.

The committee is going to give simplification a bad name. It is not very private humor among tax practitioners that: tax reform acts do not reform and technical corrections acts do not correct. I would hate to have added to that list of bad jokes, simplification bills that do not simplify.

If there is a loophole here, Mr. Chairman, one that requires a complicated closing, then it will just have to be that way. There will just have to be a complicated closing.

However, I would urge the committee to take that up as a completely separate matter and headline it "Complicated Provision to Close a Loophole." But I would urge the committee not to spoil the game of simplification by putting it in a bill headlined "Simplification."

Senator Byrd, you asked other witnesses what their priorities would be in taking up parts of the code for simplification. I have an entirely different item to suggest to the committee as its number one priority.

I believe that the committee should consider first simplifying things that are not in the law yet but which you are now considering. To talk about simplifying things that have been in the law for

50 years while simultaneously another part of the Congress is enacting laws that add further complications, seems to me to be the equivalent of asking a housewife to dust the living room while the husband is out in the backyard dumping dirt into the air-conditioning system.

I think the first step in simplification is to simplify everything that is now coming through the system and which is not yet in place.

Thank you very much, Senator.

Senator BYRD. I think you raise a very good point there and I hope that the committee and the Congress will begin to simplify the old laws and, in enacting new laws, take the simplified approach.

As you say, if that is not done, then these committee hearings will go on endlessly if we have to correct everything that is being done now as well as what has been done in the past.

I certainly agree with you in that regard. You mentioned the word "reform." I will tell you what I tell the people in Virginia when I make speeches there, which I do with some frequency. I say you had better be skeptical of any piece of legislation with the word "reform" in it.

When we had labor reform before the Congress, that meant giving more power to the national labor union leaders. When we had welfare reform, that meant doubling the people on welfare. When we had tax reform, that meant increasing everybody's taxes.

So I take a very skeptical view of the word "reform."

Thank you, sir.

Mr. MURDOCH. May I ask that my statement be included in the record, subject to a literary correction, which I have called to the attention of the counsel?

Senator BYRD. Yes; it will be inserted.

Incidentally I might mention this, since you represent the Small Business Council of America, that the Finance Committee this morning met in regard to proposals for catastrophic health insurance, a combination of a number of different proposals: the President's proposal, Senator Kennedy's proposal, Senator Long's proposal. But it was not clear to me until today—I guess it should have been—that these proposals, with regard to the part which will be paid for by employers, that part will fall almost entirely on small business and will run as high as 5 to 6 percent of payroll for small business. The mandated health insurance for large business in many cases, will not require any additional coverage and in some cases, it will be just a small, additional amount. For small business, on the other hand, it may involve additional costs which may run as high as 5 to 6 percent of payroll.

I think small business is wise to be on the alert to what goes on here in Washington.

Mr. MURDOCH. Thank you, sir.

Senator BYRD. Thank you.

[The prepared statement of Mr. Murdoch follows:]

STATEMENT OF CONVERSE MURDOCH

This statement is submitted in connection with the Committee's consideration of the Simplification of Installment Sales Rules as proposed in S. 1063 introduced by Senators Long and Dole on May 2, 1979.

This statement is submitted on behalf of myself, various clients and the Small Business Council of America, Inc.

I am an attorney in private practice in Wilmington, Delaware. Most of the clients of our office are owners and principals in small businesses. A number of our clients are engaged in farming operations.

I am also the President of an organization of small business persons known as the Small Business Council of America, Inc.

SUMMARY OF STATEMENT

The following is a summary of my statement.

I heartily recommend the approval of the parts of the bill which eliminate the 30% cash in year of sale limitation on installment sales.

I urge the Committee to recommend the elimination from S. 1063 of the part of Section 1 (of the bill) denying the installment method with respect to sales between related persons.

If the Committee is inclined to keep in the bill some provision with respect to installment treatment of sales between related parties, I urge that alternative provisions be considered.

ELIMINATION OF THE 30-PERCENT RULE

I anticipate that all those persons who either frequently or infrequently have occasion to become involved in installment sales will heartily endorse the proposal to eliminate the so-called 30 percent rule. Under present law, if a transaction is to qualify for the installment method of reporting, the seller may not receive more than 30 percent of the sales' price in a form other than installment obligation of the purchaser in the year of sale.

It has been my observation that most installment sales are structured in the way they are not for the purpose of deferring or minimizing capital gains' taxes, but rather to meet the exigencies of the situation and the financial conditions of the purchaser. The presence of the 30 percent rule considerably complicates the structuring of installment sale transactions. Because of this rule, parties negotiating an installment sale—particularly an installment sale of a going business—face a number of risks. There is always the risk that during an IRS audit the agent may contend that some payment by the purchaser during the year of sale was a cash payment of part of the purchase price, rather than what the parties considered it to be, i.e., a payment of an unrelated item.

Another risk is that in connection with an IRS audit the agent may contend that the sales' price was in actuality less than that stated in the sales agreement and that the 30 percent limit was actually lower than what the parties thought it was when the transaction was structured.

None of these situations involve tax avoidance or gimmickry of any kind. The threat of inadvertently losing the benefit of installment sale treatment needlessly complicates negotiations regarding sales of property on the installment basis.

Since the existing and now-proposed installment sale treatment results in the taxable gain on the transaction being reported ratably as cash payments are received—there would seem to be no revenue effects adverse to the government in dropping the 30 percent rule. The parties, for their own good reasons, may prefer to have an installment sale in which 90 percent of the consideration is received in cash in the year of sale and 10 percent is received the following year. There would seem to be no revenue loss in such an arrangement in view of the fact that 90 percent of the gain will be reported and taxed in the year of the sale. On the other hand, if the 30 percent rule remains in the law, such a transaction can be easily restructured to provide for a cash payment of 30 percent of the purchase price in the year of sale (which payment may be make very late in a calendar year) and the payment of the remaining 70 percent of the purchase price on January 1 of the following year. In theory at least, a sale consummated on December 31, 1978, at which time 30 percent of the purchase price was received, could qualify for installment sale treatment even though the remaining 70 percent of the purchase price was received one day later, viz., on January 1, 1979.

In summary, I believe that dropping the 30 percent rule will considerably simplify the law, will remove a complicating factor in negotiations leading to bona fide transactions and will not have a serious revenue impact.

THE PROPOSAL TO DENY INSTALLMENT SALE TREATMENT FOR SALES BETWEEN RELATED PARTIES

S. 1063, while eliminating the 30 percent rule (a move which I applaud) would amend § 453(b) of the Internal Revenue Code of 1954 (IRC) to deny the installment sale method of reporting with respect to any sale between related persons. The amendment defines "related person" by a cross-reference to IRC §§ 267(b) and 707(b)(1).

IRC § 267(b) has a catalog of many relationships which make persons related parties. This catalog is further expanded by the attribution (and in some cases re-attribution) rules of IRC § 267(c). IRC § 707(b)(1) has to do with related person status of partners and partnerships.

For purposes of this discussion, it's sufficient to note that the rule proposed in S. 1063 would, if enacted, deny installment sale treatment for sales between a parent and a child, a grandparent and a grandchild, siblings and an individual and a corporation, if the individual directly or indirectly (as through family attribution) owns 50 percent or more in value of the stock of the corporation.

Chairman Long, in his statement made at the time he and Senator Dole introduced S. 1063, mentioned a technique under which property is sold to a related party (the statement mentioned a sale to a family trust) on an installment basis, with the purchaser then reselling the property at little or no taxable gain. This follows from the fact that the purchaser has a basis equal to the principal of the installment note, even though the original seller has not yet reported gain from the transaction.

For purposes of this statement, I'm willing to concede for the sake of argument that the transaction described in the statement accompanying the bill involves exploitation of a loophole. Even conceding that, I believe the cure proposed in the bill is too drastic for the ailment.

There are many perfectly legitimate installment sale transactions which would be crippled by the proposed rule and which involve absolutely no tax avoidance motive or effect. I can mention a few common situations which would be adversely and unfairly affected.

It is frequently the case in a family-owned business that less than all of an owner's children are interested in working in or owning the business after the father phases himself out. Assume a situation in which a father owns 100 percent of the business. The father has a wife and two sons. The first son has absolutely no interest in the business and the second son works full time in the business and would like to carry it on after the father's retirement or death. In such circumstances, the father may sell all or a part of his interest in the business to the second son (i.e., the one active in the business) for what the parties believe is its full value. In this way, the father believes he is treating his wife and first son fairly because he is giving them what represents their shares of the value of the business. At the same time, he's not forcing on the second son the unwanted management input of the wife and first son. By the same token, he's not making the wife and first son entirely dependent upon the management and business acumen of the second son who will take over the running of the business.

What I've just described is a very common situation with respect to businesses which are owned by a few individuals. In working out what most people would believe is the sensible arrangement in such a situation, it is almost always the case that the second son who is going to take over the business is incapable of paying cash to the father for the business interest the son is acquiring. It is often impossible and usually very expensive to arrange outside financing for the second son's acquisition of the family business. In such circumstances, the natural way to arrange things is for the acquiring son to give the selling father some cash downpayment and to provide for the balance of the consideration to be handled through an installment payment note with interest.

The situation just described is stated in relatively simple terms. It can sometimes be complicated by virture of family trusts, family holding corporations and partnerships becoming involved in the shift.

If S. 1063 is adopted in its present form, such perfectly legitimate non-tax motivated transactions will be frustrated.

In my opinion, there is no present or threatened revenue loss under existing law which can possibly justify such a drastic change in the way business and other properties are transferred between family members. Accordingly, I respectfully urge the Committee to not approve that part of S. 1063 denying installment sale treatment for sales between related parties.

SOME SUGGESTED ALTERNATIVES

There have been indications through various discussions I have had with others interested in this subject that the drastic solution with respect to related party installment sales, just recited, may be deleted and in its place there may be substituted other solutions.

One alternative which I have heard discussed is to have a provision in the law that if the transferee in a related party installment sale transaction resells the property within some fixed period of time (e.g., one year) after the transaction, the installment sale treatment of the first sale will be forfeited.

I consider the just-stated alternative as vastly superior to the original proposal in S. 1063.

However, this alternative proposal carries with it some problems which will require special treatment.

For example, assume a situation in which a family corporation is owned 30 percent by brother A and 70 percent by brother B. Brother A decides to withdraw from the business and to transfer his 30 percent interest to his own son in an installment sale transaction.

Assume further that after this sale of the 30 percent interest to a related party, brother B (who controls the corporation through his 70 percent interest) decides to liquidate the corporation and distribute all assets ratably to the shareholders. This will mean that the son of brother A (who had absolutely no control over the situation) will be disposing of his interest acquired in a related party installment sale with the result that his father (i.e., brother A) will retroactively lose the right to installment sale treatment. This result is unfair to both brother A and his son, neither of whom had control over the situation which resulted in the retroactive loss of the installment sale method.

Assume that in the same situation, within a short time after brother A's son acquires the 30 percent interest—the son dies and for a number of reasons the executor has to dispose of the deceased son's interest in the business. Will this mean that by virtue of the son's death and the executor's decision (probably having nothing to do with tax considerations) to sell the deceased son's interest will cause the father (brother A who had no control over the situation) to retroactively lose his installment sale privilege?

I do not mention these situations to prove that it's impossible to write a law which is fair with respect to these matters. I believe that given enough time the staff technicians and private practitioners could design exceptions which would take care of the now foreseen situations. Despite that, I strongly urge that this alternative not be considered at this time.

A SIMPLIFICATION BILL IS THE WRONG VEHICLE FOR CLOSING LOOPHOLES

For years, many students of our federal tax system have decried the ever-burgeoning complexity of our federal tax laws. I include in the term "students of our federal tax system" not only professors and their students, but also Congressional leaders, Treasury Department officials, accountants and lawyers who almost daily have to try to cope with these complexities.

This situation recalls the famous quip: "Everybody talks about the weather, but nobody does anything about it."

When I noted that the ranking members of the Finance Committee and the Ways and Means Committee had introduced legislation to make a start on simplification—I was greatly encouraged. I realize that no single bill and no single session of Congress can accomplish simplification in our tax system. Nonetheless, as the Chinese say: "A thousand mile journey begins with a single step." Tax simplification has to begin some place and some time. I'm hopeful that the bill now being considered by the Finance Committee will represent that important first step on a thousand mile journey to simplification.

Because of these feelings, I strongly urge the Committee to not mar an important first step toward simplification by taking a "reform side step" to close what may be perceived by some as a loophole in the process adding to the complexities of the Internal Revenue Code.

If there is a glaring loophole in the law which has to be closed and if the closing of it requires a complex provision—I suppose there's no choice but to do the loophole closing with a complex provision.

However, such a complexity-producing reform side step should not be taken as part of a march towards simplification. Doing so may mean simplification gets sidetracked for good.

To mar the first step towards simplification by inserting more complications than simplification is to give simplification a bad name.

The tax practitioners and taxpayers of the country are rapidly growing cynical about tax reform acts which don't reform and technical corrections' acts which don't correct. I plead with the Committee to not impose on the country tax simplification acts which don't simplify.

It is my plea to the Committee that if there is a loophole in connection with installment sales between related parties, the solution to it be kept as non-complicated as is possible consistent with both closing the loophole and avoiding patently unfair results. If that means a complicating revision of the statutes—so be it.

However, it will better preserve the credibility of our legislative process if such a complicated loophole closing provision is billed as what it is (i.e., a complicated loophole closing provision), rather than making something labeled a simplification bill merely a Trojan horse containing more complicating provisions to confound the taxpayers, their advisers and those who must enforce the law.

CONCLUSION

I respectfully urge the Committee:

1. Recommend the elimination of the existing 30 percent limit on cash consideration in the year of sale.
2. Eliminate from this bill complicating provisions with respect to installment sales between related parties.

Senator BYRD. The next witness will be Mr. Harry L. Gutman, Deputy Tax Legislative Counsel, Department of the Treasury.

Welcome, Mr. Gutman.

STATEMENT OF HARRY L. GUTMAN, DEPUTY TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. GUTMAN. Mr. Chairman, in view of the limited amount of time available, I would like to request that my prepared statement by inserted in the record.

Senator BYRD. It will be inserted in the record.

Mr. GUTMAN. I will confine my response to a summary of the Treasury's views on the bills before the subcommittee and to comment on a number of other issues raised by the preceding witnesses.

Senator BYRD. Thank you, sir.

Mr. GUTMAN. As Don Lubick stated, we applaud the subcommittee's initiative in commencing a serious tax simplification effort. In this context, with two minor qualifications, which we noted in our statement, we support S. 1062, the Subtitle F Revision Act of 1979.

We also support the thrust of S. 1063, in particular its attempt to bring some order into the complex law presently governing sales for future payment.

My statement sets forth, in some detail, the Treasury's proposals in these areas.

You have heard from the preceding panel the problems that arise under the current statute governing installment sales. You have also heard it suggested by the panel that the subcommittee take this opportunity to deal not only with statutory deferred payment sales but also with all other types of deferred payment sales.

Treasury wholeheartedly agrees with this suggestion because the complexity in the area of deferred payment sales arises not only out of the statutory provisions, but also and perhaps even more important, because of the existence of nonstatutory alternatives which, as Mr. Ginsburg pointed out, in some cases permit even more advantageous tax deferral opportunities than the statutory method.

The existence of these nonstatutory methods also fosters artificially created transactions and a disproportionate expenditure of time and effort by both taxpayers and the Internal Revenue Service, the former in attempting to secure the advantages of nonstatutory tax deferral and the latter in attempting to contain the efforts of the former.

Happily, Mr. Chairman, the testimony you have received thus far recognizes this problem. Indeed, Treasury has been enormously pleased by the extent to which the interested professional groups have worked with us and the staff to formulate general principles applicable to all deferred payment sales.

It is, as Mr. Ginsburg stated, a unique time when you can find the AICPA, the American Bar Association's tax section, the New York City Bar Association's tax section, the New York State Bar Association's tax section agreeing with Treasury both as to the scope of a problem and, in general, as to what the solution ought to be.

In general, all the groups I just mentioned, including Treasury, agree upon the following principles that we think ought to be addressed by the committee in the deferred payment sale area.

First of all, a general rule which requires ratable basis recognition should be adopted for all deferred payment sales by cash-basis taxpayers.

Second, deferred payment reporting should be available to taxpayers receiving installment obligations in 12-month corporate liquidations. This point was not mentioned by any of the other witnesses, probably due to the lack of time, but there is a problem here which, in essence, gives a different treatment for installment obligations which have been received by a corporation and distributed in a 12-month liquidation as opposed to an individual who sells his stock and receives an installment obligation.

We are all in agreement that that disparity ought to be eliminated.

Third, I think all of the panelists and the Treasury agree that the tax abuse that arises through deferred payment sales to related parties where the purchaser resells the property should be eliminated. We believe it is inappropriate to permit tax deferral where the economic unit represented by the related parties has the entire sales proceeds in hand.

When I say that, I want also to add that we, too, believe that the solution set forth in the bill goes too far and that there are many legitimate transactions which are caught by the blanket net of the attribution rules presently in the bill. The solution we endorse is one which also has been mentioned by Mr. Ginsburg and the other panelist. If property is transferred in an installment sale to a related party and that property is then disposed of by the related party within 2 years, that will require the acceleration of the gain to the original seller.

We think that is a reasonable way to deal with the problem because the problem that you are really trying to address here is the fact that the economic unit has the cash proceeds in hand at the same time it is getting tax deferral.

I hasten to add, lest you think that everyone is really marching hand in hand, that there are some differences in detail. But I think they really are simply difference in detail in our respective proposals.

For example, Treasury believes that it should not be possible to sell marketable securities on the installment method. The installment method, after all, was enacted to provide relief for liquidity problems when individuals received only a certain amount of cash in the year of sale.

In the case of marketable securities there is a ready market. In most cases the reason a person would be selling on the installment method would be simply to take advantage of tax deferral. We do not believe that that is appropriate.

Others have different views on this question, and alternative solutions, such as that proposed by Mr. Lerner.

We look forward to working further with these groups in an attempt to find a unified view prior to the time that the Select Revenue Measures Subcommittee holds hearings on the House counterpart of this bill.

Now, if I could just summarize quickly the Treasury's position on S. 1063, we believe that the bill does reduce complexity in the installment sale area, but we also believe that Congress should take this opportunity to provide consistency of treatment and clarity of rules for all sales for future payment.

A set of cogent, uniform rules based on sound policy will clear up the morass created by the lack of a coordinated taxing structure.

With the following qualification, then, we support S. 1063. We support the elimination of the 30-percent limitation only if a general rule requiring cash-basis taxpayers to recover basis ratably over the term of any deferred payment sales is adopted.

Second, the abuse involved in the deferred payment sale to related parties is eliminated.

We also believe, if the 30-percent limitation is eliminated, that it is also appropriate to eliminate entirely the $1,000 floor for casual sales of personal property.

Mr. Chairman, we applaud this effort. We think that the installment sale bill, as it is going forward now, has a very good future. We would like to see this be the first in a number of cooperative efforts to simplify the tax law.

Thank you.

Senator BYRD. Thank you very much indeed, Mr. Gutman.

The Treasury, then, as I understand it, favors eliminating the 30-percent requirement. There just will not be any percent requirement in regards to installment sales.

Mr. GUTMAN. Well, Mr. Chairman, we believe the 30-percent requirement does serve a function. I think in the spirit of tax simplification, which we construe to require, if you will, even concessions on both sides from absolute purity and absolute equity, that we would be willing to see the 30-percent limitation be eliminated. But we would like to see, at the same time, some rationality brought into the system. In effect, we condition our support for the elimination of the 30-percent requirement on the adoption of overall rules governing sales for deferred payments and the elimination of what is, in our view, a patent abuse of the installment sale method, the sale to related parties.

Senator BYRD. Let me ask this: What is the disadvantage to the Treasury in this case? If a person receives a 40-percent payment instead of a 30-percent payment in the first year, and he pays the tax on 40 percent of the gain instead of 30 percent, how does the Treasury lose by that?

Mr. GUTMAN. The question of immediate revenue effect I do not think is really at stake here. The installment sale rules, as I understand it, have their genesis in an attempt to provide a statutory basis dealing with sellers on the cash method of accounting.

If an individual receives, for example, a certain number of dollars and negotiable notes and is on the cash basis, the value of those notes would be immediately taken into income, even though he did not receive the dollars which were going to paid in the future on those notes.

The installment sale method was adopted as a statutory rule to say that in those situations where you only received so much cash and you might have received something that had a fair market value, where Congress was going to permit the deferral of the tax until you received the funds. That is just fine.

We have no quarrel with that. But one initial reason for the 30-percent limitation was based on a liquidity notion. If you got more than 30 percent of the money up front, you would have enough money to pay any capital gains tax; therefore, you did not have a liquidity problem.

Senator BYRD. Yes.

If you are going to permit the use of the installment sale method—and I think you should permit use of this method—the Treasury has nothing to lose, as I see it, and something to gain, if the person wants to take 40 percent in the first year versus the present 30 percent.

Mr. GUTMAN. There is a little bit of a tradeoff there, Mr. Chairman, and that is when we get back to the question of the cash method of accounting and the extent to which negotiable notes or other types of property constitute consideration in the year of sale, which is an enormously complex area of present law.

It is true if there is more money that is paid down, Treasury will get more money, assuming, of course, people are not manipulating the payment provisions to time receipt of payments to minimize their tax liabilities. That is always a possibility.

Indeed, that is one of the things that you worry about most with the related party transactions, that people are attempting to defer gain to a later year when they are going to be in a different tax bracket, and to get the advantage of tax deferral, which is a significant advantage.

Senator BYRD. Thank you very much.

[The prepared statement of Mr. Gutman follows:]

STATEMENT OF HARRY L. GUTMAN, DEPUTY TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. Chairman and members of the subcommittee, I am pleased to have the opportunity to present the views of the Treasury Department on S. 1062, The Subtitle F Revision Act of 1979, S. 1063, relating to installment sales, and on the subject of the simplification of the tax law relating to sales for deferred payment generally.

DEFERRED PAYMENT SALES

The Treasury Department strongly supports simplification of the tax law and agrees that the installment sale area is an excellent choice for beginning what we hope will become an ongoing simplification process.

I. Current law

The current law applicable to reporting sales for future payment has been described as the very model of complexity, primarily due to a lack of a coordinated taxing structure. The general rule of installment reporting under section 453 provides that a taxpayer, under qualifying circumstances, may elect to report gain realized on a profitable sale ratably as payments are received. While this rule may be stated simply and clearly, it is a great deal more complex in practice.

Generally, the seller who does not elect or fails to qualify for statutory installment treatment under section 453 is taxed on the year of sale on the difference between the fair market value of the consideration received in the year of sale and the tax basis in the property sold. Later payments are tax free up to the amount of gain recognized in the year of sale and thereafter are, in general, taxed as ordinary income.

However, under certain circumstances, a seller may defer recognition of gain on non-statutory grounds. This possibility causes much of the complexity in the area. Specifically, if the purchaser's promise of future payment is considered not to be the equivalent of cash or it the expectation of future payment is sufficiently contingent or uncertain (for example, a specified percentage of all future profits), and thus is found to have no currently ascertainable fair market value, the seller arguably has received consideration of no value in the year of sale and the recognition of gain is deferred until the proceeds are received. Further, because the total amount to be received under the sales agreement is argued to the uncertain, the seller reports gain on the "cost recovery" method, applying proceeds first against basis. Only when the total proceeds received exceed basis is gain recognized and the gain is generally taxed as capital gain.

The installment method provides for ratable recognition; each payment received is in part a return of the seller's basis and in part gain. Non-statutory deferred payment reporting is wholly different. Basis is recovered first. Thus, at times non-statutory deferred payment reporting can produce a greater measure of tax deferral than the installment method. Well-advised taxpayers often design transactions to achieve this advantageous result.

The sale of property generally is a realization event at which time the taxpayer becomes obliged to report income and pay tax. Installment reporting and non-statutory deferred payment reporting are highly advantageous because they permit taxpayers to defer recognition of gain, and therefore payment of tax. Both thus operate as an interest-free loan from the Treasury. Taxpayers who sell property of notes are permitted to defer paying tax on a profitable sale until the notes are paid, while taxpayers who, for example, receive marketable securities or other property in an exchange must pay tax currently.

The ability to defer payment of tax is a great advantage; a tax deferred is, in effect, a tax reduced. Congress initially enacted section 453 to provide relief to taxpayers who might have difficulty paying tax in the year of sale because receipt of payment was deferred. The reason for the creation of statutory deferred payment reporting should be kept in mind as this area is revised, especially in light of the even more advantageous cost-recovery benefits of non-statutory deferred payment reporting.

II. S. 1063

S. 1063 addresses five issues under section 453:

(1) Current law limits the amount of cash and other property (other than installment obligations) which may be received in the year of sale to 30 percent of the sale price. This limitation contributes to the complexity in the area; much of the litigation involves whether the 30 percent limitation has been met. The bill would eliminate the 30 percent limitation.

(2) 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 has the initial sale been for cash. The bill would prohibit installment reporting of sales between related persons.

(3) The bill raises the current $1,000 floor on eligible sales of personal property to $3,000.

(4) The bill eliminates the requirement that there be two or more payments in separate taxable years for a sale to qualify for the installment method.

(5) The bill makes it clear that the unreported gain from an insallment sale is recognized by the seller's estate if the installment obligation is transferred or transmitted to the obligor.

III. Treasury position on S. 1063

The Treasury Department believes that S. 1063 reduces complexity in the installment sale area. However, Treasury recommends that Congress take this opportunity to provide consistency of treatment and clarity of rules for all sales for future payment. While this effort might result in a more complex statutory provision—indeed, it will require an expansion of section 453 to cover all deferred payment sales—the law will be simplified immeasurably. A set of cogent, uniform rules based on sound policy will clear up the morass created by the lack of a coordinated taxing structure.

With the following qualifications Treasury supports S. 1063. First, Treasury supports the elimination of the 30 percent limitation only if a general rule requiring cash basis taxpayers to recover basis ratably over the term of any deferred payment sale is adopted and the abuse involving deferred payment sales to related persons is eliminated. Second, if the 30 percent limitation is eliminated, we believe it is also appropriate to eliminate entirely the $1,000 floor for casual sales of personal property.

The 30 percent limitation has been criticized as adding a great deal of complexity to the tax law. It is the subject of a great deal of litigation and administrative dispute. Yet the 30 percent limitation serves an important purpose. It limits access to the advantageous deferred recognition treatment afforded by section 453 to those taxpayers for whom the method was introduced into the law—those with liquidity problems who could suffer a hardship if the tax on a deferred payment sale was payable in full in the year of sale.

If only specific complexities are to be addressed by this bill, the 30 percent limitation should be rewritten in a manner which serves its original purpose with less complexity. However, we strongly believe that the simplification process should not be viewed narrowly on an issue-by-issue basis. Rather, where complexity is identified, it should be eliminated by uniform rules which accord with sound tax equity principles and, when compared to the prior state of the law, balance fairly the legitimate interests of taxpayers and the Treasury. Thus Treasury will support the elimination of the 30 percent limitation—which we consider a major substantive liberalization and not merely a simplifying amendment—as well as other liberalizing changes contained in our proposal, if other simplifying changes, which in some instances restrict presently available tax deferral opportunities, are adopted in the same spirit. In this way we hope to establish an even-handed approach which may be applied as a precedent to future simplification efforts.

IV. Treasury proposal

A. *General rule.*—The Treasury Department proposes a general and uncomplicated rule applicable to every sale for future payment. When a seller is on the cash method and recognition of gain is deferred the seller's basis must be allocated ratably over the deferred payments. The specifics are set forth below.

We note that 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 support both the concept and the general framework of the Treasury proposals. There are some differences on details and we hope to resolve these issues by the time hearings are held on the companion measure to S.1063 (H.R. 3899) by the Subcommittee on Select Revenue Measures of the Committee on Ways and Means.

1. Recognition of gain.

a. *Installment treatment.*—Unless a taxpayer otherwise elects, the gain on any sale of real property or casual sale of personal property (in any amount) will be recognized ratably as payments are received.

b. *Non-installment treatment.*—i. Method of recognition. If a taxpayer so elects, gain shall be recognized in the year of sale, measured by the excess of the fair market value of the consideration received in the year of the sale over an allocable portion of basis. If the fair market value of consideration received in the year of sale is less than the total amount due under the contract (e.g., there are contingent payments or the value of the notes does not equal the face amount of the obligations) then basis shall be allocated according to the rules set forth in 2 below. The amount of gain recognized on the receipt of notes will be added to basis and allocated ratably to future payments.

Under current law, the taxation of future collections in excess of basis is unrelated to and independent of the original sale, except for sales of inventory. The nature of the gain reported depends upon whether the note is a capital asset in the hands of the seller and upon the holding period. However, since collection is not a "sale or exchange" if the maker is an individual, capital gain treatment is unavailable. If the maker is a corporation and the note is a capital asset in the seller's hands, section 1232 treats the retirement as an exchange and capital gain treatment is permitted.

Under the proposal, gain attributable to future payments which exceed basis (adjusted for any gain reported on receipt of the notes) retains the same character (e.g., capital gain or ordinary income) as the gain originally reported, after application of the recapture rules and any adjustments for interest under section 483.

ii. Method of election.—If the installment method is not to apply, a taxpayer must affirmatively elect not to report gain on the installment method, or actually report the gain in a manner inconsistent with the installment method.

The election is irrevocable after the later of the due date or actual filing date of the return.

2. Allocation of basis. In any deferred payment sale, basis is to be allocated according to these rules whether or not gain is reported on the installment method.

a. *Fixed contract price.* As under current law, basis is allocated to each payment in the same proportion that the total basis bears to the total contract price. If the contract price is subject to change, the stated maximum payment will serve as the basis for the computation. The proportion would then be adjusted prospectively for any change.

Example 1. A sells real property with a basis of $5,000 to B for $10,000, $1,000 in cash and $9,000 in notes with interest. The notes, due in equal $3,000 installments on January 2 of the following three years, have a fair market value at the time of sale of $6,000. Whether or not the sale is reported on the installment method, A must allocate the $5,000 of basis over the fixed contract price of $10,000. Thus, 50 cents of basis would be allocated to each $1 of sales proceeds.

If A reports on the installment method, gain is recognized only as cash is received and A would report the following:

Year	Cash received	Basis	Gain
1	$1,000	$500	$500
2	3,000	1,500	1,500
3	3,000	1,500	1,500
4	3,000	1,500	1,500

If A affirmatively elects not to report on the installment method, gain is recognized based upon the fair market value of the cash and notes received. Basis is still allocated over the fixed contract price. A would report the following:

Year	Taxable proceeds	Basis	Gain
1	$7,000	$3,500	$3,500
2	3,000	2,500	500
3	3,000	2,500	500
4	3,000	2,500	500

In year 1, A must include in income the $6,000 fair market value of the notes, as well as the $1,000 cash down payment received. This amount is added to the basis of the notes. In years 2-4, $2,000 of this $6,000 addition to basis is allocated to each $3,000 cash payment, leaving $1,000 taxable proceeds in each year from which the $500 basis originally allocated is deducted.

Example 2. B sells a machine with a basis of $5,000 for $1,000 down and the right to receive $1 per unit of output for the year of sale and the following three years, up to a maximum total purchase price of $10,000. The $5,000 basis is allocated over the maximum which may be paid, $10,000. Thus, 50 cents of basis would be allocated to each $1 paid to B, whether or not B reports on the installment method. The machine produced 0 units in the year of sale, 2,000 units in year 2, 2,000 units in year 3 and 4,000 units in year 4. B would report the following on the installment method:

Year	Cash received	Basis	Gain
1	$1,000	$500	$500
2	2,000	1,000	1,000
3	2,000	1,000	1,000
4	4,000	2,500	1,500

The total paid to B was $9,000, $1,000 less than the maximum. B recovers the remaining basis in year 4, the final year of the contract. If year 4 production had been 2,000 units, B would have reported a loss of $500 in that year.

If B had elected not to report on the installment method, and his right to receive $1 per unit was considered to be so uncertain as to have no ascertainable fair market value, B would have reported the following:

Year	Cash received	Basis	Gain
1	$1,000	$500	$500
2	2,000	1,000	1,000
3	2,000	1,000	1,000
4	4,000	2,500	1,500

The cost recovery method of reporting is not permitted even if B's right to receive $1 per unit has no ascertainable fair market value. Thus, there is no incentive to arrange transactions artificially with notes or similar promises having no ascertainable fair market value. As a result, valuation problems are avoided and commercial transactions will not be structured artificially to achieve desired tax results.

b. *Specified number of years.*—Where payments under a contract are to be made over a specified number of years, basis is allocated equally to each year. Where basis allocated to any year exceeds the amount received in that year, no loss is allowed. The excess is added to total unrecovered basis and reallocated equally to the remaining years of payment. Any basis remaining at the end of the specified period may then be treated as a loss.

Example 3. C sells a machine with a basis of $5,000 for the right to receive $1 per unit of output for the year of sale and the following three years (with no maximum on the amount C might receive). The machine produces 2,000 units in year 1, 3,000 units in year 2, 4,000 units in year 3 and 5,000 units in year 4. C would report the following on the installment method:

Year	Cash received	Basis	Gain
1	$2,000	$1,250	$750
2	3,000	1,250	1,750
3	4,000	1,250	2,750
4	5,000	1,250	3,750

Again, an argument by C that the right to receive $1 per unit had no ascertainable fair market value would not affect the amounts reported.

Example 4. D sells a machine under the same terms as in Example 3. The machine produces 950 units in year 1, 2,000 units in year 2, 3,000 units in year 3, and 4,000 units in year 4. D would report the following on the installment method:

Year	Cash received	Basis	Gain
1	$950	$950	0
2	2,000	1,350	$650
3	3,000	1,350	1,650
4	4,000	1,350	2,650

Although $5,250 of basis is initially allocated to year 1, D received only $950. D may not report a loss for year 1, and must allocate the excess of $300 equally over the following 3 years.

3. *Possible special rules.* If the foregoing is adopted, transactions may be structured to utilize ratable basis recovery over time to achieve some measure of cost recovery initially. For example, assume E sells a machine with a basis of $20,000 for the right to receive $20,000 in years 3 and 4 and $1 per unit of output in years 1-4. The machine produced 5,000 units each year. Under the rules set forth above, E would report the following on the installment method:

Year	Cash received	Basis	Gain
1	$5,000	$5,000	0
2	5,000	5,000	0
3	25,000	5,000	$20,000
4	25,000	5,000	20,000

By structuring the receipt of contingent payments first in an amount estimated in advance to be approximately equal to the basis allocated to each year, E has achieved cost recovery and tax deferral. If this situation is viewed as a serious potential abuse, it can be prevented by a special rule providing that the existence of a contingent payment component shall in no event accelerate basis recovery. The operation of this rule is illustrated by the following example.

Example 5. E sells a machine with a basis of $20,000 for the right to receive $20,000 in years 3 and 4 and $1 per unit of output in years 1-4. The machine produced 5,000 units in each year. E would report the following on the installment method:

Year	Cash received	Basis	Gain
1	$5,000	0	$5,000
2	5,000	0	5,000
3	25,000	$10,000	15,000
4	25,000	10,000	15,000

c. *Both fixed price and specified term.*—When the terms of sale include both a fixed contract price (or a stated maximum) and payments over a specified number of years, the taxpayer must allocate basis over the fixed price (or maximum).

d. *Neither fixed price nor specified term.*—Where the contract specifies no fixed price (or maximum) and payments are not limited to a specified number of years, basis may be recovered ratably over a period of 20 years if the transaction is a sale or exchange.

B. Events causing acceleration of deferred payment income.—1. Section 337 liquidations. Under present law, a corporation generally recognizes no gain upon the distribution of installment obligations to its shareholders pursuant to a twelve-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. Shareholders generally recover basis first rather than allocate basis between notes and other property receives.

Under the proposal, if a corporation sells property pursuant to a section 337 liquidation, receives notes as part of the consideration and distributes those notes in a liquidating distribution, shareholders would report gain as if the stock had been sold on the installment method for the cash or other property received in the liquidating distribution, unless they elect otherwise. Basis would be allocated according to the general rules specified above, either ratably over the value of the property distributed and the face amount of the notes or equally to each year during which a payment may be made from the liquidating corporation or on the notes. Shareholders would be taxed with respect to the notes only upon receipt of payment. If taxpayers elected not to report on the installment method, notes or other obligations would be reported as income at under the general rules set forth in A.1.b.i. and A.2. above. These rules would apply only to notes attributable to sales made by the corporation pursuant to the section 337 liquidation.

A special rule would cover liquidating distributions spanning two taxable years of a shareholder. Under current law, basis is recovered first. This rule would not be changed. In the first year, the shareholder would report gain without regard to what might be received in the second year. This is appropriate since in many cases it will be impossible to predict the form or value of future distributions.

Distributions received in the second year would be subject to a new rule. The shareholder would be treated as if all liquidating distributions had been made in the second year, except that gain reported in the first year would be subtracted from the gain that would have been recognized had the entire distribution occurred in the second year.

Example 6. F is the sole shareholder of corporation X and has a basis of $100,000 in the stock. F causes X to adopt a plan of liquidation pursuant to section 337 in July of year 1. In September of year 1, X sells all of its assets to D for $1,000,000, $500,000 in cash and $500,000 in interest-bearing notes with a fair market value of $350,000, due in equal installments in years 3-6. The cash is distributed in November of year 1 and the notes in February of year 2. F would recognize $400,000 of income in year 1 ($500,000 of cash minus 100,000 of basis).

In year 2, F is treated under the installment method as having received all of the distributions in year 2, factoring out gain reported in year 1. If X had distributed everything in year 2, F would have reported $450,000 in gain ($500,000 cash minus $50,000 basis allocated to cash), and F would have held $500,000 face amount notes with a basis of $50,000. When the $400,000 gain recognized by F in year 1 is subtracted ($450,000 in year 2 minus $400,000) $50,000 of gain remains for F to report in year 2. F's basis for the notes is $50,000, which will be recovered ratably as the notes are paid.

If F elects not to report on the installment method, F reports the same $400,000 in year 1. Again in year 2, F is treated as having received all of the distributions in year 2, subtracting the gain recognized in year 1. In this case, if X had distributed everything in year 2, F would have reported $765,000 in gain ($500,000 − $50,000 in basis attributable to the cash plus $350,000 − $35,000 in basis attributable to the notes). When the $400,000 gain recognized in year 1 is subtracted, F recognizes $365,000 of gain in year 2. F holds the notes at a basis of $365,000 ($50,000 basis allocated to the notes plus $315,000 gain recognized upon receipt of the notes).

2. Sales to related parties. Sales to family members, controlled corporations and partnerships, or to trusts and estates in which any specified related person has a specified interest would be subject to a special disposition rule. A Subsequent sale by the purchaser within two years of the original sale will result in the acceleration of gain recognition on the installment obligations held by the seller equal in amount to the consideration received in the second sale (or amount of charitable contribution deduction taken if the subsequent disposition is a contribution to a charitable organization). However, a subsequent sale for deferred payment will be treated as a disposition of the obligation from the original sale only when payment is received.

The proposal is narrowly structured to deny deferred payment treatment only where the related party unit is attempting to achieve the dual goals of tax deferral and immediate use of the economic benefits of the transferred property. Accordingly, it is appropriate to define related persons broadly to include the relationships defined in sections 267(b) and 707(b)(1). In addition, family members should be expanded to include spouses of the persons described.

Example 7. G sells property with a $10,000 basis in year 1 to spouse S for $45,000 in notes, due $15,000 each in years 3-5. Still in year 1, S sells the property for $45,000 cash. G is treated as having disposed of S's obligations in year 1.

Example 8. Same facts as Example 7 except that S sells the property in year 1 for $45,000 in notes, payable $25,000 in year 3 and $20,000 in year 4. G is treated as having disposed of obligations in the face amount of $25,000 in year 3 and $20,000 in year 4. Although S received payment after the two-year period had elapsed, the fact that the sale occurred within that time causes this provision to apply.

C. Clarification of current law.—1. Cancellation of obligations. Under some current case law, it may be argued that a cancellation of an installment note is not a disposition. The proposal would make it clear that there is a taxable disposition when the holder cancels or forgives an obligation or bequeaths an item of income in respect of a decedent to the obligor.

2. Obligations held in trust which are transmitted at death. Some court decisions have held that the section 691(c) deduction is not available for deferred receipts on installment obligations held by a trust that is included in a decedent's estate. The section 691(c) deduction would be available for installment obligations in existence at the date of the decedent's death held by a trust that is included in the decedent's gross estate.

3. Sale for less than fair market value. A taxpayer who disposes of installement obligations in a sale for less than a fair market value (e.g., to a related person)

would be taxed on the excess of the fair market value of the obligation over its basis, and not on the lower sales price.

D. *Miscellaneous provisions.*—1. Selling Expenses. Selling expenses would be deducted from the gross sales price.

2. Two Payment Rule. The rule requiring payments in two or more taxable years would be eliminated explicitly.

3. Marketable Securities. Marketable securities could not be sold on the installment method. The definition of "marketable securities" would exclude large blocks not immediately saleable in an open market transaction.

As discussed above, deferred payment reporting is designed to provide relief to taxpayers who might have difficulty paying tax when receipt of proceeds is deferred to future years. In the case of marketable securities, the decision to sell for future payments and thereby create a situation which in form qualifies for deferred payment treatment lies totally in the hands of the seller. A ready cash market is available. The only purpose for sale on those terms is to qualify for tax deferral. This is inconsistent with the relief nature of section 453.

THE SUBTITLE F REVISION ACT OF 1979

In addition to providing a forum to achieve simplification of substantive areas of the tax law, this Subcommittee can make a significant contribution to fostering efficient administration of the tax laws. The Subtitle F Revision Bill is a good example of this process and Treasury looks forward to participating, with other interested professional groups, in continuing efforts to to simplify tax administration. With two minor amendments, Treasury supports S. 1062.

I. Section 2.—Section 2 of the bill would amend section 6343(b) to provide that where there is a subsequent administrative determination by the Internal Revenue Service that a seizure for the collection of a delinquent taxpayer's liability was wrongful, interest, at the statutory rate, would be paid to the taxpayer. Under the present law, interest is payable only when there is a judicial determination of wrongful levy. Interest ought also to be payable when there is an administrative determination by the Internal Reveune Service that a wrongful levy has been made. Therefore, Treasury supports this change. We do, however, recommend a technical amendment. The bill provides that interest is to be paid until the date the money is returned. Literally, this is impossible to do. Under section 6611(b)(2) interest is computed until a date preceding the check by not more than 30 days. We suggest that this section of the bill be amended to provide that interest be paid for the period described in section 6611(b)(2).

II. Sections 3 and 4.—Sections 3 and 4 of the bill incorporate changes proposed by the Internal Revenue Service. Presently, private foundations are required to file two annual returns, one under section 6033 and another under section 6056. The proposal would consolidate the two reporting requirements into one, under section 6033. In addition, non-exempt charitable trusts described in section 4947(a)(1), whose returns are presently filed pursuant to section 6011, will also be required to file the annual return (including the additional reporting requirements heretofore required under section 6056) required under section 6033.

The proposed change would subject all private foundations to section 6033 and would permit a wholesale consolidation of sections 6033 and 6056. In addition to streamlining the federal filing requirements for private foundations, the proposal would facilitate efforts underway to bring state filing requirements into line with the federal requirements. If the efforts to coordinate state and federal filing requirements prove successful, the net effect would be a very substantial reduction in the paperwork burden on the Internal Revenue Service, state governments and affected foundations. This would be welcome simplification and the Treasury supports these sections of the bill.

III. Section 5.—Section 5 of the bill would repeal section 6658, which provides for an additional 25 percent penalty in the case of termination assessments. This change was originally proposed in 1976 in connection with revisions to the termination and jeopardy assessment procedure in the Tax Reform Act of 1976.

It has been the experience of the Internal Revenue Service that this provision, which provides an additional penalty, is not needed. Consequently, the Treasury supports this section.

IV. Section 6.—Section 6 would eliminate the requirement that corporations file a return with the Internal Reveune Service concerning certain stock options. The section also eliminates the requirement, in section 6039, that a corporation furnish certain information to a person who exercises a restricted stock option.

Treasury understands there are still some restricted stock options outstanding. The information supplied by corporations pursuant to section 6039 is necessary to enable holders of stock acquired through the exercise of restricted stock options to determine their basis. Thus, while Treasury supports this section of the bill we suggest that it be amended to continue to require corporations to furnish information to individuals who exercise restricted stock options.

V. Section 7.—Tax professionals feel that many individuals do not become aware of their gift tax return responsibilities until a review of transactions for the previous calendar year is made in connection with their individual income tax return, due April 15. At this time the gift tax return is already late.

Section 7 would coordinate the time for filing gift tax returns for the fourth calendar quarter with the April 15 income tax return filing date in order to consolidate an individual's tax responsibilities on one date. An extension of time to file an income tax return will also extend the time to file the fourth quarter gift tax return. The Treasury does not oppose this provision.

VI. Section 8.—Section 8 would permit excise tax information to be disclosed to state tax officials. The Treasury supports this provision.

SUMMARY

The Treasury enthusiastically endorses the goal of tax simplification. With the minor modifications suggested above, we support S. 1062. Moreover, we believe the installment sale area is an appropriate place to begin the process of substantive simplification and entertain the hope that all interested parties will cooperate in an effort to consummate this project successfully. We further believe that if the proposals set forth in this statement are adopted, two major causes of complexity in the deferred payment area, e.g., whether a transaction is "open" or "closed" and whether a promise of future payment has an ascertainable fair market value, will be eliminated, commercial transactions will not be structured artificially to achieve full basis recovery prior to the recognition of any gain and the deferred payment reporting privilege will be made available in a uniform and fair manner.

Senator BYRD. The next subject is stock accribdcion. Che witness will be Mr. Sheldon M. Bonovitz, tax section, American Bar Association.

Good afternoon, Mr. Bonovitz. Welcome, and you may proceed.

STATEMENT OF SHELDON M. BONOVITZ, ON BEHALF OF THE TAX SECTION, AMERICAN BAR ASSOCIATION

Mr. BONOVITZ. Thank you. I am pleased to testify on behalf of the tax section of the American Bar Association to express its views concerning the creation of a single set of attribution rules to be applied to certain provisions of the Internal Revenue Code, in lieu of the multiple set of attribution rules which are presently applied to these provisions.

With your permission, Mr. Chairman, I would like to submit both my written statement and the tax section's legislative recommendation for the record and briefly summarize some of the points in my statement.

Senator BYRD. Your statement and the tax section's legislative recommendation will be published in the record.

Mr. BONOVITZ. Thank you.

In 1968, the American Bar Association adopted the tax section's legislative recommendation to create a uniform set of attribution rules. This legislative recommendation was a production of more than 10 years of extensive study by the tax section of the American Bar Association in which many of its leading members participated.

Under the legislative recommendation, six sets of attribution rules are superseded by one set of attribution rules, those contained in section 318, which is amended.

The attribution rules contained in sections 267, 425, and 1563 are repealed in their entirety and the attribution rules contained in sections 544 and 554 are substantially modified so as to make applicable the rules of section 318 to these attribution rules.

Section 318 consists of two subsections. Subsection (a) sets forth the general rules of constructive stock ownership and subsection (b) sets forth the substantive tax provisions to which the rules as described in subsection (a) apply.

The legislative recommendation substantially amends the general rules of attribution contained in section 318(a) in the areas of family attribution; attribution to corporations, partnerships, estates and trusts; attribution from corporations, partnerships, estates and trusts; and attribution in the case of ownership of stock options. The legislative recommendation then applies the general rules of section 318(a) to all of the provisions of the code to which the six sets of attribution rules were formerly applied.

It is interesting to note that the proposal specifically applies to 28 code provisions and to another 100 code provisions although not expressly referred to in subsection (b). Under current law, the cross-reference of section 318(a) is only specifically to eight code provisions under section 318(b).

In the evolution of this legislative recommendation, each substantive Federal tax committee of the tax section carefully reviewed the specific substantive provisions under its jurisdiction to which the general rule of section 318(a) would apply.

Many recommendations of these committees contained exceptions or modifications to the general rule of section 318(a) in light of the countervailing purposes of these substantive provisions, when balanced against the objective of a single rule of attribution. The final legislative proposal contains many of the exceptions or modifications recommended by these substantive committees.

Today, in 1979, the tax section continues to strongly advocate legislation which would provide a single set of attribution rules. A single set of attribution rules will achieve simplification and greater tax certainty in areas of the tax law which are highly complex and yet are areas in which the general tax practitioner often finds himself representing and advising clients in common business transactions, without any degree of certainty as to whether his advice is correct. Also, the existing multiple, sets of attribution rules create an area of the tax law that is extremely difficult for the Government to administer, to assure there is compliance.

The reasons for enacting legislation in 1979 to create a uniform set of attribution rules are far stronger that the reasons which existed in 1968. As the chairman is well aware, since 1968, there has continued to be a proliferation of complex tax laws, and with this proliferation the multiple sets of attribution rules have been applied to these new complex provisions, further complicating the law in the attribution area.

What must be done in 1979, in order to accomplish a uniforn set of attribution rules? The tax section's proposed general rule of section 318(a) should be reviewed in light of the developments in the law since 1968. However, it would appear that the proposed general rule has stood the test of time very well and may be capable of enactment in essentially the form as contained in the 1968 legislative recommendation.

With respect to legislation enacted since 1968, the proposed general rule of section 318 must be studied to determine whether it can be applied to such recently enacted legislation as proposed or whether some exception or modification should be made to the general rule, as was the case with certain provisions enacted prior to 1969.

With respect to substantive provisions enacted prior to 1969, again, section 318(a) must be studied in light of any developments in the law involving these provisions since 1968. However, because of the exhaustive work done by the tax section in 1968 in this area, it would seem this effort should not be nearly so great and should involve merely updating the tax section's work with respect to these pre-1969 provisions.

The tax section's legislative recommendation should provide an excellent foundation on which to build a solid piece of legislation in 1979 with a minimum of effort. The goals of simplication and tax certainty have generally in the past been pushed aside and to the background at the expense of accomplishing substantive tax legislation. The goal of this legislative proposal is solely that of achieving simplification and tax certainty in an area of the tax law that admittedly is very complex but yet is an area where the general tax practitioner oftentimes finds himself mired.

The resources necessary to accomplish the objective of a single set of attribution rules, in the short run, seem fairly significant, however, their use can be more than justified in view of the long-term objective that can be accomplished with the passage of a unform set of attribution rules which will be substituted for the existing sets of six complex attribution rules which apply today.

The Treasury's response to the tax section's statement expresses general agreement with it, cautioning, however, that it might be difficult to replace six sets of attribution rules with one set. It suggests that perhaps three sets of attribution rules may necessarily evolve. Whether three sets of attribution rules evolve from the present six sets, or one set, it is important to note that the Treasury recognizes that importance of this effort and supports it. The 1968 legislative recommendation did accomplish the task of fitting all six sets of attribution rules into one set of attribution rules, with exceptions or modifications where required in light of the objective of specific substantive code sections.

Thank you, Mr. Chairman.

Senator BYRD. Thank you very much.

[The prepared statement of Mr. Bonovitz follows:]

STATEMENT OF SHELDON M. BONOVITZ, ON BEHALF OF THE TAX SECTION OF THE AMERICAN BAR ASSOCIATION

My name is Sheldon M. Bonovitz and I appear on behalf of the Tax Section of the American Bar Association to present the Tax Section's views on the advisibility of providing a single set of constructive stock ownership rules to be applied to certain provisions of the Internal Revenue Code in lieu of the multiple sets of constructive stock ownership rules which are now applicable to these provisions.

We are filing simultaneously with this statement the Tax Section's legislative recommendation,[1] adopted by the American Bar Association, (the "Recommendation"), which directs the Tax Section to urge upon the proper committees of Congress its legislative recommendation to create a single set of rules relating to the

[1] Recommendation 1968-1, 21 Tax L. 921 (1968).

constructive ownership of stock to be applied to specific provisions of the Intenal Revenue Code.

Since the adoption of its legislative recommendation, the Tax Section has continued to strongly advocate that Congress enact legislation to provide a single set of constructive stock ownership rules. Such legislation, if adopted, would significantly contribute to reducing complexity in areas of the tax law that are far too complex for the general tax practitioner to properly advise his clients with confidence as to the correctness of his advice and far too complex for the Government to administer in order to assure there is taxpayer compliance.

The goal of simplication and certainty in tax transactions is one that is shared by the taxpayer and the Government. The Tax Section feels that the reasons for proposing the creation of a single set of attribution rules in 1979 are far stronger than those which existed in 1968. Since 1968 the proliferation of highly complex tax legislation has continued unabated. Such proliferation has continued to generate the use of varying sets of attribution rules to certain of the provisions in recently enacted legislation.

The Tax Section's legislative recommendation is the product of extensive study by virtually each of the Section's substantive Federal tax committees. The Committee on Affiliated and Related Corporations, of which I am the current chairman, made its initial legislative recommendation in 1967 at the Tax Section's 1967 annual meeting. At that meeting, each of the substantive committees of the Tax Section was directed to review the legislative proposal and suggest modifications to the proposal as they affect provisions within their respective jurisdictions to which the rules would apply. During the following year, each subcommittee carefully reviewed the legislative proposal. Most of the recommendations of these subcommittees were incorporated in the final legislative proposal.

The Tax Section's 1968 legislative proposal represents a major effort on the part of many of its most outstanding and qualified members to simplify an enormously complex area of the law. The basic structure of this legislation is as valid today as it was in 1968. It constitutes the framework on which a 1979 legislative proposal can be built.

Six sets of attribution rules contained in §§ 267(c), 318(a), 425(d), 544(a), 554(a) and 1563(e) are superseded by one set of attribution rules. Section 318(a), which contains the most widely recognized, utilized and understood set of attribution rules is amended, §§ 267(c), 425(d) and 1563(e) are repealed, and §§ 544(a) and 554(a) are substantially rewritten so as to incorporate by reference most of the rules of amended § 318(a).

From the time of enactment of § 318 in 1954, there was widespread criticism of the lack of uniformity among the various Code provisions containing attribution rules.[2] In response to this criticism, in the late 1950's the Tax Section began its work on a new § 318, which effort appeared in § 19(a) of HR 11450. Unfortunately, there was no legislative solution to this problem at that time and the attribution rules continued to proliferate and grow more complex. In 1962 and 1964 the attribution rules of §§ 958 and 1563(e) were enacted, and Congress enacted other new code sections to which new and old attribution rules applied—e.g., §§ 422-424, 964, 1248, 1249 and 1561-1563.

In 1964 the Tax Section appointed a special subcommittee in investigate the possibility of drafting a uniform set of attribution rules. Out of this subcommitttee's work came the legislative recommendation of the Tax Section. The Tax Section's legislative recommendation reflects more than ten years of study by the Section and should provide the basic structure on which to build a uniform set of attribution rules under current law.

Although it is difficult to summarize the very thorough discussion contained in the Tax Section's Recommendation explaining proposed § 318 and its application to the various provisions of the Internal Revenue Code, it nevertheless is appropriate to discuss its main features and some of the underlying assumptions and reasoning behind the proposed changes to § 318.

FAMILY ATTRIBUTION (§ 318(a)(1))

Under the Recommendation, there is no attribution between parents and adult children or from grandchildren to grandparents, as in present § 318(a)(1). The Reccommendation reduces the size of the family to approximately that used in § 1563(e) of current law.[3] One of the basic principles of the Recommendation is that there

[2] See Ringel, Surrey and Warren, "Attribution of Stock Ownership in the Internal Revenue Code", 72 Harv. L. Rev. 209 (1958).

[3] Section 1563(e) adopted many of the suggestions made by Messrs. Ringel, Surrey, and Warren in their landmark article.

should be no mandatory attribution among family members unless there is overwhelming support for the presumption of factual control. Because factual control is frequently absent in the case of adult children and their parents and because adult children are often the intervening control factor between grandchildren and grandparents, attribution is accordingly limited. Similarly, there is no attribution between siblings.

The general narrower definition of the family is, however, broadened through exceptions for purposes of certain specific provisions.[4]

ATTRIBUTION FROM PARTNERSHIPS, ESTATES, TRUSTS, AND CORPORATION (§ 318(a)(2))

Under the Recommendation, a five percent interest, actual or constructive, in a partnership, estate, trust or corporation results in attribution. Attribution is felt appropriate, based on a five percent interest, since it reflects the cosntructive owner's indirect economic interest in the actual owner's property.

With respect to partnerships, stock owned by a partnership is considered as being owned by any partner having an interest of five percent or more in the capital of the partnership in proportion to his interest in capital. The Recommendation uses an interest in capital rather than an interest in profits to measure attribution because the concept of capital is both more measurable and more in accord with the principle of reflecting indirect economic interests than is the concept of profits. Under current § 318, stock owned by a partnership is considered as being owned proportionately by its partners irrespective of the percentage of ownership of the partner in the partnership. Nor does current law specify how a partner's proportionate interest in a partnership is to be measured.

A beneficiary's five percent interest in an estate or trust also results in attribution. Stock owned by an estate or trust is considered as being owned by any beneficiary having an actuarial interest of five percent or more in such estate or trust in proportion to that beneficiary's actuarial interest in the estate or trust.

Under current § 318, there is no five percent threshold ownership requirement. Stock is constructively owned by beneficiaries of trusts in proportion to their actuarial interests and by beneficiaries of estates based on their proportionate interest in the estates.

The Recommendation also changes § 318 to eliminate attribution of stock to a beneficiary who could not under any circumstances receive from the estate or trust an interest in such stock. The ownership of such stock is instead attributed to the other beneficiaries in proportion to their relative actuarial interests.

With respect to corporations, the Recommendation makes two major changes to § 318. It reduces the percentage ownership required for attribution to a shareholder from fifty percent under current law to five percent and excludes the value of stock which is limited and preferred as to dividends from all computations. The Recommendation also provides for two different attribution rules, one where the substantive provision is solely concerned with the actual or constructive voting power of a shareholder; e.g., §§ 302(b)(2)(B), 951(b) and 957(a), and the other where the substantive provision is concerned with the value of corporate stock. For purposes of determining a shareholder's voting power, attribution from corporations is determined solely on the basis of the shareholder's voting power in corporations which own stock in the corporation with respect to which the ultimate determination of voting power is being made. With respect to attribution based upon the value of stock in the corporation, the stock to be included includes the value of voting preferred as well as all other voting stock. The inclusion of voting preferred stock in the computation is deemed advisable in view of the considerable significance such stock has gained in recent years in connection with corporate acquisitions and reorganizations.

ATTRIBUTION TO PARTNERSHIPS, ESTATES, TRUSTS, AND CORPORATIONS (§ 318 (a)(3))

In the area of so called "back attribution" the Recommendation establishes the general rule of requiring that a partner, beneficiary, or shareholder possess at least a fifty percent interest in such entity to bring attribution into play. The Recommendation takes the position that since these entities neither factually control their partners, beneficiaries or shareholders, nor have an economic interest therein, attribution should not occur unless the entity can properly be regarded as the alter ego of the person whose stock is to be attributed to it.

It should be noted that by reason of § 318(a)(5)(E)(iii) of the Recommendation, stock attributed to a person under other rules of constructive ownership is taken into account in determining whether the fifty percent requirements have been satisfied. For example, if a widow has a forty percent actuarial interest in a trust

[4] For example, see the discussion infra., beginning at page 12, discussing §§ 302, 304 and 306.

and each of her two minor sons has a thirty percent actuarial interest in such trust, all stock in the corporation owned by any of them will be attributed to the trust. Another reason for the elimination of the applicability of § 318 where there is less than a fity percent ownership in the entity is the nonexistence of "back attribution" under any other set of attribution rules. It was thought that a very broad concept of back attribution could lead to unforeseen and unfortunate results in these areas. On the other hand, where it was thought appropriate with respect to certain substantive provisions, back attribution was broadened; e.g., §§ 302, 304, 306 and 382.

Under present § 318, all of the stock owned by a beneficiary of a trust (unless the beneficiary's interest in the trust is a "remote contingent interest" in which event there is no attribution to the trust), by a beneficiary of an estate, or by a partner in a partnership is attributable to the trust, estate or partnership, as the case may be, irrespective of the ownership interest in the entity. Thus, 100 percent of the stock of Corporation X owned by partner A is attributed to partnership Z, notwithstanding that A has only a one percent interest in partnership Z.

With respect to back attribution to corporations, stock owned by any shareholder who owns at least fifty percent in value of all of the outstanding stock of a corporation (excluding stock which is non-voting, limited and preferred as to dividends) is considered as being owned by the corporation. Only in the case of back attribution to corporations is the rule under current law similar to the rule in the Recommendation.

OPTIONS (§ 318(a)(4))

The option rules of present § 318(a)(4) were modified in two respects. An option does not result in attribution unless it gives the optionee a significant present interest in the stock in question. The definition of an "option" for attribution purposes is limited to an option which is exercisable within three years of the date of determination of constructive stock ownership at a price not in excess of 150 percent of the fair market value on such date and is not subject to any substantial contingency beyond the control of the beneficiary. Secondary, in determining the percentage stock ownership of an optionee of unissued stock, the unissued stock subject to his option is treated as issued and outstanding.

DIRECTLY OR INDIRECTLY

At each place in current § 318 where the phrase "stock owned, directly or indirectly, by or for" appears, the Recommendation substitutes the phrase "stock owned by". The presence and absence of the phrase "directly or indirectly" in the attribution rules and similar provisions has caused confusion and concern and the Recommendation favors its elimination.

OPERATING RULES (§ 318(a)(5))

The Recommendation uses current § 318(a)(5)(A) through (C) and current (D) with a slight modification. The first three clauses in subparagraph (E) represent a modification of Regs. § 1.318-1(b)(1), (2) and (3). Clauses (iv) and (v) of subparagraph (E) are new changes. With respect to clause (v), it is felt that attempts to avoid the attribution rules through the use of agents or secret agreements as well as any other problems which may arise in identifying actual nonconstructive ownership of stock can be dealt with the aid of proposed clause (v).

SUMMARY OF § 318(a)

The above is only a very general discussion of some of the main features of § 318(a). The Recommendation itself should be consulted for a more detailed explanation. It would seem that virtually all of the changes for § 318(a) contained in the Recommendation can be embodied in any legislation in 1979 to amend § 318.

APPLICATION OF ATTRIBUTION RULES (§ 318(b))

Proposed § 318(b) sets forth the applicability of the new attribution rules described in § 318(a). Under current § 318(b) there is a cross reference to eight sections to which the attribution rules of § 318 apply. Under the recommendation, the provisions of § 318(a) are extended to apply to twenty-eight code provisions. These twenty-eight provisions are presently covered by §§ 267(c), 544(a), 554(a), 958(a) and 1563(e) as well as 318(a). The twenty-eight sections listed in proposed § 318(b)(1) do not fully describe the applicability of proposed § 318. It is necessary to consider many other provisions which incorporate such rules by reference or refer to some other section which in turn refers to § 318(a).

Paragraphs (2), (3), and (4) of proposed § 318(b) extend the scope of § 318 to additional sections.

SPECIFIC EXCEPTIONS TO GENERAL RULE OF SECTION 318

Certain stock redemptions.—For purposes of the Sections 302, 304 and 306, in order to prevent excessive opportunities for tax avoidance, the attribution rules of proposed § 318(a) applicable to members of the family and to partnerships, estates and trusts are broadened. Stock transferred between parents and adult children and from grandchildren within the preceding ten years remain subject to attribution. Also, where partners who own stock in a corporation have in the aggregate an interest of fifty percent or more in the capital of a partnership such stock is considered as owned by the partnership, or where beneficiaries of an estate or trust who own stock in a corporation have in the aggregate an actuarial interest of fifty percent or more in the estate or trust such stock is considered as being owned by the estate or trust.

The loopholes which these exceptions are designed to eliminate may be illustrated by the following examples:

A one-hundred percent stockholder transfers some of his stock to an adult child (or to a trust for same) and it is promptly redeemed. Without attribution, the redemption might qualify as a sale or exchange under Section 302.

A, B, C and D each own twenty-five precent of the stock of a corporation. They transfer some of the stock to a partnership in which they have equal interests (or possibly form one for this purpose) and the transferred stock is then redeemed. Under the recommendation, without any exception, this might qualify as a sale or exchange under Section 302.

Loss carryovers.—The fifty percent limitation on back attribution under Section 318(a)(3) is reduced to five percent for purposes of Section 382(a)(3) since Congress' intent quite clearly was to favor a broad concept of back attribution in this area.[5]

FAMILY ATTRIBUTION IN PERSONAL HOLDING COMPANIES

Broader family attribution rules than under proposed Section 318(a)(1) of the Recommendation are applied to the Code provisions dealing with domestic and foreign personal holding companies. Family attribution includes all children and parents, as well as grandchildren, grandparents, brothers and sisters. It is felt that the concentration of stock ownership for personal holding company status provided in Sections 542(a)(2) and 552(a)(2) (ownership of more than fifty percent by not more than five individuals) was designed with the broad family attribution rules of Section 544(a) and 554(a) in mind, that a broad family definition was appropriate in grouping ownerships for personal holding company purposes and that the substantial narrowing of the family group in the Recommendation would make avoidance of the personal holding company tax unduly easy.

The above three specific exceptions to the general rule of proposed § 318(a) illustrate the work of the Tax Section's substantive subcommittees in applying the general rule of Section 318 to the particular provisions under which they have jurisdiction.[6]

LEGISLATION ENACTED SINCE 1968 TO WHICH THE ATTRIBUTION RULES APPLY

Since the date of approval of the Recommendation in 1968 the existing attribution rules have been applied to additional code sections dealing with a wide variety of problems of Federal taxation. For example, the attribution rules of § 267 have been applied in §§ 447, 464, 465, 613A, 4946 and 6166; the rules of § 318 have been applied in §§ 382, 465, 856, 995, 1239 and 2036; and the rules of § 1563 have been applied to §§ 50B, 414 and 613A. Also certain Sections to which the attribution rules applied in 1968 have been modified or repealed. For example, § 382 was newly enacted and the qualified stock option rules were repealed under the Tax Reform Act of 1976.[7]

STEPS TO BE TAKEN TOWARD ENACTMENT OF A NEW §318 UNDER CURRENT LAW

What must be done in 1979 is exactly what was done in 1968. Section 318(a) as proposed in the Recommendation must be carefully reviewed in light of the developments in the law since 1968. It would seem, however, that proposed § 318 has stood the test of time well and may be capable of adoption in essentially the form as

[5] Section 382 was newly enacted under the Tax Reform Act of 1976. The effective date of new § 382 was deferred until January 1, 1980 under the Technical Corrections Act of 1978. § 382 would have to be reviewed in order to determine how proposed § 318(a) should be applied to it. See discussion infra, beginning at page 14.

[6] Two other exceptions contained in the Recommendation involve a broadening of family attribution under subparagraph F and modifications to § 318(a)(4) as it affects certain Employee Stock Option rules.

[7] The effective date of new § 382 was, however, deferred until January 1, 1980 under the Technical Corrections Act in order to enable Congress to re-examine the appropriateness of the Section as corrected in 1976.

contained in the Recommendation. Also, each of the provisions enacted subsequent to the adoption of the Recommendation must be carefully reviewed to determine whether proposed Section 318 can be applied to such sections, or whether exceptions must be made for certain of these provisions. Lastly, the existing substantive provisions to which Section 318(a) applies must be carefully reviewed in light of any legislative changes or other developments in the law which could affect the application of the attribution rules.

With a careful review of these newly enacted sections, and a general review of proposed Section 318(a) and (b) under the law as it exists in 1979, it should not be difficult to draft a new Section 318 which greatly simplifies the law in the attribution area.

CONCLUSION

The attribution rules are used not only by the sophisticated tax practitioner, but also by the less sophisticated practitioners in many conventional business transactions. Accordingly, it is imperative that these rules be simplified and made workable. One leading tax authority's conclusion in 1965 to his extensive analysis of the attribution rules is even more applicable in today's jumbled tax world:

"The foregoing may indicate that the attribution rules are only the most obvious symptom of a disease called multiplicity and complexity which runs throughout the Code . . . The situation is so bad at present that even the most skilled tax practitioner, after hours of costly research, may either make errors or have to tell his client there is no clear answer. By thus converting tax practice into a form of gambling or guessing game, Congress has done little to establish confidence in our revenue raising machinery.[8]

This Committee is to be commended for conducting hearings on this vital, albeit complex subject. It is believed that simplification and certainty in the attribution rule area is a significant project worthy of the necessary resources that must be marshalled in order to effect a sound single set of constructive ownership rules. The Tax Section's legislative proposal should provide an excellent foundation toward accomplishing this result.

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[8] Goldstein, "Attribution Rules: Undue Multiplicity, Complexity Can Create Liabilities" 15th Ann. Tulane Tax Inst. 384, at p. 440 (1965).

Legislative Recommendation of the American Bar Association Dealing With Attribution of Stock Ownership

Resolved, That the American Bar Association recommends to the Congress that the Internal Revenue Code of 1954 be amended so as to create a single set of rules relating to the constructive ownership of stock to be applied to specific provisions of Subtitles A and F, subject to certain modifications contained in such provisions; and

Further Resolved, That the Association proposes that this result be achieved by amending section 318 of the Internal Revenue Code of 1954, by expanding its applicability, and by repealing or amending certain other Code provisions; and

Further Resolved, That the Section of Taxation is directed to urge the following amendments, or their equivalent in purpose and effect, upon the proper committees of Congress:

Sec. 1. Section 318 of the Internal Revenue Code of 1954 is amended to read as follows (eliminate matter struck through and insert new matter in italics):

SEC. 318 CONSTRUCTIVE OWNERSHIP OF STOCK.

(a) General Rule.—For purposes of those provisions of ~~this subchapter to which the rules contained in this section are expressly made applicable~~ *Subtitles A and F listed or described in subsection (b), a person shall be considered as owning any stock of which he is made the constructive owner under the provisions of this section in addition to any other stock owned by such person*—

(1) Members of family.—

(A) In general.—An individual shall be considered as owning stock owned~~, directly or indirectly,~~ by ~~or for~~—

(i) his spouse (other than a spouse who is legally separated from the individual under a decree of divorce, *whether interlocutory or final, or a decree of* separate maintenance), and

(ii) his children ~~grandchildren, and parents~~ *who have not attained the age of 21 years, and*

(iii) if the individual has not attained the age of 21 years, his parents.

(B) Effect of adoption.—For purposes of subparagraph (A)(ii) *and (iii)*, a legally adopted child of an individual shall be treated as a child of such individual ~~by blood~~.

(2) Attribution from partnerships, estates, trusts and corporations.—

(A) From partnerships ~~and estates~~.—Stock owned~~, directly or indirectly,~~ by ~~or for~~ a partnership ~~or estate~~ shall be considered as being owned ~~proportionately~~ by ~~its partners or beneficiaries~~ *any partner having an interest of 5 percent or more in the capital of the partnership in proportion to his interest in capital.*

(B) From *estates or* trusts.—

~~(i) Stock owned, directly or indirectly, by or for a trust (other than an employees' trust described in section 401(a) which is exempt from tax under section 501(a)) shall be considered as owned by its beneficiaries in proportion to the actuarial interest of such trust.~~

(~~ii~~) Stock owned~~, directly or indirectly,~~ by ~~or for any portion of~~ a trust, *a portion* of which a person is considered ~~the owner~~ *as owning* under subpart E of part I of subchapter J (relating to grantors and others

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treated as substantial owners), shall be considered as *being* owned by such person *to the extent that he is treated as the owner of the trust.*

(ii) Except to the extent that clause (i) applies, stock owned by an estate or trust shall be considered as being owned by any beneficiary having an actuarial interest of 5 percent or more in such estate or trust in proportion to that beneficiary's actuarial interest in the estate or trust, except that stock owned by an esate or trust shall not be considered as being owned by those beneficiaries who cannot under any circumstances receive from the estate or trust any interest in the stock (or proceeds of disposition thereof), or the income therefrom, but shall be considered as being owned by the other beneficiaries in proportion to their relative actuarial interests in the estate or trust.

(iii) This subparagraph shall not apply to stock owned by any employees' trust described in section 401(a) which is exempt from tax under section 501(a).

(C) FROM CORPORATIONS.—~~If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation.~~

(i) For purposes of determining a shareholder's voting power where such a determination is required under a provision listed or described in subsection (b), stock owned by a corporation shall be considered as being owned by any shareholder of that corporation who owns stock possessing 5 percent or more of the total combined voting power of all classes of stock of such corporation in that proportion which the voting power of the stock which such shareholder so owns bears to the total combined voting power of all the stock in such corporation.

(ii) For purposes of all other determinations, stock owned by a corporation shall be considered as being owned by any shareholder of that corporation who owns 5 percent or more in value of its stock in that proportion which the value of the stock which such shareholder so owns bears to the value of all the stock in such corporation. For this purpose, in determining the value of the stock owned by the shareholder and the value of all the stock in such corporation there shall be excluded the value of nonvoting stock which is limited and preferred as to dividends.

(3) ATTRIBUTION TO PARTNERSHIPS, ESTATES, TRUSTS AND CORPORATIONS.—

(A) TO PARTNERSHIPS ~~AND ESTATES~~.—Stock owned~~, directly or indirectly,~~ by ~~or for~~ any partner ~~or beneficiary of an estate~~ *having an interest of 50 percent or more in the capital of a partnership* shall be considered as *being* owned by the partnership.

(B) TO *ESTATES AND* TRUSTS.—

~~(i) Stock owned, directly or indirectly, by or for a beneficiary of a trust (other than an employees' trust described in section 401(a) which is exempt from tax under section 501(a)) shall be considered as owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest. For purposes of this clause, a contingent interest of a beneficiary in a trust shall be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest, computed actuarially, is 5 percent or less of the value of the trust property.~~

(ii) Stock owned~~, directly or indirectly,~~ by ~~or for~~ a person who is considered the owner of any portion of a trust under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners) shall be considered as *being* owned by the trust.

(ii) Except to the extent that clause (i) applies, stock owned by a

beneficiary having an actuarial interest of 50 percent or more in an estate or trust shall be considered as being owned by the estate or trust.

(iii) This subparagraph shall not apply to stock owned by the beneficiary of an employees' trust described in section 401(a) which is exempt from tax under section 501(a).

(C) TO CORPORATIONS.—~~If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person.~~ *Stock owned by any shareholder who owns at least 50 percent in value of all the outstanding stock of a corporation (excluding stock which is nonvoting, limited and preferred as to dividends) shall be considered as being owned by the corporation.*

(4) OPTIONS.—If any person has an option to acquire stock, such *that* stock shall be considered as being owned by such person. For purposes of this paragraph,—

(A) an option will not result in attribution if it is not exercisable within 3 years of the date of determination of constructive stock ownership, if on such date it is subject to substantial contingencies beyond the control of the optionee, or if on such date the option price exceeds 150 percent of the fair market value of the stock subject to such option;

(B) an option to acquire ~~such~~ an option, and each one of a series of such options, shall be considered as an option to acquire such stock; *and*

(C) in determining the percentage stock ownership of an optionee of stock which is not issued and outstanding, such stock shall be considered as issued and outstanding.

(5) OPERATING RULES.—

(A) IN GENERAL.—Except as provided in subparagraphs (B) and (C), stock constructively owned by a person by reason of the application of paragraph (1), (2), (3), or (4) shall, for purposes of applying paragraphs (1), (2), (3), and (4), be considered as *being* actually owned by such person.

(B) MEMBERS OF FAMILY.—Stock constructively owned by an individual by reason of the application of paragraph (1) shall not be considered as *being* owned by him for purposes of again applying paragraph (1) in order to make another the constructive owner of such stock.

(C) PARTNERSHIPS, ESTATES, TRUSTS, AND CORPORATIONS.—Stock constructively owned by a partnership, estate, trust, or corporation by reason of the application of paragraph (3) shall not be considered as *being* owned by it for purposes of applying paragraph (2) in order to make another the constructive owner of such stock.

(D) ~~OPTION RULE IN LIEU OF FAMILY RULE.~~ *PRIORITY OF RULES.*—For purposes of this paragraph, if stock may be considered as owned by ~~an individual~~ *a person* under paragraph ~~(1) or~~ (4) *and any other paragraph,* it shall be considered as *being* owned by him under paragraph (4).

(E) SPECIAL RULES.—In applying the rules of this section—

(i) a corporation shall not be considered as owing its own stock;

(ii) in any case in which an amount of stock owned by any person may be included in the computation more than once, such stock shall be used in such computation only once and in the manner in which it will impute to the person or persons concerned the largest total stock ownership;

(iii) in determining whether the 5 percent requirement of paragraph (2) or the 50 percent requirement of paragraph (3) has been met, the rules of constructive ownership of this section shall be applied without regard to such percentage limitations;

(iv) a beneficiary's actuarial interest in an estate or trust shall be determined on the assumption that there will be a maximum exercise of

any power in his favor, provided however, that any such power which is limited by an ascertainable standard relating to the health, education, support or maintenance of such beneficiary shall be disregarded; and

(v) a person may be the owner of stock whether or not he is the record owner, but paragraphs (1), (2), (3), and (4) shall exclusively govern the attribution of stock ownership between persons having the relationships described therein.

~~(b) CROSS REFERENCES.—~~

~~For provisions to which the rules contained in subsection (a) apply, see—~~

~~(1) section 302 (relating to redemption of stock);~~
~~(2) section 304 (relating to redemption by related corporations);~~
~~(3) section 306(b)(1)(A) (relating to disposition of section 306 stock);~~
~~(4) section 334(b)(3)(C) (relating to basis of property received in certain liquidations of subsidiaries);~~
~~(5) section 382(a)(3) (relating to special limitations on net operating loss carryovers);~~
~~(6) section 856(d) (relating to definition of rents from real property in the case of real estate investment trusts);~~
~~(7) section 958(b) (relating to constructive ownership rules with respect to controlled foreign corporations); and~~
~~(8) section 6038(d)(1) (relating to information with respect to certain foreign corporations).~~

(b) APPLICATION OF GENERAL RULE.—

(1) PROVISIONS COVERED.—The rules contained in subsection (a) shall be applicable to each of the following provisions except to the extent therein expressly modified or otherwise provided—

(A) section 178(b)(2)(B)
(B) section 179(d)(2)(A)
(C) section 267(b)(2), (3) and (8)
(D) section 302(b)(2) and (3) (as modified by section 302(c)(1), and except as provided in section 302(c)(2))
(E) section 304(c)(1) (as modified by section 304(c)(2))
(F) section 306(b)(1)(A)(ii) and (iii) (as modified by the last sentence of section 306(b)(1)(A))
(G) section 341(d)(1) and (e)
(H) section 382(a) (as modified by section 382(a)(3))
(I) sections 422(b)(7), 423(b)(3) and 424(b)(3)
(J) section 542(a)(2) (as modified by section 544(a))
(K) section 543(a)(4), (6) and (7) (as modified by section 544(a))
(L) section 552(a)(2) (as modified by section 554(a))
(M) section 553(a)(5) and (6) (as modified by section 554(a))
(N) section 707(b)
(O) section 856(d)(2) and (3) (applies to assets and net profits as well as stock)
(P) sections 951(b), 954(d)(3), 957, 1248(a)(2) and 1249 (as modified by section 958(b))
(Q) section 1246(b)(2)
(R) section 1361(f)
(S) sections 1551(b) and 1563(a)(2)
(T) section 6038(d)(1) (as modified by section 6038(d)(1)(A) and (B))
(U) section 6046(a) (as modified by section 6046(c))

(2) INCORPORATION BY REFERENCE.—If the applicability of any of the provisions of subtitles A and F is determined by reference, direct or indirect, to one of the provisions listed in paragraph (1) or described in paragraph (4), the effect of the latter provision shall be determined after the application of the rules of subsection (a).

(3) Interests in property other than corporate stock.—If the rules of subsection (a) are made applicable by paragraphs (1) and (2) of this subsection to property other than corporate stock, such rules shall apply to such property in the same manner as if it were corporate stock.

(4) References to subsection (a) in provisions not listed in paragraph (1).—If any provision of subtitles A and F refers to all or part of subsection (a), such provision shall be given effect in accordance with its terms notwithstanding the fact that it is not listed in paragraph (1).

(5) Section 302(b)(1).—Notwithstanding the fact that the rules of subsection (a) are not expressly applicable to section 302(b)(1), the relationships described in such subsection may be taken into account under section 302(b)(1) along with all other facts and circumstances.

Sec. 2. The following sections of the Internal Revenue Code of 1954, or the indicated portions thereof, are hereby repealed:

178(b)(2)—last sentence
179(d)(2)(A)—parenthetical phrase
267(c)
304(b)(1)—second sentence
341(d)—last sentence
341(e)(8)—next to last sentence
341(e)(10)
425(d)
707(b)(3)
856(d)—last sentence
1235(d)—the words "and (c)" and paragraph (2)
1563(e)
1563(f)(2) and (3)(A)

Sec. 3. The words "as defined in section 267(c)(4)" or "within the meaning of section 267(c)(4)" are hereby replaced by the words "as described in section 318(a)(1)" in the following sections of the Internal Revenue Code:

170(g)(4)
274(e)(5)
503(c), (e) and (j)
681(b)(2) and (5)
1237(a)(2)(A)

Sec. 4. The following amendments to the Internal Revenue Code are hereby made:

(a) In section 382(a)(4), before the words "paragraph (3)" add "section 318(a) as modified by".
(b) In section 543(a)(4), delete "544" and substitute "318(a) (as modified by section 544(a))".
(c) In section 1361(g), delete the words "267(c) other than paragraph (3) thereof" and substitute "318(a)".
(d) In section 1551(b), delete "1563(e)" and substitute "318(a)"; in section 1563(d)(1)(B), delete the words "subsection (e)(1)" and substitute "section 318(a)(4)"; and in section 1563(d)(2)(B), delete the words "subsection (e)" and substitute "section 318(a)".
(e) In sections 542(c)(6)(D), 542(c)(8) and 6035(b)(1) and (2), delete "544(a)(2)" and substitute "544(a)(1)".
(f) In sections 958(b)(3) and 6038(d)(1)(B), delete the figure "50" and substitute "5".
(g) In section 958(a)(2), delete the word "proportionately" and add the following words at the end of the first sentence: "in accordance with the rules of section 318(a)(2) as modified by section 958(b)(3)".
(h) In section 170(g)(4) (twice) and 245(b)(1), delete the words "(directly or indirectly)".

(i) In sections 503(c), 542(b)(4)(A), 681(b)(2), 707(b)(1)(A) and (B), 707(b)(2)(A) and (B), 856(d)(2) (second appearance), (3)(A) and (B), 904(f)(2)(twice), 954(d)(3), 958(b)(2), 1249(b), 1504(d) and following the last semi-colon in section 503(j)(1), delete the words ", directly or indirectly,".

(j) In sections 267(b)(2) and (3), 542(a)(2), 543(a)(6) and (7), 552(a)(2), 553(a)(5) and (6), and 958(a)(2), delete the words, ", directly or indirectly, by or for" and substitute "by".

(k) In section 267(b)(8), delete the words ", directly or indirectly, by or for the trust or by or for" and substitute "by the trust or".

(l) In sections 542(c)(6)(D) and 6035(b)(1) and (2), delete the words "or for" and "directly or indirectly".

(m) In section 542(c)(8), delete the words "directly or indirectly".

(n) In sections 422(c)(3)(B) and 423(b)(3), delete "425(d)" and substitute "318(a)", and in section 424(b)(3) delete "425(d)" and substitute "318(a) other than section 318(a)(4)".

(o) In sections 422(c)(3)(C) and 423(b)(3), delete the words "options shall" and substitute "options described in sections 422(b), 423(a) and 424(b) shall also".

(p) In section 1246(b)(2), delete the words "held, directly or indirectly (within the meaning of section 958(a))," and substitute "owned (within the meaning of section 318(a))".

(q) The sentence, "For constructive ownership of stock, see section 318(a).", shall be added as new sections 178(d), 179(f), 267(e), 341(g), 707(d), 856(e) and 1361(k).

Sec. 5. The following additional amendments to the Internal Revenue Code are hereby made:

(a) Section 302(c)(1) of the Internal Revenue Code of 1954 (relating to constructive ownership of stock in redemptions) is amended to read as follows (eliminate matter struck through and insert new matter in italics):

(1) IN GENERAL.—~~Except as provided in paragraph (2) of this subsection,~~ *In applying* section 318(a) ~~shall apply~~ in determining the ownership of stock for purposes of this section—

(A) MEMBERS OF FAMILY.—In applying section 318(a)(1) (relating to family members), an individual shall also be considered as owning all stock in a corporation owned or considered under section 318(a)(2) as owned by his children who have attained the age of 21 years, his grandchildren and, if the individual has attained the age of 21 years, his parents, where:

(i) such individual owns, or is considered under section 318(a)(2) as owning, any stock in such corporation as a result of a transfer from such member of his family within the 10-year period preceding the date as of which ownership is determined; or

(ii) such member of the individual's family owns, or is considered under section 318(a)(2) as owning, any stock in such corporation as a result of a transfer from such individual within the 10-year period preceding the date as of which ownership is determined.

For purposes of clauses (i) and (ii), stock will be considered as transferred from an individual within the 10-year period if acquired from a person from whom such stock would be attributed to such individual under section 318(a) (as modified by this subparagraph (A)) and who acquired (or is considered under this subpararaph (A) to have acquired) such stock from such individual within such period.

(B) ATTRIBUTION TO PARTNERSHIPS, ESTATES AND TRUSTS.—

(i) TO PARTNERSHIPS.—In applying section 318(a)(3)(A), where partners who own stock in a corporation have in the aggregate an interest

of 50 percent or more in the capital of a partnership, such stock shall be considered as being owned by the partnership.

(ii) TO ESTATES AND TRUSTS.—In applying section 318(a)(3)(B)(ii), except to the extent that section 318(a)(3)(B)(i) applies, where beneficiaries who own stock in a corporation have in the aggregate an actuarial interest of 50 percent or more in an estate or trust, such stock shall be considered as being owned by the estate or trust.

(b) Section 302(c)(2)(B) (relating to transfers within the preceding 10 years causing family attribution in determining whether complete termination of interest has occurred) is amended to read as follows (eliminate matter struck through and insert new matter in italics):

(B) Subparagraph (A) of this paragraph shall not apply if—

(i) any portion of the stock redeemed was acquired~~, directly or indirectly,~~ within the 10-year period ending on the date of the distribution by the distributee from a person the ownership of whose stock would (at the time of distribution) be attributable to the distributee under section 318(a) *(as modified by paragraph (1) of this subsection)*, or

(ii) any person owns (at the time of the distribution) stock the ownership of which is attributable to the distributee under section 318(a) *(as modified by paragraph (1) of this subsection)* and such person acquired any stock in the corporation~~, directly or indirectly,~~ from the distributee within the 10-year period ending on the date of the distribution, unless such stock so acquired from the distributee is redeemed in the same transaction.

For purposes of clauses (i) and (ii), stock will be considered as acquired from a person within the 10-year period if acquired from another person from whom such stock would be attributed to such person under section 318(a) (as modified by clause (i) of this subparagraph) and who acquired (or is considered under this sentence to have acquired) such stock from such person within such period. The preceding sentences *of this subparagraph* shall not apply if the acquisition (or, in the case of clause (ii), the disposition) by the distributee did not have as one of its principal purposes the avoidance of Federal income tax.

(c) Section 304(c)(2) (relating to constructive ownership of stock for purposes of section 304) is amended to read as follows (eliminate matter struck through and insert new matter in italics).

(2) CONSTRUCTIVE OWNERSHIP.—*In applying* ~~S~~ section 318(a) (relating to the constructive ownership of stock) ~~shall apply~~ for purposes of determining control under paragraph (1), ~~For purposes of the preceding sentence, sections 318(a)(2)(C) and 318(a)(3)(C) shall be applied without regard to the 50 percent limitation contained therein.~~ *section 318(a)(1) (relating to family members) shall be applied with the modifications contained in section 302(c)(1)(A), and section 318(a)(3) (relating to corporations, partnerships, estates and trusts) shall be applied with the modifications contained in section 302(c)(1)(B).*

(d) Section 306(b)(1)(A) (relating to dispositions of section 306 stock, other than redemptions, which terminate the shareholder's interest) is amended to read as follows (eliminate matter struck through and insert new matter in italics):

(A) NOT IN REDEMPTION.—If the disposition—

(i) is not a redemption;

(ii) is not, directly or indirectly, to a person the ownership of whose stock would ~~(under section 318(a))~~ be attributable to the shareholder; and

(iii) terminates the entire stock interest of the shareholder in the corporation ~~(and for purposes of this clause, section 318(a) shall apply)~~.

For purposes of clauses (ii) and (iii), in applying section 318(a) (relating to constructive ownership of stock), section 318(a)(1) (relating to family members) shall be applied with the modifications contained in section 302 (c)(1)(A) and section 318(a)(3) (relating to corporations, partnerships, estates and trusts) shall be applied with the modifications contained in section 302(c)(1)(B).

(e) Section 382(a)(3) of the Internal Revenue Code of 1954 is amended to read as follows (eliminate matter struck through and insert new matter in italics):

(3) ATTRIBUTION OF OWNERSHIP.—*In applying* ~~S~~ section 318 (relating to constructive ownership of stock) ~~shall apply~~ in determining the ownership of stock, ~~except that~~ sections ~~318(a)(2)(C),~~ *318(a)(3)(A), 318(a)(3)(B)(ii)* and 318(a)(3)(C) shall be applied ~~without regard to~~ *as if* the 50 percent limitation contained therein *were 5 percent.*

(f) Paragraphs (1), (2), (3), (5) and (6) of section 544(a) of the Internal Revenue Code of 1954 are deleted and section 544(a) is amended to read as follows (insert new matter in italics):

(a) CONSTRUCTIVE OWNERSHIP.—*In applying section 318(a) (relating to constructive ownership of stock)* ~~F~~ *f*or purposes of determining whether a corporation is a personal holding company, insofar as such determination is based on stock ownership, under section 542(a)(2), section 543(a)(7), section 543(a)(6) or section 543(a)(4)—

(1) FAMILY OWNERSHIP.—Such sections shall be applied as though the following modifications were a part of section 318(a)(1) (relating to family members)—

(A) Sections 318(a)(1)(A)(ii) and (iii) shall be inapplicable and an individual shall be considered as owning stock owned by his children, grandchildren, parents and grandparents.

(B) An individual shall be considered as owning stock owned by his brothers and sisters (whether by the whole or half blood).

(C) For purposes of subparagraph (A), a legally adopted child of an individual shall be treated as a child of such individual.

(g) Paragraph (4) of section 544(a) of the Internal Revenue Code of 1954 is renumbered as paragraph (2) and is amended to read as follows (eliminate matter struck through and insert new matter in italics):

(2) APPLICATION OF FAMILY PARTNERSHIP AND OPTION RULES.—~~Paragraphs (2) and (3)~~ *Section 318(a)(1), as modified by paragraph (1) hereof, and section 318(a)(4) shall be applied—*

(A) for purposes of the stock ownership requirement provided in section 542(a)(2), if, but only if, the effect is to make the corporation a personal holding company;

(B) for purposes of section 543(a)(7) (relating to personal service contracts), of section 543(a)(6) (relating to the use of property by shareholders), or of section 543(a)(4) (relating to copyright royalties), if, but only if, the effect is to make the amounts therein referred to includible under such paragraph as personal holding company income.

(h) Paragraphs (1), (2), (3), (5), and (6) of section 554(a) of the Internal Revenue Code of 1954 are deleted and section 554(a) is amended to read as follows (insert new matter in italics):

(a) CONSTRUCTIVE OWNERSHIP.—*In applying section 318(a) (relating to constructive ownership of stock)* ~~F~~ *f*or purposes of determining whether a corporation is a foreign personal holding company, insofar as such determination is based on stock ownership under section 552(a)(2), section 553(a)(5), or section 533(a)(6)—

(1) Family ownership.—Such section shall be applied as though the following modifications were a part of section 318(a)(1) (relating to family members)—

(A) Sections 318(a)(1)(A)(ii) and (iii) shall be inapplicable and an individual shall be considered as owning stock owned by his children, grandchildren, parents and grandparents.

(B) An individual shall be considered as owning stock owned by his brothers and sisters (whether by the whole or half blood).

(C) For purposes of subparagraph (A), a legally adopted child of an individual shall be treated as a child of such individual.

(i) Paragraph (4) of section 554(a) of the Internal Revenue Code of 1954 is renumbered as paragraph (2) and is amended to read as follows (eliminate matter struck through and insert new matter in italics):

(2) Application of family ~~partnership~~ and option rules.~~—Paragraphs (3) and (3)~~ *Section 318(a)(1), as modified by paragraph (1) hereof, and section 318(a)(4)* shall be applied—

(A) for purposes of the stock ownership requirement provided in section 552(a)(2), if, but only if, the effect is to make the corporation a foreign personal holding company;

(B) for purposes of section 553(a)(5) (relating to personal service contracts) or of section 553(a)(6) (relating to the use of property by shareholders), if, but only if, the effect is to make the amounts therein referred to includible under such paragraph as foreign personal holding company income.

(j) Paragraph (1) of section 958(b) is amended to read as follows (eliminate matter struck through and insert new matter in italics):

(1) In applying paragraph (1)(A) of section 318(a)~~,~~—

(A) clauses (ii) and (iii) thereof shall not apply and an individual shall be considered as owning stock owned by his children, grandchildren, parents, grandparents, and his brothers and sisters (whether by the whole or half blood);

(B) for purposes of subparagraph (A), a legally adopted child of an individual shall be treated as a child of such individual; and

(C) stock owned by a nonresident alien individual (other than a foreign trust or foreign estate) shall not be considered as owned by a citizen or by a resident alien individual.

(k) Subsection (c) of section 6046 of the Internal Revenue Code of 1954 is amended to read as follows (eliminate matter struck through and insert new matter in italics):

(c) Ownership of stock.—For purposes of subsection (a), ~~stock owned directly or indirectly by a person (including, in the case of an individual, stock owned by members of his family) shall be taken into account. For purposes of the preceding sentence, the family of an individual shall be considered as including only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants~~ *the provisions of section 318(a)(1), (2)(A), (2)(C) and (5) shall apply and no other provisions of section 318 shall apply.*

(l) Paragraphs (1) and (9) of section 267(b) of the Internal Revenue Code of 1954 are amended to read as follows (eliminate matter struck through and insert new matter in italics):

(1) Members of a family~~, as defined in subsection (c)(4)~~ *of an individual including only his brothers and sisters (whether by the whole or half blood), spouse (other than a spouse who is legally separated from the individual under a decree of divorce, whether interlocutory or final, or a decree of separate maintenance), ancestors and lineal descendants;*

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(9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual *as described in paragraph (1)*.

Sec. 6. The amendments made by sections 1, 2, 3, 4 and 5 shall apply with respect to taxable years beginning after the date of the enactment thereof.

EXPLANATION

Summary

As directed by the Section at the 1967 Annual Meeting, each substantive committee of the Section has reviewed the legislative proposal of the Committee on Affiliated and Related Corporations printed at pages 14-19 of the 1967 Annual Report. Certain modifications to the proposal, which creates a single set of rules relating to the constructive ownership of stock, were recommended by the substantive committees for purposes of particular provisions within their respective jurisdictions to which such rules would apply. The Committee on Affiliated and Related Corporations has accepted most of these recommendations and incorporated them in its proposal; in addition, it has made several changes of general applicability in the proposed rules which are now submitted for final Section approval.

The proposed amendment to § 318 will apply to the many provisions throughout the Code presently covered by such section or one or more of the other sets of rules creating constructive ownership of corporate stock. Thus, in the interests of uniformity and simplicity, §§ 267(c), 425(d) and 1563(e) would be repealed as would most of the statutory rules modifying these sections and § 318(a) for purposes of particular substantive provisions. Sections 544(a) and 554(a) would also be rewritten so as to incorporate by reference most of the rules of the revised § 318. On the other hand, a few exceptions will persist in order to meet the policy objectives of certain substantive provisions—e.g., § 958(b) will continue to modify § 318(a) for purposes of certain provisions dealing with controlled foreign corporations. The proposed § 318(a) is based upon § 19(a) of H.R. 11450 (the so-called A.B.A. tax bill) which in turn incorporates certain improvements now made by Code § 1563(e). Finally, the Committee on Affiliated and Related Corporations has made several novel modifications designed to ameliorate certain problems which have developed under the present proliferation of rules. In order to facilitate an understanding of the present rules and the proposed amendment, a chart designated Appendix A follows this Explanation.

Discussion

Not long after § 318(a) first saw the light of day, critics were calling for its modification and decrying the lack of uniformity among the various Code provisions containing attribution rules. See especially, Ringel, Surrey and Warren, *Attribution of Stock Ownership in the Internal Revenue Code*, 72 Harv. L. Rev. 209 (1958). About this same time the Tax Section commenced work on the revised version of § 318(a) which now appears as § 19(a) of H.R. 11450. Despite these good works, the attribution rules continued to proliferate and grow more complex—notably through the enactment of §§ 958 and 1563(e) in 1962 and 1964, respectively. Moreover, Congress has created many new Code provisions to which the old and/or new rules now apply—e.g., §§ 422-424, 951-964, 1248, 1249 and 1561-1563.

In 1964, the Tax Section appointed a special subcommittee to investigate the possibility of drafting a uniform set of attribution rules which would apply throughout the Code, and in 1965 a member of that subcommittee prepared a lengthy paper, complete with charts, designed to show just how bad the present situation is. See Goldstein, *Attribution Rules: Undue Multiplicity, Complexity*

Can Create Liabilities, 15th Ann. Tulane Tax Inst. 384 (1965). Among other things, this article demonstrated that provisions like § 1563(e), which adopted many of the suggestions made by Messrs. Ringel, Surrey and Warren in their 1958 article, only served to compound the confusion because similar modifications were not made simultaneously in the other sets of rules.

The foregoing recommendation, as noted above, constitutes a single basic set of attribution rules designed to apply to those provisions now covered by §§ 267(c), 318(a), 425(d), 544(a), 554(a) and 1563(e). While the recommendation retains some modifications of the general rules to meet the policy objectives of certain substantive provisions such as §§ 302, 304, 306, 382, 542, 552, 951 and 6038, such exceptions have been kept to a minimum. The entire proposal, consisting of a general set of rules and specific exceptions, will, if approved by the Section, be substituted for § 19(a) in H.R. 11450.

Since the 1967 Annual Meeting, each substantive committee of the Section having jurisdiction over a provision to which the new attribution rules will apply has reviewed the general set of rules and has either approved the applicability of such rules to such provisions or has proposed specific exceptions. The Committee on Affiliated and Related Corporations has accepted the substance of virtually all such exceptions and included them in its revised proposal, principally in Sec. 5 thereof. The reasons given by the various substantive committees for proposing such exceptions are set forth below.

Scope of the Recommendation

Six basic sets of attribution rules, now contained in §§ 267(c), 318(a), 425(d), 544(a), 554(a) and 1563(e), would be superseded by the recommendation. At present, no change is proposed in such quasi-attribution rules as §§ 382(b)(5), 401(d)(9)(B), 542(c)(7) and 851(e). Furthermore, no substantial change is proposed in such provisions as §§ 170(g)(4), 267(b),[1] 341(e)(8), 503(j), 681(b)(2), 954(d)(3) and 1239 which purport to describe or define "related persons" for purposes of fixing the tax consequences of certain transactions. It should be noted, however, that the instant recommendation, by superseding § 267(c) would affect determinations under §§ 267(b) and 341(e)(8). Finally, the recommendation does not deal with the problem of the many similar but differing rules defining an "affiliated group of corporations" (§ 1504), a "controlled group of corporations" (§ 1563), a "controlled foreign corporation" (§ 957(a)), or a "controlled corporation" (§§ 269(a), 332(b)(1), 368(c), 1551(b), etc.).

Family Attribution

The committee believes that, *as a general rule*, there should be no mandatory attribution among family members unless there is overwhelming support for the presumption of factual control. Accordingly, the recommendation reduces the size of the family to approximately that used in § 1563(e) of existing law. I.e., there is no attribution between parents and *adult* children or from grandchildren to grandparents (as in present § 318(a)) because factual control is frequently absent in the former case and the parents themselves are usually intervening control factors in the latter case. As will be seen below, the general definition of the family is broadened through exceptions for purposes of certain specific provisions.

Attribution from Partnerships, Estates, Trusts and Corporations

The committee agreed with the prior Tax Section recommendation that attribution in this area is generally appropriate since it is based primarily upon

[1] Section 5(1) of the proposal, upon the recommendation of the Committee on General Income Tax Problems, would retain the substance of present § 267(b)(1) and (9) and thus differ from § 14(a) of H.R. 11450.

the constructive owner's indirect economic interest in the actual owner's property. Thus, as in H.R. 11450, a 5 percent interest, actual or constructive, in a partnership, estate, trust or corporation will result in attribution. The balance of the changes from present § 318(a)(2) are either derived from H.R. 11450 or are explained below.

Partnerships. H.R. 11450 provides for attribution to a partner in proportion to the greater of his interest in either capital or profits. Upon consideration of the many perplexing problems raised by the necessity of determining a partner's interest in "profits" at a particular point in time, and by the possibility that various partners would have differing interests in different classes of income—which under the regulations are subject to retroactive change up to the time of filing a partnership return for a given taxable year—the committee felt that attribution based on capital interests alone would be far more manageable and yet sufficiently broad—in keeping with the concept of merging indirect economic interests—to accomplish the purposes of § 318(a)(2)(A). Where attribution is based generally upon economic interest, it seems sensible to determine constructive ownership in accordance with who would receive the stock in question upon the liquidation of the partnership.

Estates and Trusts. As in H.R. 11450, the rules relating to attribution from estates and trusts are unified and based upon a beneficiary's actuarial interest. Unlike the prior Tax Section recommendation, however, the committee has established the primacy of attribution to the grantor of a grantor trust by designating the provision covering such attribution as clause (i) and barring attribution to trust beneficiaries if clause (i) applies.

As in H.R. 11450, stock owned by an estate or trust is not to be attributed to a beneficiary who cannot under any circumstances receive from the estate or trust any interest in such stock, the proceeds of its disposition, or the income therefrom. Rather, the ownership of such stock is attributed to the other beneficiaries in proportion to their *relative* actuarial interests. Thus, if a mother and son each have a 50 percent interest in an estate but all of the decedent's stock in X Corporation is specifically bequeathed to the son, no stock ownership is attributed to the mother and 50/50, or 100 percent, is attributed to the son.

As in H.R. 11450, § 318(a)(5)(E)(iv) provides that a beneficiary's actuarial interest in an estate or trust shall be determined on the assumption that there will be a maximum exercise of any power in the fiduciary in his favor, but the committee has added a proviso to the effect that any such power which is limited by an ascertainable standard relating to the health, education, support or maintenance of such beneficiary shall be disregarded. The committee thus felt that a discretionary interest subject to a condition which is generally beyond the beneficiary's control should not result in attribution. Several suggestions similar to the one which gave rise to the modification just mentioned were deemed to have considerable merit by the committee but were not incorporated in the recommendation in the interest of brevity.[2] It is anticipated that the substance of some of these suggestions would be incorporated in the regulations under § 318(a)(2)(B)(ii).

Corporations. H.R. 11450 makes two major changes in § 318(a)(2)(C) as presently in effect; it reduces the percentage ownership required for attribution to a shareholder from 50 percent to 5 percent and excludes the value of stock which is limited and preferred as to dividends from all computations. The committee and the members of other committees who commented on this provision were troubled by the applicability of an attribution rule based on the *value* of corporate stock to determinations under substantive provisions which are solely concerned with the actual or constructive *voting power* possessed by certain shareholders; e.g., §§ 302(b)(2)(B), 951(b) and 957(a). Accordingly, the recommendation provides that, for purposes of determining a shareholder's voting power under such provisions, attribution from corporations will be determined

[2] *E.g.*, suggestions for computing actuarial interests under "sprinkle" trusts, accumulation trusts and those affected by powers of appointment.

solely on the basis of a shareholder's voting power in corporations which own stock in the corporation with respect to which the ultimate determination of voting power is being made. For example, Mr. X, the actual owner of 40 percent of the voting power of S Corporation, would be considered the constructive owner of 50 percent of such voting power immediately following a redemption for purposes of § 302(b)(2)(B) if he also owned all of the voting stock of P Corporation which in turn owned 10 percent of the voting power of S; this result would not obtain under present law if P also had nonvoting stock outstanding. Clause (i) of proposed § 318(a)(2)(C) would also apply for purposes of voting power determinations under those provisions which require that a shareholder's constructive ownership be determined on the basis of *both* voting power and some other basis—e.g. §§ 302(b)(2)(C) and 422(b)(7).

Clause (i) would not apply, however, to such provisions as §§ 542(a)(2) and 552(a)(2) since the determination there required is whether the individuals in question own more than "50 percent in value" of the personal holding company's stock. If this result seems unfortunate in view of the importance of voting control in this area of the tax law (see Estate of Miller, 43 T.C. 760 (1965)), this situation should presumably be remedied by appropriate amendments to the substantive provisions in question.

The final change made by the committee in clause (ii), relating to attribution based upon the value of stock in a corporation, is to include the value of *voting* preferred stock as well as all other voting stock. This was deemed advisable in view of the considerable significance such stock has gained in recent years in connection with corporate acquisitions and reorganizations.

Attribution to Partnerships, Estates, Trusts and Corporations

In this area of so-called "back attribution," H.R. 11450 provides for 5 percent limitations in the case of partnerships, estates and trusts and 50 percent in the case of corporations. The committee felt, however, that since these entities neither factually control their partners, beneficiaries or shareholders nor have an economic interest therein, attribution should not occur unless the entity could properly be regarded as the "alter ego" of the person whose stock is to be attributed to it. At the minimum, in establishing a *general rule*, this would seem to require that a partner, beneficiary or shareholder possess at least a 50 percent interest in such entity to bring attribution into play, and, accordingly, such a limitation is included in subparagraphs (A) and (B) as well as (C) of § 318(a)(3) of the recommendation. In evaluating this decision, it should be remembered that, by reason of § 318(a)(5)(E)(iii) of the proposed statute, stock attributed to the partner under other rules of constructive ownership will be taken into account in determining whether the 50 percent requirements of § 318(a)(3) have been satisfied. For example, if a widow has a 40 percent actuarial interest in a trust and each of her two minor sons has a 30 percent actuarial interest in such trust, all stock in a corporation owned by any of them will be attributed to the trust.

A further reason for eliminating the applicability of the general rule of § 318(a)(3) via the 50 percent limitation is, of course, that there is presently no "back attribution" under any set of attribution rules other than § 318(a), and hence a very broad concept of back attribution might lead to unforeseen and unfortunate results. On the other hand, as will be seen below, it was thought appropriate to broaden back attribution under the proposal for purposes of §§ 302, 304, 306 and 382.

As in the case of § 318(a)(2)(A) of the recommendation, § 318(a)(3)(A) is based solely upon interests in the capital of a partnership. Section 318(a)(3)(B) of the recommendation differs from the corresponding provision of H.R. 11450 in the priority given to the grantor trust rules. Furthermore, the committee felt that, if the "alter ego" theory is adopted and the 50 percent requirement of § 318(a)(3)(B)(ii) is satisfied, a beneficiary's stock should be attributed to an estate or trust regardless of whether such estate or trust also owns other stock in the corporation which could not be distributed to such beneficiary. Finally, the recommended § 318(a)(3)(C) is the same as that in H.R. 11450 with the exception that voting preferred stock would be counted in computing the 50 percent limitation. The committee did not believe that separate rules were necessary in the back attribution area for determining constructive ownership of the voting power as distinguished from the value of corporate stock—i.e. in deciding whether the stock of corporation B owned by Mr. X, also a shareholder of corporation A, should be attributed to the latter corporation in determining its constructive voting power in corporation B, X's voting power in corporation A seems irrelevant.

Options

The option rule of present § 318(a)(4), left untouched by H.R. 11450, is modified in two respects by the recommendation. First, subparagraph (A), implementing the committee's belief that an option should not result in attribution unless it gives the optionee a significant present interest in the stock in question, and designed with particular concern for the problems raised by shareholder buy-sell agreements in closely held corporations, limits the definition of an "option" for attribution purposes to an option which is exercisable within three years of the date of determination of constructive stock ownership at a price not in excess of 150 percent of the fair market value on such date of the stock subject thereto and is not on such date subject to any substantial contingency beyond the control of the optionee (such as the death of another shareholder). Subparagraph (A) would also for purposes of the general rules limit the attribution which would otherwise result from certain employee stock options and convertible debentures, the latter being considered "options" in the opinion of the committee.

The second modification of § 318(a)(4) is found in paragraph (C) which provides that, in determining the percentage stock ownership of an optionee of unissued stock, the unissued stock subject to his option will be treated as issued and outstanding. Thus, in the case of an employee stock option, the holder of an option on 52 shares of stock in a corporation with 1,000 shares outstanding will *not* be considered to own more than 5 percent of its stock—i.e., because the shares subject to the option will be included in both the numerator and the denominator of the crucial fraction. It was suggested that, in making the computation with respect to a particular optionee, *all* unissued stock subject to options should be included in the denominator and even that, in computing the constructive stock ownership of a nonoptionee, *all* such unissued stock subject to options should be treated as outstanding. *Cf.* Sorem v. C.I.R., 334 F.2d 275 (10th Cir. 1964). The committee felt, however, that such suggestions constituted too drastic a change in present concepts and could lead to great complexity if convertible securities were involved. *But cf.* §§ 544(b) and 554(b).

"Directly or Indirectly"

At each place in the H.R. 11450 version of § 318(a) where the phrase "stock owned, directly or indirectly, by or for" appears, the committee has substituted the phrase "stock owned by."[3] Both the presence and the absence of the phrase "directly or indirectly" in the attribution rules and similar provisions have caused confusion and consternation,[4] and the committee strongly favored its elimina-

[3] See also subsections (h) through (m) and (p) of Sec. 4 of the recommendation which make similar changes in numerous other Code sections dealing with stock ownership. *But see* Code §§ 267(b)(9) and (d)(2), 503(j)(1) (first appearance), 542(c)(7) and 707(b)(1) and (2) where the phrase appears in a different context, such as in describing certain transfers of stock, and should be retained.

[4] See *e.g.*, Shelden Land Company, 42 B.T.A. 498 (1940); Mitchell v. C.I.R., 300 F.2d 533 (4th Cir. 1962), *rev'g* 35 T.C. 550 (1960); Harry Trotz, 43 T.C. 127 (1964), *rev'd*, 361 F.2d 927 (10th Cir. 1966), *on remand* T.C. Memo 1967-139; *cf.* § 6016(c) and Regs. § 1.6016-1(h) and (i). See also Goldstein, *Attribution Rules: Undue Multiplicity, Complexity Can Create Liabilities*, 15th Ann. Tulane Tax Inst. 384, 434-36 (1965).

tion. The committee believes that attempts to obviate the attribution rules through the use of agents or secret agreements as well as any other problems which may arise in identifying actual *nonconstructive* ownership of stock can be adequately dealt with by the courts with the aid of proposed § 318(a)(5)(E)(v) and, perhaps, appropriate regulations.

With respect to such provisions as §§ 170(g)(4), 503(j), 542(c)(6)(D), 542(c)(8), 542(b)(1) and 542(b)(4)(A), where the proposal eliminates the phrase "directly or indirectly," the committee recommends that further study be given to see whether it would be appropriate to apply the attribution rules. A similar study should, perhaps, be made with respect to such provisions as §§ 269(a)(2), 482, 542(c)(7), 543(b)(1)(C), 545(d), 959(a)(2), 4939(a)(1), 267(b)(9), 401(d)(9)(B), 631(c)(2), 4914(c)(5)(A)(ii) and 4915(a)(1), where the phrase would be retained under the proposal but where it might be more appropriate to substitute an attribution concept.

Operating Rules

Subparagraphs (A) through (C) of § 318(a)(5) come directly from the present Code. The latter provision eliminates so-called "sidewise attribution" and hence would bar the attribution between partners presently authorized by §§ 544(a)(2) and 554(a)(2). Subparagraph (D) comes directly from H.R. 11450 and constitutes a slight modification of the corresponding provision in the present Code. The first three clauses in subparagraph (E) are derived from H.R. 11450 and represent a codification and clarification of Regs. § 1.318-1(b)(1), (2) and (3).[5] The nature and function of clauses (iv) and (v) of subparagraph (E) are discussed above.

Application of Attribution Rules

Proposed § 318(b) sets forth the applicability of the rules prescribed in subsection (a). Paragraph (1) lists the Code provisions under which computations are to be made with the application of the attribution rules and also indicates where such rules are to be applied as modified in such provisions. These provisions, of course, are presently covered by such sections as 267(c), 544(a), 958(a),[6] and 1563(e) as well as 318(a). The provisions listed in § 318(b)(1) do not, however, fully describe the applicability of the rules of new § 318(a); rather, it is necessary to consider many other provisions which incorporate such rules by reference or refer to some other section which in turn refers to § 318(a).

Paragraphs (2), (3) and (4) of § 318(b) are designed to answer certain questions with respect to the scope of the new attribution rules. Paragraph (2) would apply to such provisions as §§ 514(b)(2)(B), 631(c)(1), 381(a)(1), 316(b)(2), 856(a)(6), and 1022. Each of these provisions presently relates back through some other provision to one of the attribution rule sections; under the recommendation each would relate back to § 318(a) through one of the provisions listed in § 318(b)(1) or described in § 318(b)(4) 135.

Paragraph (3) relates to such provisions as §§ 707(b), 856(d)(2) and (3) and 1361(g). Paragraph (3) seems necessary to avoid any possible confusion which

[5] If Mr. X owns 4 percent of the stock of A Corporation and 4 percent of the stock of B Corporation, which in turn owns 50 percent of A Corporation, Mr. X will be deemed to own 6 percent of A Corporation (and hence 6 percent of any stock owned by it) by reason of § 318(a)(5)(E)(iii) even though he would not, for other purposes, be deemed to own any stock held by B Corporation.

[6] Upon the recommendation of the Committee on Banking Institutions and Regulated Investment Companies, proposed § 318(a) would be made applicable to § 1246(b)(2) in lieu of present § 958(a) or the modified version thereof proposed in section 4(g) of the recommendation. Such committee believes that the provisions of § 318(a)(2), as supplemented by the operating rules of § 318(a)(5), are more appropriate in dealing with foreign investment companies than any rules designed primarily for closely held corporations. Furthermore, the committee finds it desirable to extend the family, "back" and option attribution rules of § 318(a)(1), (3) and (4) into this area.

might otherwise result from the application of a provision entitled "constructive ownership of stock" to property other than corporate stock.

Paragraph (4) refers to such provisions as § 334(b)(3)(C) which place considerable importance upon the relationships described in § 318(a), but as to which it seems technically inaccurate to say that such section "applies." In other words, these provisions are more like §§ 170(g)(4) and 274(e)(5) which incorporate the attribution rules definition of "family" and which are also covered by new § 318(b)(4).

Finally, § 318(b)(5) of the recommendation, like § 19(c) of H.R. 11450, describes the role which the new attribution rules are to play in determinations under § 302 (b)(1). This provision is consistent with action taken by the Tax Section in recent years.

It will be noted that, with very minor exceptions, the recommendation does not purport to extend the application of § 318(a) beyond the Code provisions presently covered by one of the attribution rules. Some members of the committee and other commentators felt that it would be desirable to make the new rules applicable to such sections as 334(b)(2)(B), 351, 368(c), 382(b)(3) and 1237(a)(1)(A). The absence of attribution rules under these provisions often proves disadvantageous to taxpayers[7] but this is not the sole reason for considering these changes since it has also been pointed out that an expanded concept of attribution might fortify the Government's position in so-called liquidation-reincorporation cases. Nevertheless, none of the committees and subcommittees having jurisdiction over those substantive provisions to which the new rules might properly be extended has offered a recommendation of this type, and the committee has therefore decided to postpone action in this area for the time being.

Sections 2, 3 and 4 of the recommendation make the changes in the Code which are necessary to coordinate new § 318 with the other provisions. Section 2 repeals the attribution rules and other provisions which are no longer necessary. Section 3 of the recommendation changes the reference to the definition of a taxpayer's family from § 267(c)(4) to § 318(a)(1), and section 4(a) through (e) makes similar changes in other provisions. Section (4)(f) and (g) are conforming provisions, and the functions of section 4(h) through (m) and 4(p) have been noted above. Section 4(q) places an appropriate cross-reference to § 318(a) in each of the provisions listed in § 318(b)(1) which needs one. Section 4(n) and (o), like section 5, implement the recommended exceptions to the general rules of § 318(a). See below.

Miscellaneous

In drafting the recommendation many interesting suggestions were carefully considered but ultimately rejected. For example, consideration was given to including all § 152(a) "dependents" in the definition of the taxpayer's family under § 318(a)(1) as well as to creating a series of rebuttable presumptions either in favor of or against attribution in the case of certain family relationships. Another difficult area involves the treatment of aliens and foreign trusts, estates and corporations under the attribution rules; § 958 contains special rules for certain purposes but as the Miller case, *supra*, illustrates, many questions remain unanswered in other areas. Finally, provisions such as §§ 544(a)(4), 554(a)(4), 958(b) and 1563(f)(3)(B) and (C) have not been altered insofar as they provide that the attribution rules may only be applied to the taxpayer's disadvantage even though it was most difficult to identify what harm might be done to the revenue if such provisions were to be eliminated. See proposed § 318(a)(5)(E)(ii).

Specific Exceptions

Certain Stock Redemptions. The Committee on Corporate Stockholder Relationships recommended that for purposes of §§ 302, 304 and 306, in order to prevent excessive opportunities for tax avoidance, stock transferred between parents and adult children and from grandchildren within the preceding 10 years should

[7] See Goldstein, *supra*, n. 3 at pp. 428-429.

remain subject to attribution. The loophole to be closed may be illustrated by the following example:

Under § 318(a)(3)(A) and (B) of the proposal, stock owned by partners and beneficiaries is attributed to partnerships, estates and trusts only if the interest of a partner or beneficiary in the partnership, estate or trust is at least 50 percent. The Corporate Stockholder Relationships Committee recommended that an exception be made for purposes of §§ 302, 304 and 306 to avoid creation of a loophole. This loophole may be illustrated by the following example:

> A 100% stockholder transfers some of his stock to an adult child (or to a trust for same) and it is promptly redeemed. Without attribution, the redemption might qualify as a sale or exchange under § 302.
>
> A, B, C and D each own 25% of the stock of a corporation. They transfer some of their stock to a partnership in which they have equal interests (or possibly form one for this purpose) and the transferred stock is then redeemed. Under the proposal, without any exception, this might qualify as a sale or exchange under § 302. While this problem could have been solved by simply creating an exception restoring existing law, this solution was considered unsatisfactory since it might cause a partnership in which a single major stockholder of a corporation owned a very small interest to be exposed to the possibility of a dividend tax on a redemption which would otherwise qualify as a sale or exchange.

Sec. 5(a), (c) and (d) of the proposal provide for the recommended exceptions, and Sec. 5(b) conforms § 302(c)(2)(B) to the proposed new § 302(c)(1) introduced by Sec. 5(a).

Loss Carryovers. The Committee on Corporate Stockholder Relationships recommended that the 50 percent limitation on back attribution under § 318(a)(3) be reduced to 5 percent for purposes of § 382(a)(3) since Congressional intent seems quite clearly to have favored a broad concept of back attribution in this area. Sec. 5(e) of the proposal implements this recommendation.

Family Attribution in Personal Holding Companies. The Committees on Corporate Stockholder Relationships and Foreign Tax Problems have each recommended broadening family attribution under § 318(a)(1) of the proposal to include all children and parents, as well as grandchildren, grandparents, brothers and sisters, for purposes of the Code provisions dealing with domestic and foreign personal holding companies. Sec. 5(f) and (h) accomplish this result. It was felt that the concentration of stock ownership for personal holding company status provided in §§ 542(a)(2) and 552(a)(2) (ownership of more than 50 percent by not more than 5 individuals) was designed with the broad family attribution rules of §§ 544(a) and 554(a) in mind, that a broad family definition is appropriate in grouping ownerships for personal holding companies purposes, and that the substantial narrowing of the family group in the proposal would make avoidance of the personal holding company surtax unduly easy.

Family Attribution Under Subpart F. The Committee on Foreign Tax Problems recommended that the definition of the family be broadened for purposes of those provisions covered by § 958(b), as well as the related provision of § 6046(c). The special rule for foreign personal holding companies has been adopted for purposes of uniformity by Sec. 5(j) and (k) of the proposal, although this represents a broadening of current rules in certain respects.

Option Attribution and Employee Stock Options. The Committee on Employee Benefits made two recommendations which have been incorporated in Sec. 4(n) and (o) of the proposal. Since there is presently no option attribution in determining the eligibility of an employee to receive a *restricted* stock option under § 424 in the limited circumstances to which such provision applies, § 318(a)(4) has been made inapplicable for this purpose. Since Congress probably intended that all outstanding restricted and qualified stock options and options granted under employee stock purchase plans be taken into account for purposes of the percentage limitations of §§ 422(b)(7) and 423(b)(3), this has been accomplished by expressly broadening § 318(a)(4) in these circumstances.

APPENDIX A

TABLE I: *Attribution—Step One*

Code §	1 Spouse to Individual*	2 Lineal Descendants to Individual*	3 Ancestors to Individual*	4 Siblings[8] to Individual*	5 Corporation to Shareholder (proportionately)*	6 Partnership to Partner (proportionately)*	7 Estate to Beneficiary (proportionately)*
267(c)	(2) and (4)	(2) and (4)	(2) and (4)	(2) and (4)	(2)	(2)	(2)
318(a)	Unless legally separated or divorced—(1)(A)(i)	Children and grandchildren only—(1)(A)(ii)[6]	Parents only—(a)(1)(ii)	—	Only if shareholder owns 50% or more in value—(2)(C)	(2)(A)	(2)(A)
425(d)	(1)	(1)	(1)	(1)	(2)	(2)	(2)
544(a)	(2)[3]	(2)[3]	(2)[3]	(2)[3]	(1)	(1)	(1)
554(a)	(2)[3]	(2)[3]	(2)[3]	(2)[3]	(1)	(1)	(1)
958[1]	Unless legally separated or divorced—(b)[4]	Children and grandchildren only—(b)[4]	Parents only—(b)[4]	—	Only if shareholder owns 10% or more in value—(b)(2)[9, 10]	(b)[9, 10]	(b)[9, 10]
1563(e)[2]	Unless legally separated or divorced or the 4 part test of § 1563(e)(5) is met—(6)[5]	Minor children; grandchildren and adult children if individual owns[7] more than 50% of voting stock or value of all classes—(6)(A) and (B)[6]	Parents if individual is a minor; parents and grandparents of adult individuals if individual owns[7] more than 50% of voting stock or value of all classes—(6)(B)	—	Only if shareholder owns 5% or more in value—(4)[10]	Except less than 5% partners; proportion based on interest in capital or profits, whichever is greater—(2)	If actuarial interest is 5% or more—(3)[11]

* Includes stock owned "directly or indirectly" by the first party.

[1] Applies only if it helps to make § 951(b), 954(d)(3) or 957 applicable. § 958(b).

[2] If, by reason of § 1563(e), stock is deemed to be owned by two or more persons, such stock is considered as owned by the person whose ownership results in the corporation being a "component member of a controlled group." § 1563(f)(3)(B).

[3] Applies only if the effect is to make the corporation a personal holding company or foreign personal holding company, or to make certain amounts includible as personal holding company or foreign personal holding company income—§§ 544(a)(4) and 554(a)(4).

[4] Stock owned by a nonresident alien is not attributed to a citizen or resident alien—§ 958(b)(1).

[5] Spouse's stock is not attributed if during the taxable year of the corporation: (a) the individual does not own directly any stock; (b) he is not a director, employee or participant in management; (c) not more than 50 per cent of the corporation's income was derived from royalties, rents, dividends, interest and annuities; and (d) the spouse's stock is not subject to restrictions on transfer which run in favor of the individual or his minor children. § 1563(e)(5).

[6] Legally adopted children specifically included—§ 318(a)(1)(B); § 1563(e)(6)(C).

[7] Within the meaning of § 1563(d)(2) but without regard to § 1563(e)(6)(B).

[8] By the whole or half blood.

8 Trust to Beneficiary (proportionately)[9]	9 Trust to Grantor or Other Owner[13] (proportionately)[9]	10 Shareholder to Corporation[9]	11 Partner to Partnership[9]	12 Beneficiary to Estate[9]	13 Beneficiary to Trust[9]	14 Grantor or Other Owner[13] to Trust[9]	15 Partner A to Partner B[9]	16 Stock Subject to Option to Optionee
(1)	—	—	—	—	—	—	(3)[16]	—
Proportionately based on actuarial interests—(2)(B)(i)[12]	(2)(B)(ii)	Only if shareholder owns 50% or more in value—(2)(C)	(3)(A)	(3)(A)	Unless beneficiary's actuarial interest is contingent and 5% or less—(3)(B)(i)[12, 15]	(3)(b)(ii)	—	(4)[17]
	—	—	—	—	—	—	—	—[18]
.a)	—	—	—	—	—	—	(2)[9]	(3)[9, 17]
(1)	—	—	—	—	—	—	(2)[9]	(3)[9, 17]
Proportionately based on actuarial interests—(b)[9, 14]	(b)[9]	Only if shareholder owns 50% or more in value—(b)[14]	(b)[14]	(b)[14]	Unless beneficiary's actuarial interest is contingent and 5% or less—(b)[12, 14, 15]	(b)[14]	—	(b)[17]
If actuarial interest is 5% or more—(3)[11, 12]	(3)(B)	—	—	—	—	—	—	(1)[17]

[9] A partnership, estate, trust or corporation which owns more than 50% of a corporation's voting power is deemed to own all of its voting stock. § 958(b)(2).

[10] Section 958(a)(2) also provides for attribution from *foreign* corporations partnerships, estates and trusts to shareholders, partners and beneficiaries; this provision differs from § 958(b) in certain respects and has broader applicability. See Table III.

[11] In determining a beneficiary's actuarial interest, the maximum exercise of discretion by the fiduciary in his favor and the maximum use of the corporation's stock to satisfy his rights are assumed. § 1563(e)(3)(A).

[12] Employee's § 401(a) trusts are specifically excepted. §§ 318(a)(2)(B)(i) and (3)(B)(i); 1563(e)(3)(C).

[13] *I.e.*, a person who is considered to own any portion of a trust under §§ 671-678.

[14] Not applicable if effect is to attribute stock to a "United States person" from an owner who is not a "United States person." § 958(b)(4).

[15] The maximum exercise of discretion by the trustee in favor of the beneficiary is assumed for purposes of the 5% test.

[16] Attribution only to *individuals* who own stock in the corporation other than through the family attribution rules of § 267(c)(2).

[17] An option to acquire an option to purchase stock is considered as an option on the stock itself. If stock is attributable to an *individual* under § 318(a)(1) and (4), or 544(a)(2) and (3), or 554(a)(2) and (3), or to *any person* under § 1563(e)(2)-(6) and (1), it shall be considered in each case as owned by him under the latter (option) provision. §§ 318(a)(5)(D); 544(a)(6); 554(a)(6); 1563(f)(3)(A).

[18] Stock subject to options is, however, attributed to an employee for purposes of determining his percentage ownership under §§ 422(b)(7) and 423(b)(3). See §§ 422(c)(3)(C) and 423(b)(3).

[19] Preferred stock is excluded from computation.

TABLE II: *Attribution—Step Two, Etc.*

Table I Column / Code §	1-4 Family Stock Reattributed from Individual*	5-9 Corporation, Partnership, Estate or Trust Stock Reattributed from Shareholder, Partner, Beneficiary, Grantor or Other Owner*	10-14 Shareholder, Partner, Beneficiary, Grantor or Other Owner Stock Reattributed from Corporation, Partnership, Estate or Trust*	15 Partner A Stock Reattributed from Partner B*	16 Optioned Stock Reattributed from Optionee*
267(c)	No—(5)	Yes—(5)	—[2]	No—(5)	—[2]
318(a)	Only to a partnership, estate, trust or corporation—(5) (A) and (B)	Yes—(5)(A)	Only to a corporation, partnership, estate or trust—(5)(A) and (C)[3]	—[2]	Yes—(5)(A)[4]
425(d)	No[1]	No[1]	—[2]	—[2]	No[1]
544(a)	No—(5)	Yes—(5)	—[2]	No—(5)	Yes—(5)[4]
554(a)	No—(5)	Yes—(5)	—[2]	No—(5)	Yes—(5)[4]
958	Only to a partnership, estate, trust or corporation—(b)	Yes—(b)	Only to a corporation, partnership, estate or trust—(b)[3]	—[2]	Yes—(b)[4]
1563(e)	No—(f)(2)(B)	Yes—(f)(2)(A)	—[2]	—[2]	Yes—(f)(2)(A)

* *I.e.*, stock constructively owned is treated as actually owned and the rules of Table I, under each Code section, are reapplied until a stopping place is reached.

[1] Quaere: Could constructive ownership under Table I constitute "indirect" ownership since reattribution is not expressly forbidden by § 425(d)?

[2] Not applicable because there is no step one under Table I.

[3] *I.e.*, only through a second application of § 318(a)(3). *E.g.*, beneficiary to trust to estate of which such trust is a beneficiary.

[4] Since option attribution takes precedence over certain other types of attribution the likelihood of reattribution is increased. See note 16 to Table I.

TABLE III: *Applicability of Attribution Rules*

Code §	Directly Applicable	Applicable as Modified	Indirectly Applicable*
267(c)	170(g)(4);[1] 267(a); 274(c)(5);[1] 503(c), (e) and (j);[1] 681(b)(2) and (5);[1] 1237(a)(2)(A)[1]	178(b)(2);[2] 179(d)(2)(A);[2] 341(e)(8);[2] 707(b)(3);[3] 1235(d)(2);[2] 1361(g)[3]	341(e)(1) and (4);[4] 514(b)(2)(B);[5] 631(c)(1);[6] 1341(b)(2);[7] 48(c)(3)(A)[19]
318(a)	306(b)(1)(A); 334(b)(3)(C); 545(c)(3)(B)	302;[8] 304(c)(2);[9] 382(a)(3);[9] 856(d);[10] 6038(d)(1)[11]	381(a)(1)[12]
425(d)	422(b)(7); 423(b)(3); 424(b)(3)	—	—
544(a)	542(a)(2); 543(a)(4), (6) and (7); 6035(b)	341(d) and (e)(10)[13]	316(b)(2);[14] 341(e)(1)(2) and (4);[15] 856(a)(6)[14]
554(a)	552(a)(2); 553(a)(5) and (6)	—	1022[16]
958	951(b); 954(d)(3); 957; 1248(a)(2); 1249(b)	951-964 except 955 (b)(1)(A) and (c)(2) and 960 (a)(1);[17] 1246(b)(2)[17]	1016(a)(20)[18]
1563(e)	1551; 1561; 1562; 1563	—	—

* List not complete.
[1] § 267(c)(4) only.
[2] Siblings omitted from § 267(c)(4).
[3] § 267(c)(3) omitted.
[4] Via § 341(e)(8).
[5] Via § 267(a).
[6] Via § 267(b) and 707(b)(1).
[7] Via § 267(b).
[8] Under § 302(c)(2), § 318(a)(1) does not apply in the case of a complete termination of interest under § 302(b)(3) if a quite complicated three-part test is met.
[9] § 318(a)(2)(C) and (3)(C) applied without regard to the 50% limitation contained therein.
[10] § 318(a)(2)(C) and (3)(C) modified to substitute 10% for 50%.
[11] § 318(a)(3) does not apply to attribute stock from a non-United States person to a United States person. § 6038(d)(1)(A). § 318(a)(2) is modified by substituting 10% for 50%.
[12] Via § 334(b)(2) and (3).
[13] Family under § 544(a)(2) broadened to include siblings (by the whole or half blood) and spouses of lineal descendants.
[14] Via § 542.
[15] Via § 341(d) and (e)(10).
[16] Via §§ 1014(b)(5) and 552.
[17] Stock owned, directly or indirectly, by or for a foreign corporation, partnership, trust or estate is considered to be owned proportionately by its shareholders, partners or beneficiaries.
[18] Via § 961.
[19] Via § 179(d)(2).

Committee on Employee Benefits

1. AMENDMENT OF LEGISLATIVE RECOMMENDATION OF COMMITTEE ON AFFILIATED AND RELATED CORPORATIONS ON CONSTRUCTIVE OWNERSHIP OF STOCK

Resolved, That the legislative recommendation of the Committee on Affiliated and Related Corporations to create a single set of rules relating to the constructive ownership of stock, should be amended to modify its application to employee stock options, so as—

(1) to treat all stock which a person has an option to buy as owned by such person without regard to the three-year and other rules of proposed section 318(a)(4)(A);

(2) to continue unchanged the present constructive ownership rules governing "restricted stock options" under section 424 (relating to certain options granted before January 1, 1964); and

(3) to provide a transition period after enactment of the new constructive ownership rules during which for purposes of sections 422 (relating to qualified stock options) and 423 (relating to employee stock purchase plans) a taxpayer may elect to apply either the new constructive ownership rules or the constructive ownership rules previously governing these sections;

and

Further Resolved, That these results be achieved by amending the constructive ownership proposal as follows:

Sec. 1. Section 1, adding section 318(b)(1)(I) of the Code, is amended by inserting after "422(b)(7)" the following: "(as modified by section 422(c)(3))".

Sec. 2. Section 2 is amended by deleting therefrom "425(d)", and by inserting "422(c)(3)(C)" and "423(b)(3) from the word 'and' in the last sentence to the end of the sentence".

Sec. 3. Section 4(n) is amended to read as follows: "In sections 422(c)(3)(B) and 423(b)(3) delete '425(d)' and substitute '318(a) other than section 318(a)(4)(A)'".

Sec. 4. Section 4(o) is amended to read as follows: "In section 425(d), delete 'sections 422(b)(7), 423(b)(3) and' and insert 'section'".

Sec. 5. Section 6 is amended by deleting the word "The" at the beginning thereof and by inserting in lieu thereof the phrase "Except as provided in Section 7, the".

Sec. 6. Following Section 6, a new section 7 is added reading as follows:

> Sec. 7. In the case of options granted before [insert December 31 of third year following enactment], an individual may elect, under regulations prescribed by the Secretary or his delegate, for the purposes of determining the percentage limitations of sections 422(b)(7) and 423(b)(3), to apply the attribution rules in effect immediately before the date of enactment hereof.

EXPLANATION

Summary

The statutory stock option provisions generally restrict their benefits to individuals who own, directly and constructively, not more than 5 percent of the stock of the optionor or subsidiary company; for smaller companies, the percentage can be as high as 10 percent. The other statutory provisions dealing with attribution rules involve percentages of stock ownership which are substantially greater than 5 percent or 10 percent in determining tax consequences. Consequently, any changes in the attribution rules which may vary the stock option percentage limitation by even 1 or 2 percentage points of ownership amount to a very substantial change in both the present statutory scheme and as a matter of economic benefit or detriment to the optionee. Accordingly, our committee has attempted to balance the goal of uniformity in attribution rules with the unique aspects, goals and policies of the stock option rules. Many of the committee's recommendations have already been incorporated into the present draft of proposed § 318. The legislative recommendations here presented represent the last areas of difference between the respective committees.

Discussion

1. *Proposed § 318(a)(4)(A).* In response to our prior proposals and memoranda, the Committee on Affiliated and Related Corporations has agreed that the provisions of proposed § 318(a)(4)(A), which excludes from attribution options exercisable after three years and other circumstances, should not be applicable to outstanding qualified and restricted stock options. This result is to be achieved by retaining the reference to § 318(a)(4), plus adding a separate attribution rule under §§ 422(c)(3)(C) and 423(b)(3). We believe that this approach is undesirable for several reasons.

First, there is the statutory construction problem arising from the fact that there are now two sections presumably covering the same options. This would apparently require some provision that, for example, qualified options should not be included twice, i.e., once under § 318(a)(4)—via § 422(b)(3)(B)—and a second time under § 422(b)(3)(C). Similar provisions would be needed for § 423 option and restricted stock options. While this can be done, it only serves to make the statute more complex, unnecessarily so in our opinion.

Second, it is not at all clear what is meant by "outstanding qualified and restricted options." For example, in the proposed amendment to § 422(b)(3)(C), does this refer to options which at the time of determination of attribution are then "qualified" or "restricted"? Or, would it include options which were originally qualified options but were changed or modified so that they are not at the date of the determination qualified options? This problem, too, could be dealt with by appropriate language; but, again, at the cost of complexity.

Third, and most importantly, it is our opinion that this provision would violate sharply defined Congressional intent which led to the stock option revisions in the Revenue Act of 1964. One of the avowed specific purposes was to cut down the number of options available to any optionee and, in so doing, Congress provided that all options owned by an optionee were to be included in the 5 percent limitation. This involved a two-fold change in the law: (1) reduction of permissible ownership to 5 percent, and (2) inclusion of an option rule in the attribution rules. As tax lawyers, we are all aware of the increasing use of "nonqualified" stock options under the rules of Regs. § 1.421-6. The applicability of the three-year rule under § 318(a)(4)(A) permits easy circumvention of the 5 percent ownership limitation deliberately placed on stock options by the '64 Act. For example, a would-be optionee might have a substantial number of nonqualified options which may be exercisable immediately. He now wants, and his employer is willing to give him, a batch of qualified options. All that has to be done is to postpone the exercise date of the nonqualified options beyond the three-year period. Now, those options would not be counted against this optionee's 5 percent ownership limitation. At some later date, no doubt, the exercise date of the nonqualified option could be accelerated—without any adverse tax consequences—to a date within the three-year period. Simply stated, there could be a substantial amount of jockeying of exercise dates of nonqualified options, so as to permit maximum utilization of the 5 percent limit under § 422(b)(7).

Fourth, since it has been recognized that the provisions of § 318(a)(4)(A) cannot be applied without an exception for the stock option rules, we see little reason for preserving a double set of rules. It would certainly be simpler and more in keeping with the purposes of the stock option rules to eliminate the applicability of proposed § 318(a)(4)(A).

2. *Restricted Stock Options under § 424.* The newest proposal of the Committee on Affiliated and Related Corporations has eliminated proposed § 318(a)(4)

from being applicable to restricted options which may still be granted under § 424(c)(3), but has retained all the other proposed attribution rules with respect to them. The apparent reason for this split decision is that it would be preferable not to continue the broader attribution rules of present law for these special restricted stock options. Our committee is certainly not really opposed to such a result. However, we are not at all certain that all the new rules would be narrower than the old rules. Our committee's proposal is simply to retain the old rules for these old options, both in order not to affect adversely any possible optionee and also to keep within the Congressional intention to limit the use of these old restricted options to specified circumstances. The transitional rule, discussed below, could take care of this objective.

3. *Transitional Rule*. The Committee on Affiliated and Related Corporations has rejected our concept of the transition period for two reasons, each discussed in turn below.

First, it was apparently thought that the new option rules could not work adversely with respect to any new optionee as compared with the old rules. This is an erroneous conclusion in at least two respects. The proposed § 318(a)(4) applies the option rule to options owned by "any person"—which, obviously, includes options owned by corporations, etc. Present rules of §§ 422(c)(3)(C) and 423(b)(3) limit option attribution to options owned by "individuals." Therefore, the proposed rules are broader in this respect than the old rules. Another example was found in the rules dealing with attribution of stock held by corporations. The present stock option rules refer to a percentage of ownership in either the voting power or value of stock of a corporation. The proposed attribution rules (§ 318(a)(2)(C)(ii)) eliminate nonvoting preferred stock in determining the value of stock. This provision is broader, i.e., creates greater attribution, than the present statute which includes all stock in determining percentage of value. We have not considered all the other possibilities, but we feel that there probably are other instances lurking in the new rules which create broader attribution than the old rules. While the above-described situations might, in a given situation, increase ownership by only a very small percentage over the 5 percent limit, that small difference could amount to a very substantial dollar amount to the affected employee.

Second, it was suggested that there would be no harm in putting all future optionees under the new rules, i.e., that they could not be adversely affected since the qualified status of options are determined as of the date of grant. We do not necessarily oppose this view as a matter of policy. However, we do point up certain problems associated with making the new rules immediately applicable. We know that qualified option plans are often drafted in a manner to incorporate the various Code requirements, by including specific references to present attribution rules, or by setting these rules out in full. No doubt, these plans could be amended. However, amendment might be costly and time consuming. Furthermore, the issue may not be so much whether a person has been adversely affected by new rules, but whether it is appropriate to change the rules of existing plans which have been made known to employees and which may have been relied upon in planning. An analogous situation arose when present income averaging rules were enacted. At that time, a transition rule was adopted to permit taxpayers to use the old averaging provisions or the new averaging provisions. It would seem that the considerations which led to that conclusion would be equally applicable here. The fact that no transition rule has been proposed for other affected sections of the Code does not mean that a transition rule is not appropriate here. It could well be that no taxpayer would be adversely affected by the new rules under these other sections, i.e., that clearly and without doubt all the old rules relating to §§ 302, 267, 531, etc. are broader than the new rules. But, as is pointed out above, that is not the case with the stock option rules. Perhaps a transition rule should be adopted for all purposes, not merely for stock option purposes.

In conclusion, we wish to point out that even the Revenue Act of 1964 permitted a transition period of approximately one year in order to permit corporations to adjust to the new option rules in several respects. Again, we don't see why that approach cannot be applied in this instance.

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Senator BYRD. The next matter will deal with procedure and administration. The panel will consist of Mr. Martin L. Kamerow, Federal tax division, AICPA, and Mr. Donald Thurmond, American Bankers Association.

Welcome, gentlemen.

Mr. Kamerow?

STATEMENT OF MARTIN L. KAMEROW, TAX ADMINISTRATION SUBCOMMITTEE, FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. KAMEROW. Thank you, sir.

My name is Martin L. Kamerow, and I am a member of the Tax Administration Subcommittee of the Federal Tax Division of the American Institute of Certified Public Accountants. I am privileged to have this opportunity to present to you the observations and recommendations of the institute in connection with S. 1062, Subtitle F Revision Act of 1979, a bill presented to simplify certain provisions of subtitle F of the Internal Revenue Code of 1954.

My colleagues and I obviously support the objective stated in Senator Long's introductory statement indicating that this bill was the first of a series of bills needed over the next several years to clarify and simplify the tax law. With specific reference to the seven provisions in S. 1062, we wish to submit the comments which follow.

Section 2 provides for the payment of interest on money received by the U.S. Treasury as a result of wrongfully made levies. We are in favor of this provision in that it promotes a fair administration of our Federal tax system.

Section 3 of the act provides for the repeal of the requirement that transferors of certain property to exempt organizations must file returns. We are pleased with the elimination of this reporting requirement.

With regard to section 4 dealing with simplification of private foundation return and reporting requirements, we are particularly pleased with the elimination of burdensome duplicate filing requirements imposed upon private foundations. The elimination of the requirement for the filing of the annual report of private foundation—form 990-AR is a welcome change, relieving practitioners and foundation managers of a burdensome duplication of effort since most of the information is already reported on the returns of private foundations exempt from income tax—form 990-PF.

We presume form 990-PF will be modified slightly so that the one filing will include all the information required.

We concur with both of the provisions of section 5. One provision deals with the repeal of the 25-percent penalty for jeopardy assessments, which we recommend as fair and reasonable. The other change eliminates certain reporting requirements in connection with stock option information, which is another step in the direction on reducing paper work.

The provisions of section 7 extending the filing date for the fourth quarter gift tax return to April 15, and granting automatic extensions for the filing of these returns where an extension is granted for the donor's income tax, is a pragmatic recognition of the realities of the problems faced by tax practitioners.

All too often practitioners discover during their client's income tax preparation interview that gift tax deadlines have unknowingly been overlooked. The Federal tax division heartily endorses and welcomes this change. We also recommend that, unless the delay in tax revenue is an overriding consideration, the gift tax return quarterly filing requirement be eliminated entirely, and that you take this opportunity to return to annual filing requirements on the due date of the related individual income tax return.

The disclosure of manufacturer's excise tax information to State tax officials as provided in section 8 appears to be a technical change upon which we do not wish to express a position.

We thank you for the opportunity to present the institute's views on S. 1062, and we express our appreciation to you and your staff for your initiative and stated objectives to "begin your review of the Internal Revenue Code in order to clarify and simplify the tax law."

Senator BYRD. Mr. Thurmond?

STATEMENT OF DONALD W. THURMOND, GROUP VICE PRESIDENT, TRUST CO. BANK, ATLANTA, GA.

Mr. THURMOND. Mr. Chairman, I am Donald W. Thurmond, group vice president of the Trust Co. Bank in Atlanta, Ga., and chairman of the taxation committee of the trust division of the American Bankers Association. I appear here today on behalf of the ABA, a trade group composed of over 13,000 banks, some 4,000 of which exercise fiduciary powers.

The American Bankers 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 would like to comment on S. 1063 on simplifying installment sales rules, and on two sections of S. 1062 on filing gift tax returns and reporting requirements for private foundations.

S. 1063—Simplification of installment sales rules. This bill is intentionally narrow in scope and attempts to simplify installment sale reporting and to close what are regarded as two tax loopholes in this area. Our written statement covers this in more detail and we ask that it be made a part of the record.

We also suggested three other changes which we think are needed. They are in the written statement. These deal with the crisis situations and we offer our assistance in working with staff as to how these changes may be accomplished.

The ABA supports the change recommended for gift tax returns and submits that this rationale also applies to the gifts made in the first, second and third quarters which are reportable on a return to be required to be filed for said quarter.

We agree with the AICPA that the best way to eliminate this problem might well be to do away with the quarterly filing requirement and simply require the filing of an annual return, as was required prior to 1971. It is possible that the rationale that supported going to a quarterly return no longer exists, due to additional unified credit and the $100,000 gift to spouse provisions in the Tax Reform Act of 1976.

It is clear to us that the quarterly return increased complexity and added expense for the taxpayer and the Internal Revenue Service.

We urge that one additional change be made in the administration's provisions under subtitle F and it should be made by the addition of a new section. This section, currently in the gift tax provisions of the law, provides that if the time has expired within which to assess a gift tax, and if a gift tax has been paid, the value of the gift is final in connection with determining the gift tax for any preceding calendar quarter involving other gifts.

As a result of the changes in the transfer tax law made in 1976, primarily with the estate tax and then the chapter 13 generation skipping tax being added, we also have problems in those areas as well.

The provision in the gift tax law should be replaced by a new section in subtitle F and apply this same concept currently in 2504(c) to all related transfer tax determinations.

Since Section 4 of S. 1062 deals with simplifying the reporting requirements of charitable trusts, we would like to suggest that the reporting simplification would be in order for section 664, charity remainder trusts. These were brought about by the 1969 act, commonly referred to as unitrusts and annuity trusts.

Today, the charitable remainder annuity trusts and unitrust are required to file a form 1041(b), a form 5227 and a form 1041(a). A review of the information contained in these forms would show that the necessary reporting requirements could best be achieved by combining form 1041(b) and 5227 into a single return and eliminating 1041(a) as a required return.

We thank the subcommittee for the opportunity to testify on these first of a series of proposals to simplify specific provisions in the Internal Revenue Code.

Senator BYRD. Thank you, Mr. Thurmond. Thank you, Mr. Kamerow. We appreicate your being here.

[The prepared statement of Mr. Thurmond follows:]

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION

I am Donald W. Thurmond, Group Vice President of the Trust Company Bank in Atlanta, Georgia, and Chairman of the Taxation Committee of the Trust Division of the American Bankers Association. I appear here today on behalf of the ABA, a trade group composed of over 13,000 banks, 4,000 of which exercise fiduciary powers.

The American Bankers 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 would like to comment on S. 1063 on simplifying installment sales rules, and on two sections of S. 1062 on filing gift tax returns and reporting requirements for private foundations.

S. 1063—Simplification of installment sales rules

This bill is intentionally narrow in scope and attempts to simplify installment sale reporting and to close what are regarded as two tax "loopholes" in this area. In explaining the loophole closing changes, Senator Long said:

In addition, the bill would deny installment method reporting for sales between related parties. Under present law, a tax planning technique involves selling appreciated property on the installment basis to a related party, such as a family trust, and then having the property sold by the related party at little or no taxable gain because the cost basis for the second sale would reflect the entire purchase price under the installment sale. In this situation, the appreciation has been realized within the related party group but gain is recognized for tax purposes only as the related party purchaser makes installment payments to the original seller. Under the bill, this technique could not be used.

* * * * * * *

Finally, the bill provides that the installment obligation disposition rules cannot be avoided by bequeathing an installment obligation to the obligor. Under present law, some have argued that this technique could avoid having the unreported gain from an installment obligation treated as an item of income in respect of a decedent.

In general, the ABA supports these changes as a part of a bill which is balanced by making other changes which assure that taxpayers making installment sales are treated fairly. These changes are:

1. To amend section 1038 (which provides that in the case of certain reacquisitions of real property by the seller no gain or loss shall result to him), to "reverse" Revenue Rule 69-83, 1969-1 Cum. Bull. 202, holding that the section does not apply in the case of a reconveyance to the decedent's estate rather than the decedent.

2. To amend section 453, relating to installment sales, to provide that the disposition (transfer) of an installment sale obligation by an estate or trust will not result in "acceleration" of income when the sale is made by the executor or trustee. The need for a modification of section 453 in this regard will become more pressing if carryover basis takes effect on January 1, 1980 as scheduled. Bills (S. 2461 and H.R. 10617) were introduced in Congress during 1978 which included the recommended change.

3. To "reverse" *Sun First National Bank of Orlando* v. *United States*, 587 F.2d 1073 (Ct. Cls. 1978), holding that the capital gain portion of an installment sale subject to both estate tax and income tax is not income in respect of a decedent (section 691 income) and no section 691(c) deduction for the estate tax on such portion is available. If this case accurately reflects current law, the combined income and estate taxes on the capital gain portion of the installment sale may exceed 100 percent of such portion, which is an inequitable result.

The disallowance of installment reporting on sales to a related party when the related party does not sell the purchased property within a short period of time after acquiring the property is in our opinion unwise tax policy. No loophole exists when the purchaser retains the property. Thus while the rule proposed is simple, it is unfair. In many cases, installment sales are made between related parties when the purchaser has no intention of selling 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.

Congress has dealt with the "quick" sale problem in seciton 644, relating to sales by trusts, and directed that the income tax on sales of property within two years of a transfer to the trust other than by death shall be determined as if made by the grantor. We believe disallowance of installment reporting should be confined to cases where the related party obligor under the installment obligation disposes of the property within two years of the transaction. In such a case, two approaches might be used. One would be to treat the disposition by the purchaser as a disposition of the installment obligation by the original seller, thus invoking section 453(d) and resulting in gain to the original seller. The other approach would be to provide that the obligor's basis in the acquired property for the two year period is limited to the payments made the original seller prior to disposition and that subsequent payments may be claimed as a capital loss in the year made.

In conclusion, we would like to point out 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 the seller and purchaser. Why should the rules for installment sales be different from the rules for private annuities? The area has been appropriately criticized as lacking a "coordinated taxing structure." (See Ginsburg, Taxing the Sale for Future Payment, 30 Tax L. Rev. 469, 475 (1975)).

S. 1062—Simplification of certain provisions of subtitle F

Section 7 of S. 1062 amends section 6075, relating to the time for filing a gift tax return, to provide in effect that a return for the fourth calendar quarter shall be due on the same date as the taxpayer's income tax return covering that same quarter. Thus, the normal filing date will be April 15th rather than February 15th under current law and, if an extension of time is granted for filing the income tax return, the same extension will automatically be effective for filing the gift tax return. In explaining this change, Senator Long said:

The change relating to gift tax filing requirements will assist practitioners in avoiding inadvertent penalties for late filing since a taxpayer's obligation to file a gift tax return for the last calendar quarter or year is often ascertained when data for final preparation of the donor's income tax return is assembled. Thus, the provision would improve compliance with the tax law.

The ABA supports this change, but submits that its rationale also applies to gifts made in the first, second or third calendar quarters which are reportable on a return required to be filed for such a quarter. This problem could be eliminated by doing away with the quarterly filing requirement and simply requiring an annual return (as was required prior to 1971). 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 is clear that the quarterly return increased complexity and added expense for the taxpayer and the Internal Revenue Service.

Another way this problem could be eliminated is by removing the ability of the Service to assess a penalty in connection with a gift tax return required to be filed on the 15th day of the second month following the close of the first, second or third calendar quarter of a year or a failure to pay the tax due for such a quarter at that time. In effect, the result would be a return to the old law for calendar year filings, except that interest would be due on a gift tax payable on the 15th day of the second month following the close of the first, second or third calendar quarter. If this change were made, the special rule of Section 6075(b)(2) were gifts for a calendar quarter are $25,000 or less should be eliminated.

We urge that one additional change in administration provisions under subtitle F should be made by the addition of a new section to subchapter B, relating to miscellaneous provisions. Section 2504(c) provides that if the time has expired within which to assess a gift tax and if a gift tax has been paid, the value of the gift is "final" in connection with determining the gift tax for any succeeding calendar quarter. As a result of changes made in the transfer tax laws by the Tax Reform Act of 1976, the same problem may arise in determining an extate tax or a Chapter 13 tax because the tax may be affected by the amount of the adjusted taxable gifts of the decedent or of the adjusted taxable gifts or the taxable estate of the deemed transferor. Section 2504(c) should be replaced by a new section in subchapter B of subtitle F applying its concept to all related transfer tax determinations.

Section 4 of S. 1062 amends Section 6033 relating to returns filed by exempt organizations. We support the efforts to simplify reporting requirements of private foundations, particularly the proposed combining of the Return of Private Foundation Exempt from Income Tax (Form 990-PF) and the Annual Report of Private Foundations (Form 990-AR) into a single return containing information currently required on the separate forms. However, the extension of the requirement to file a Return of Organization Exempt from Income Tax (Form 990) to nonexempt charitable 4947(a)(1) trusts deemed to be public charities would be contrary to the basic purpose of this Congressional review of simplifying reporting requirements. Nonexempt charitable trusts classified as public charities are currently only required to file a U.S. Fiduciary Income Tax Return (Form 1041) and to attach to the return a copy of the IRS determination letter stating that the trust is not a private foundation or it qualifies as a public charity. To impose a Form 990 reporting requirement on these trusts would greatly increase the reporting burden on fiduciaries. In order to carry out the purpose of the bill of greater public disclosure we recommend that the Form 1041 filing requirement be retained but that a fiduciary be required to attach to it a listing of the trust's assets and their market values as of the beginning and/or end of the trust's taxable year and that this information be made available to the public or to State officials.

Since Section 4 of S. 1062 deals with simplifying the reporting requirements of charitable trusts, we would like to suggest that reporting simplification would be in order for Section 664 charitable remainder trusts. Today charitable remainder annuity trusts and charitable remainder unitrusts are required to file a Form 1041-B, a Form 5227, and a Form 1041-A. A review of the information in these three forms would show that the necessary reporting could best be achieved by combining Form 1041-B and Form 5227 into a single return incorporating the information on the two separate forms, and by eliminating Form 1041—A since the information requested is either duplicative or not relevant.

We thank the Subcommittee for the opportunity to testify on these first of a series of proposals to simplify specific provisions of the Internal Revenue Code.

Senator BYRD. That was scheduled to conclude the hearing, but I understand that Prof. Thomas R. White of the University of Virginia and Prof. James Halpern of the New York University Law School are here and have asked to testify. I will be glad to take the next 10 minutes and let the two of you divide that time between you, if you would care to do so.

STATEMENT OF JAMES HALPERN, NEW YORK UNIVERSITY LAW SCHOOL

Mr. HALPERN. Sir, I am James Halpern, a visiting professor at NYU Law School and this is a tremendous day. It seems like the fox and the chickens both agree on how to clean out the henhouse, and I think that is really marvelous.

We have only a few things we would like to bring to your attention, and the first is that we applaud loudly this effort of reform. Reform has not seemed to work well in omnibus tax bills; maybe the idea to do it piecemeal, taking smaller bites at the problem, will work better. The installment sales rules seem an ideal place to start.

We have a rather complex statement which we would like to submit for the record. In the interest of simplification, I will summarize one or two points about the proposed changes.

First, with regard to the 30-percent rule, everybody seems to agree that eliminating it is a good change. The reasons have been well stated by Professor Ginsburg. I would like to point out the consequences of not having an installment sale rule—not permitting deferral of tax on the gain—in cases where more than 30 percent is paid in the year of sale.

Under the cash method of accounting the full amount of the gain could be taxed immediately to the seller even though very little or nothing was received. For example, suppose a farmer sold his farm which he purchased years ago for $10,000, and the buyer agreed to pay a relatively high price, say $100,000, to be paid $50,000 next year and $50,000 the year after. It is very possible that, unless our farmer can elect the installment method of reporting, the full $90,000 gain will be taxed in the year of sale. Note that the farmer received no cash in the year of sale.

The installment method allows deferral of tax until the actual cash is received.

Assume further that our farmer received a $40,000 payment in the year of sale. The installment sale election will not be available under the present statute but, in the year of sale, he will have to pay tax not only on $36,000 of his $90,000 gain but, very possibly, on the full $90,000, even if he is a cash-basis taxpayer.

Senator BYRD. The proposal does not do away with the installment method.

Mr. HALPERN. No; the proposal would do away with the 30-percent limitation. What we are saying is that when even more than 30 percent is received in the year of the sale—40 percent in my example—that it is unfair to require the taxpayer to pay a tax on the full amount of the gain, including gain to be received in the future.

Senator BYRD. Well, the bill does not do that; does it?

Mr. HALPERN. No; it doesn't. The bill eliminates the 30-percent test. We are saying that under the present law——

Senator BYRD. The present law does, yes.

Mr. HALPERN [continuing]. If more than 30 percent is received, the situation is inequitable in that it requires the taxpayer to pay a tax on money that he has not received.

Senator BYRD. You are complaining about the present law.

Mr. HALPERN. Yes. We are illustrating the problem with present law and supporting everything everybody else has said.

The second point we would like to make has to do with the only revision that seems to have engendered any kind of argument whatsoever—the provision preventing sales to related parties from being taxed on the installment method. We are in agreement with everybody who has testified so far that the provision in the bill should be limited—that it should not simply outlaw all sales to related parties.

We also want to emphasize, though, that a limited restriction in such cases is appropriate. The problem arises, Senator, for example, when I sell property to my wife on the installment method, and she immediately turns around and sells that property to a third party. She has not realized gain if the price she receives from the third party is exactly the sales price that she has agreed to pay to me. I do not recognize gain immediately either, because I have elected the installment sales method. I recognize gain only as my wife makes installment payments to me.

Between my wife and myself, however, we have already received the sales price. We have the cash in hand and may yet defer the tax. That is the problem.

We maintain that it is a loophole, inequitable, or just bad policy to allow a related party group such as husband and wife to sell the property, receive the cash, and not pay the tax.

We feel that the current proposal can be appropriately limited to deal only with cases where the related party purchaser resells the property within a limited period of time. In our written statement we have outlined some methods for doing so.

We do not think that this provision should be dropped from the bill simply because it does more than merely simplify the Code. Everybody has agreed on the bill's provisions so far, mainly because they are favorable to taxpayers, doing away with the 30-percent limit, doing away with the two-payment rule, et cetera.

We suggest, Senator, that the bill be looked at as a whole. It may indeed be appropriate to include in a simplification measure which primarily benefits taxpayers a bit of the burden of loophole closing, a bit of the burden of tax reform.

Simplification is only one of the goals of tax reform and need not be the only goal of this bill.

With that, Senator, I would like to turn the make over to my colleague, Professor White, who has a few further things to say.

Senator BYRD. Thank you.

Professor White?

STATEMENT OF THOMAS WHITE, UNIVERSITY OF VIRGINIA

Mr. WHITE. Well, it is difficult to add to what has already been said about this provision but I was thinking while the Assistant Secretary was discussing the problem of complexity generally and using his cancer metaphor that complexity grows insidiously in secret ways until suddenly it develops into a terminal case. I was trying to think of the metaphor for the cure, whether radical surgery—which used to be the technique that was employed for certain types of cancer—was the proper device to be used in the situation. Radical surgery sometimes works and sometimes does not. Sometimes it leaves the cancer in place, and the complexities continue.

More sophisticated cures, cures that require more careful study and longer period of treatment, a more comprehensive approach, seems to be more likely to be successful in dealing with the installment sales area.

The tax treatment of installment sales seems to be an appropriate place to begin because of the general agreement that we have already seen among concerned persons. The witnesses that have appeared today, regardless of the different points of view that they may represent, all seem to agree on the importance of the measure and on the important points that should be contained in the bill.

Very few of the witnesses, a very small portion of the testimony, really came to the conclusion that Congress ought to only do one or two things and let it go at that. The point of what I have to say here, with my cure metaphor for the cancer of complexity, is not to be misled by the thought that surgery—meaning elimination of the 30-percent rule, which is the primary focus of this testimony here today—is going to produce the desired results.

Now, I also want to emphasize—and we have discussed this at some length—that the statements made by Professor Ginsburg and by Mr. Gutman focusing on the pressure on the present installment method election ought to be relieved. The pressure arises because there are different and inconsistent ways of reporting deferred payment sales for tax purposes. Eliminating the choices and focusing on ratable reporting as the one permissible method for deferring tax on the gain from the sale is the best way for doing that and holds the best chance for lasting simplification in this area.

Once Congress has eliminated from the statute those provisions that make installment reporting an exception rather than the rule, it is no longer necessary to retain it, elective feature or those other provisions which emphasize the fact that the installment method is an exception.

We reiterate our support for the notion that ratable reporting for all deferred payment sales—a concept familiar to most ordinary taxpayers that tax should be paid as cash is received—be made the rule rather than the exception.

With that, I will conclude our testimony.

Senator BYRD. Thank you, Professor White.

Thank you, Professor Halpern.

[The prepared statements of Professors Halpern and White follow:]

TESTIMONY SUBMITTED BY PROFESSORS JAMES S. HALPERN, NEW YORK UNIVERSITY LAW SCHOOL, AND THOMAS R. WHITE, 3RD, UNIVERSITY OF VIRGINIA LAW SCHOOL, IN A HEARING BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY OF THE SENATE COMMITTEE ON FINANCE, JUNE 22, 1979.

Senator Byrd and Members of the Subcommittee:

This memorandum is submitted in response to the Subcommittee's invitation for testimony on two bills proposing amendments to the Internal Revenue Code. Those two bills--S.1062 (the "Subtitle F Revision Act of 1979") and S.1063 (a bill to simplify the income tax rules relating to installment sales)--were introduced on May 2, 1979, by Senator Long (D-LA) on behalf of himself and the ranking minority member of the Committee, Senator Dole (R-KAN). While the bills themselves have a narrow focus, their real importance lies mainly outside their particular subject matter because they represent the first step in a proposed systematic review to clarify and simplify the Internal Revenue Code. That goal was emphasized by Senator Long, who introduced the bills with the stated purpose to continue the process in a series of bills, each with a similarly narrow focus, over the next few years.[1/]

Recent experiences with efforts at comprehensive revision have been disappointing, but it is very important not to lose the momentum of the reform process. Hopefully, making revisions in more manageable stages will prove more successful. We encourage that effort in the belief that tax reform--in the form of clarification and simplification--must be a prime focus of Congress' present and future concern with the tax system. We know that our belief is not novel, for many have spoken out against complexity and for simplification, but, again, we emphasize our support for the current plan. If a wholesale revision of our tax system is not now feasible (or desirable), then piecemeal revision is certainly worth attempting, and since the task is large, now is the time to begin.

Furthermore, we believe that review of the installment sale rules is a good place to begin. The problems are obvious and the alternatives often discussed. Effective revision is possible and necessary: (1) to clarify the requirements, (2) to reduce complexity and (3) to increase the fairness of the rules. With that in mind, we first offer some suggestions and comments on the proposed changes. Following that, we suggest some additional areas, with regard to the taxation of sales of property with payment deferred, where further reform may be considered. We will confine our comments to the installment sale area and will not address the proposed Subtitle F changes.

Before proceeding, however, we make an important observation about the piecemeal nature of the proposed reform package. A step-by-step approach may invite the possibility of step-by-step opposition. Not everybody favors tax changes which, though they accomplish broader policies by enhancing simplicity and certainty or by making operation of the law fairer, may impinge on tax benefits some taxpayers have enjoyed in the past. Moreover, it is rare that all interested parties can agree on what legislative changes are appropriate. By bringing forth a few, narrowly focused proposals at a time, the Committee may find the opposition equally narrowly focused, undistracted by a range of other proposals. We are concerned that dividing reform into more manageable pieces may make opposition seem more significant than it is, for any change necessarily means that some taxpayers must give up something. We urge the Committee to treat the installment sale bill as a package--a single reform--and not to give up its more difficult elements to enact those parts on which all seem to agree.

Improvements in clarity and certainty, however, are long overdue, especially in the area chosen to begin the process. Once the process of reform has begun, it may well get easier. Until that time, however, an extra measure of judgment and perseverance will be called for.

S.1063 (a Bill to Simplify the Income Tax Rules Relating to Installment Sales)

Under present law (I.R.C. § 453(b)), a taxpayer may elect to report gain from the sale of real estate or from certain casual sales of personal property for the taxable years in which payments are received (the "installment method" or "installment reporting"). That treatment should be contrasted with the general rules of tax accounting, under which the seller of property, whether he uses the accrual or the cash method of accounting, must include in income for the year of sale the full measure of gain realized on such sale, even though part or all of the actual sales price is not to be received until a subsequent year (or years).[2/] The purpose of the installment method is clear: to correlate the seller's liability for tax with the payments he receives.

Elimination of 30% Rule

To qualify for the installment method the seller may not receive, in the year in which the sale occurs, payments totalling more than 30 percent of the selling price. The bill proposes to dispense with the 30 percent limitation altogether, thereby allowing sales with deferred payments to qualify for installment reporting, no matter how large the downpayment may be. We support this change, since the 30 percent limitation, far from screening out cases which do not merit the benefit provided by the installment rules, has been more effective in trapping the unsophisticated or unwary taxpayer who, without the benefit of proper counselling, has failed to qualify for installment reporting. In other cases transactions have been tailored for installment reporting even though it might be in the best interest of both buyer and seller to have a larger downpayment made.

Senator Long's statement makes very clear that elimination of the 30 percent rule provides the primary impetus behind the bill. However meritorious that change may be by itself, we would be dismayed if that change were the only result of the bill considered here. We consider other provisions of the bill to be equally significant.

Increase of the $1,000 Minimum to $3,000

A restriction presently applicable to casual sales of personal property (but not to sales of real property) precludes installment reporting unless the sales price exceeds $1,000. The proposed legislation would increase this amount to $3,000. No reason for that change has been offered, although the change may be suggested because of concern that elimination of the 30 percent rule will increase use of the installment method, consequently overburdening the taxing authorities if the election were to be available for sales of personal property for relatively small amounts. Furthermore, no explanation has been given as to why the same reasoning does not suggest a $3,000 minimum for sales of real property as well.

Elimination of the Two Payment Rule

Another objectionable feature of present law--also characterized as a "trap for the unwary" by Senator Long--is the requirement that payments must be received in at least two taxable years.[3/] Thus, under present law, the installment method is available where the seller receives a very small downpayment in the year of sale with the balance due in another taxable year but is not available if no downpayment is received with the entire amount payable in another taxable year. The two payment rule is entirely a matter of form, without any basis in the substance of the installment method. The bill proposes to eliminate it.

Curtailing Use of the Rushing Trust Device

Going beyond mere simplification, the bill proposes two changes to reduce the use of planning techniques which are perceived as abuses. First, the availability of the installment method would be denied for sales between related parties. The tax planning technique at which that change is directed involves a sale of appreciated property under the installment method to a related party (such as a family trust). Subsequently, the property is resold by the related party with little or no taxable gain because the cost basis for the resale would equal the entire purchase price under the installment sale (including the as yet unpaid portion). That technique has gained currency as of late because of a number of court decisions favorable to taxpayers, the most widely known being Rushing v. Commissioner.[4/] The perceived abuse is that appreciation not only has been realized but also has actually been received by the related party group (from value paid by the third party purchaser) although the resulting gain is reportable only as installment payments are made within the related party group. Furthermore, the movement of funds from one member to another may actually be unimportant to the group and can, in any event, be timed so as to minimize the tax incurred.

To combat this perceived abuse, installment reporting would be denied for all deferred payment sales between related persons irrespective of whether or not there is a subsequent resale.[5/] The only exception is provided for deferred payment stock redemptions qualifying as sales or exchanges on the ground that the installment method is not then being used to obtain a cost basis to offset a subsequent taxable sale by a related party.

IRD Status Assured

Finally, the bill provides that the installment obligation disposition rules cannot be avoided by bequeathing an installment obligation to the obligor. Such a provision is necessary, Senator Long stated, because under present law some have argued that this technique could avoid having the unreported gain from an installment obligation treated as an item of income in respect of a decedent ("IRD").[6/] The result is wrong because, when combined with the step-up in basis (cost basis) received by the purchaser-obligor, it results in the total escape from taxation of gain clearly realized before the death of the seller-obligee. That problem is quite different from the issue posed by taxation of unrealized appreciation at death.

ANALYSIS OF THE PROPOSED CHANGES

Although the stated goal is clarification and simplification, the changes proposed in the bill do go beyond that narrow format. The anti-*Rushing* provision and the IRD change serve more to correct perceived abuses than they do to clarify and simplify. The distinction is noted not to denigrate these changes, but simply to avoid confusion in any debate that may arise. Indeed, we think that a reduction in the techniques by which sophisticated tax planning obtains undue advantage from the installment rules will not only measurably improve the evenhanded operation of the rules, but also support and justify extension of the method to transactions which do not now qualify. Abuse elimination may be the proper price to exact when simplification works to the advantage of taxpayers.

Elimination of the 30% Rule

Elimination of the 30 percent rule cannot but result in simplification. Although some form of initial payment limitation has been with us since the beginning,[7/] the justification for the limitation is not clear.[8/] The litigation engendered by the limitation has been extensive, and, as one leading commentator has observed: "[T]he game has not proved worth the candle."[9/] Clearly, the limitation should be eliminated.

Many of the complexities and obscurities of installment reporting stem from taxpayer efforts to avoid the 30 percent rule. For example, the treatment of the assumption of indebtedness--a common occurrence in real estate transactions--is governed by intricate rules designed to permit common types of sales to take place without running afoul of the 30 percent limitation. Once the 30 percent rule is abandoned, the operation of some of the derivative rules, particularly those involving the treatment of indebtedness, should be reconsidered. We have done so later in our testimony, both in light of the change discussed here and in light of our recommendation to extend installment reporting to other types of transactions.[10/]

$3,000 Minimum for Casual Sales of Personal Property

As stated before, it is hard to see why a different rule should apply to sales of personal property than to sales of real property. Conceivably the distinction is justified on the ground that since sales of real property for $3,000 or less are infrequent, there is no real need to subject such sales to a $3,000 limitation. If so, then no real harm could arise if sales of real property were also subject to the $3,000 limitation. Further, the goal of simplification would be served by having only one rule for all transactions rather than separate rules for sales of real property and for casual sales of personal property.

Even greater simplification would be achieved if the $3,000 limitation were dropped altogether. We do not believe that the administrative burden would be overwhelming and, furthermore, we believe that the likelihood is that most deferred payment sales for $3,000 or less are probably made by small and untutored taxpayers who only report gain when cash is received, and not before--i.e., under a de facto installment method. Disallowing the installment method then subjects those sales to the arcane rules on valuation of promises to pay in cash method accounting--for precisely those taxpayers who are least prepared to cope with such problems. We are convinced that it would be preferable for all concerned--including the Service--to abandon any limitation altogether.

Elimination of the Two Payment Rule

There is no good reason for the two payment rule. It rests solely on the presence of the word "installment" in the statute. The cause of simplification would be well served if it were legislatively eliminated.

Although it is clear from Senator Long's remarks that this is intended, the language of the proposed legislation is not explicit as to this point. We think that the bill should be modified so as to make the intention unmistakable.

The Anti-Rushing Provision

As we have previously observed, the anti-Rushing provision cannot be regarded solely as a matter of tax simplification. The proposal is intended to prevent the undue advantage obtained by an installment sale within a related group which is closely followed by a resale by the related group purchaser. Gain has been realized--and, more importantly, value (other than the third party purchaser's obligation) has been received (from outside the group)--but recognition is postponed. The funds derived from the sale are retained, as yet untaxed, for investment for the benefit of the group, allowing it to derive the economic fruits of deferral of tax on funds already received, a benefit clearly not contemplated by the installment method. To correct that abuse, however, we think the proposed remedy--denying installment reporting for nearly all dispositions to related parties--may at once be both too powerful and too weak.

The remedy is too powerful in that installment reporting is denied for virtually all dispositions to related parties, not merely those following which a further disposition soon occurs.[11/] Installment reporting should not be denied as a matter of policy for virtually all sales between related parties. We see no abuse, for example, in a sale of a family farm by a father to his son in an arm's-length transaction with payments deferred where the son does not promptly resell. A father and son may have a community of interest, but they do not necessarily have an identity of interest. Furthermore, is not the same observation true for other pairings of related parties--e.g., husband and wife, grantor and trust, shareholder and closely-held corporation?

We suggest that installment reporting for related party sales should not be prohibited as a general rule. Instead, since the abuse lies in the direct resale by the related party purchaser for cash, the appropriate remedy is to deny installment treatment only in such situations--i.e., when there is a direct resale. Installment sales that do not give rise to this abuse would thus be protected.

There are some technical problems which require study. Thus, the period during which the disqualifying resale has to occur must be set, and the mechanism by which the installment method is altered in the event of a resale must be decided.

A workable analogy might conceivably be found in the mechanics of Code section 644, which operates upon the resale by a trust of property transferred to it for less than the fair market value of the property. There, if appreciated property is transferred to a trust and within two years thereafter the trustee sells the property at a gain, the amount of the "includible gain" realized (a defined term) will attract a special income tax imposed on the trust but computed as though the gain had been included in the gross income not of the trust but of the initial transferor. A more direct solution in the installment case might be simply to deem all unpaid installments to have come due and been paid at the time (if within a prescribed period which need not be as long as two years) that the related party purchaser resells the purchased property. Though the suggested solutions may themselves seem complex when compared to an outright exclusion for related party sales, the equitable considerations seem to outweigh a loss in simplicity.

At the same time that an outright ban on the installment reporting of related party sales may be too strong a remedy for the abuse perceived, it may also be too weak--at least in the case of a disposition to a family trust. The weakness arises from the choice of Code section 267(b) for the definition of related persons. Although members of a family are there defined to be "related persons," section 267(b) limits "related persons" in the case of a trust to the grantor and a fiduciary.[12/]

We question, however, whether that category covers the relationship between a taxpayer and a family trust where the taxpayer is not a settlor of the trust and his only direct relationship to the trust is as the installment seller of property in an arm's-length transaction.[13/] A case which may not be covered, for example, is the sale of property by a mother to a family trust established by her father-in-law for the benefit of his grandchildren (her children). By allowing that type of transaction, the proposed legislation may be too weak, and the proper attribution rules may need to be considered carefully.

Income in Respect of a Decedent

As we have noted, the bill clarifies the rule in the case of a testamentary disposition to the obligor. We agree with the proposed change and suggest that a similar result be made clear for a testamentary cancellation and for the analogous inter vivos situation--*i.e.*, when an installment obligation is gratuitously cancelled or transferred to the obligor. In the former case (a cancellation) there is at least some authority for the view that since a cancellation is not technically a disposition, gain is not realized under section 453(d) when an installment obligation is cancelled.[14/] That view is wrong. The donee-obligor has already received a step-up in basis because of his purchase of the underlying property, and unless the donor is taxed on the prior appreciation, it will have escaped taxation forever--clearly an incorrect result.

ADDITIONAL PROPOSALS FOR SIMPLIFICATION AND REVISION OF SECTION 453--INSTALLMENT SALES

It is tempting in a proposal in which revision of this area of the law is the stated purpose to delve deeply into the wide variety of problems that attend deferred payment sales. The limited purpose of the Committee to achieve simplification while making as few changes as possible is, however, evinced by the limited scope of the bill. Moreover, any expansion of legislation tends to proliferate legislative problems and to increase the risk that what was intended to be simplification may in fact result in a different form of complexity.

Nonetheless, the problems to which the pending proposal is specifically addressed represent and, more importantly, cause other difficulties which should, at least, be considered if there is to be a satisfactory conclusion to this, the first effort to achieve simplification in partial steps. Before turning to those difficulties, however, we would like to reiterate two things that we have said before. First, simplification has never been the sole end of tax reform; indeed, simplification may itself serve other ends (e.g., the elimination of abuses). Legislation devoted exclusively to simplification may be self-defeating if it allows uniquely situated taxpayers to continue to receive benefits not fairly contemplated by the statutory provisions. The inequities thereby perpetuated may clearly be perceived as such by other taxpayers, not so well situated, or not so well advised. Thus, reforms which appear to go beyond mere simplification ought not to be rejected on that ground alone. Second, this particular proposal is an excellent starting place for the process envisioned by overall simplification. The problems with deferred payment sales are relatively well known, and may themselves be quickly understood. The process of making appropriate changes can then proceed with fair consideration given to both sides of any of the questions considered. What is suggested is to eliminate the most serious problems--those producing unfair, unintended or unequal results--and, at the same time, to close those avenues where manipulation for the benefit of more sophisticated taxpayers is apparent and inconsistent with the underlying purpose of the provision.

It should be borne in mind, of course, that simplification does not necessarily mean simple legislative provisions. To achieve specific results sometimes necessitates specific provisions. The cause of simplification may be well served even though complicated language is needed to produce a clear solution to a complex problem. Furthermore, simplification itself may mean elimination of tax rules which encourage complicated transactions. Some taxpayers have benefitted from such rules and can be expected to oppose any proposed change. If revision--even if only simplification is intended--is to be effective and worthwhile, there is likely to be conflict. After all, when have taxpayers voluntarily relinquished a tax benefit without a fight, no matter how unjustified the benefit may be from a policy point of view? Any revision which does not produce differences of opinion--a noncontroversial or consensus bill--is not likely to have much impact on the complicated transactions which led this Committee to consider the prospect of legislative change in the first place.

With that in mind, we respectfully suggest to the Committee that it would be fruitful to consider the following additional areas for legislative action.

The Requirement that Installment Treatment be Elected

We propose that the presumption of present law be reversed and that, for all deferred payment sales, installment reporting be made the rule rather than the exception.

The present statute, section 453(b)(1), provides that income from certain sales (sales of real property or casual sales of personal property for a price in excess of $1,000) "may (under regulations prescribed by the Secretary) be returned" on the installment basis. The Treasury regulations, and the Internal Revenue Service's interpretation of them, require an "election" by the taxpayer on the taxpayer's return for the year of sale.[15] The election may be made on an amended return--a concession grudgingly made by the Service after it lost some cases in which it sought to disqualify elections not made on returns which had been timely filed--provided certain conditions are met. One such condition is that no "inconsistent election" have been made in the interim. If a taxpayer, whether by choice or through bad advice, reports a sale of property as a completed transaction in the year of sale, even though actual payment is to be made later, the sale has been properly reported under the general rule. That taxpayer is barred from a subsequent effort to change his method of reporting to the installment basis.[16/]

On the other hand, a taxpayer who seeks to use the cost recovery method of reporting gain from the sale--a method which is fully explained in testimony submitted by Professor Ginsburg--but finds his path blocked by the Service, may subsequently elect the installment method.[17/] That result follows because election of the cost recovery method, having been rejected on the facts by the Commissioner and the courts, is not a proper election and the taxpayer has, therefore, not made an effective inconsistent election. It does not take much reflection to realize that the unsophisticated taxpayer, who initially has either been straight-forward or ignorant, is likely to lose the benefit of the installment election, while the more sophisticated taxpayer, gambling that his efforts will achieve an even greater tax benefit, apparently retains ultimate recourse to the installment election should his gambit fail.[18/]

Eliminating the 30% Limit Justifies Reversing the Election

Once the 30 percent limitation has been repealed, however, there is little policy justification for retaining the requirement of a formal election to use the installment method.[19/] Given the reason for installment reporting in the first place--to match the payment of tax on gain from the sale with the actual receipt of cash from the buyer--it makes sense to reverse the operation of present law and make installment reporting the rule rather than the exception. Under that proposal, gain from every qualifying deferred payment sale would be reported ratably as payments are received. Since most taxpayers would wish to use the installment method anyway, this change would eliminate a major source of confusion and conflict at very little cost.

Both Professor Ginsburg and the ABA Section on Taxation have recommended similar rules.[20/] Both, however, would make exceptions. The ABA's proposal would be limited to cash basis taxpayers, since those taxpayers are most likely to make the "unwitting" error its proposal seeks to prevent. An accrual method taxpayer would be able to use the installment method of reporting under the ABA proposal, but would have to make an election first. We see little reason for this distinction. Although accrual method taxpayers may generally be thought to be more sophisticated in tax matters than are cash method taxpayers, they may be no less prone to make erroneous elections.

Furthermore, two rules inevitably add a complexity that, to be justified, must serve some significant distinction.

More generally, both proposals permit an election to report the gain from the sale under the general rules required by section 1001. The ABA proposal contemplates valuation of the buyer's promise to pay under existing rules, thus, presumably, preserving the cost recovery method of reporting gain for certain cash basis taxpayers. We agree that a seller should be permitted to report all of the gain from a transaction in the year the transaction takes place. We understand that the seller may have peculiar tax characteristics--an unusually large loss carryover or capital loss--which make that choice desirable, but we believe that the offsetting advantage when that occurs--full reporting of the transaction--outweighs any possible revenue reduction. Moreover, we point out that full reporting of the gain in the year of sale has long been thought appropriate for a general rule.[21/]

Open Transactions--"the Cost Recovery Method"

All of this leaves a further question, not explicitly addressed by the ABA proposal but elaborately developed in Professor Ginsburg's memorandum. If the seller reports income on the cash basis, and can arrange the sale to receive an obligation of the buyer which is not sufficiently convertible to cash to justify, in the view of some courts, imposition of tax on the gain, a method of reporting the gain is available (the "cost recovery method") under which the seller offsets his basis against cash receipts until all of the basis has been recovered. Then, and only then, are subsequent receipts taxable. When compared with the ratable reporting requirement of the installment method, the cost recovery method of reporting, as Professor Ginsburg clearly demonstrates, does result in an undue deferral of tax on the gain. It is a method with a questionable legal basis, seeming to provide an inappropriate result and generally utilized only by those taxpayers who are more sophisticated and better advised. It is also difficult to administer and, when discovered in the audit process, productive of litigation. In operation, the system of taxing deferred payment sales would clearly be simpler were the cost recovery method not available.

Professor Ginsburg's solution is to keep the installment method as elective, but to require the same result--that is, ratable reporting--whenever any of the gain would be deferred. Thus, ratable reporting would be required even when the installment method is <u>not</u> elected, irrespective of whether the obligation can <u>or cannot</u> be valued for purposes of cash method accounting. If the same result is to be achieved within or without the installment method, however, then why allow an alternative ratable reporting system at all? We think Professor Ginsburg's proposal should be taken one step further by redefining the installment method to be the general rule and to require ratable reporting for all deferred payment sales, unless the seller specifically elects to report all of the gain, measured by the face amount of the buyer's obligation, in the year of sale. Such a proposal essentially restricts a seller to ratable reporting or to accrual reporting, and would eliminate intermediate situations in which the obligation of the buyer has sufficient value--less than its stated face amount--to justify imposing tax on the gain measured by market value of the obligation. Where presently three separate methods of reporting appear to be available, only two would remain; clearly a simplification.

In restricting the alternatives open to sellers in reporting gain from deferred payment sales, eliminating the cost recovery method and its attendant valuation problem appears to result in significant derivative benefits. First, valuation questions are always difficult, often producing conflict and uncertainty beyond any justifiable limit. Moreover, there would no longer be any difficulty where the amount eventually collected by the seller (the face amount of the buyer's obligation) exceeds the fair market value earlier determined for that obligation. Under current law, there is a problem because that excess is taxed as ordinary income, even though the gain on the sale of the property (utilizing the fair market value of the obligations as the amount realized) was taxed as capital gain.[22/] That result follows because once the initial sales transaction is closed, any further gain on collection of the buyer's obligation is seen as not arising from a sale or exchange.[23/] A sophisticated buyer can avoid this result by selling the buyer's obligation shortly before it comes due. The problem disappears in a world where the buyer's obligations are valued at face (i.e., are accrued) or taxed ratably as payments are actually made.[24/]

Installment Method to be Rule for all Deferred Payment Sales

In sum, we think that the installment method, far from being the exception, should be made the normal method of taxing all deferred payment sales. We would include even contingent and hybrid sales (a hybrid sale being one in which the consideration consists partly of fixed and definite payments and partly of payments contingent on some future event).[25/] The actual techniques for treating such unusual transactions need not be specified at this juncture. Such matters are technical problems, capable of development in the legislative drafting process. It is important, however, that the principle of ratable reporting be firmly accepted as the all but universal rule. As we have noted, our thinking would permit a seller to elect to accrue the face amount of the buyer's obligations in the year of sale; that would be the only exception. The result is a significant change from current law[26/]--not just a reversal of the presumption, but a change which would eliminate the major complicating factor in the taxation of deferred payment sales.

If the seller is permitted to elect to accrue the face amount of the buyer's obligations, inevitably some taxpayers will later discover the election to have been unwise and will wish to change. Thus, how binding the election should be will require consideration. If the effect of the election is limited to accrual of the gain in the year of sale, however, undoing the election need be no more complicated than filing amended returns for the year of the sale and any payment year. Provided the statute of limitations has not expired for any of the years in which gain would be recognized under the ratable reporting urged here, that should not pose an insuperable problem. Consequently, we recommend that the election to accrue the gain be revocable within the period allowed by the statute of limitations for filing amended returns for the year of sale.

Installment Reporting for Contingent Payment Transactions

Even if a more general application of the ratable reporting rule is not adopted, whether in the form we suggest or in that proposed in the Ginsburg memo, there is a class of sales which we think should be permitted to qualify for installment treatment (but which now cannot). If the consideration received in a sale consists of (1) a note for a specific amount plus (2) contract rights giving rise to future payments contingent upon income earned by the property,[27/] the Service takes the position (sustained successfully in court)[28/] that the sale cannot qualify for the installment method of reporting. The asserted rationale is that the amounts necessary to compute the portion of gain to be recognized cannot be determined. As a result, the value of the note must be reported in the year of sale even though payments are not due until a later year. We think that contingent transactions of this nature should qualify, at least where there is a stated maximum price and perhaps even in cases like Gralapp where there is not.

The problem can be seen as a matter of form. If the purchase price is defined as contingent on future events (say the amount of a tax to be determined later)[29/] the selling price is said to be indeterminate and the installment method unavailable. On the other hand, if the price is stated (but is subject to reduction for future contingencies) the transaction qualifies,[30/] with the amount of gain to be recognized from each payment subject to recalculation should any of the contingencies occur.[31/] A properly informed seller need not suffer loss of the installment method since an articulation of the selling price will be made in the form necessary to qualify. We do not think that a difference in form should lead to the difference in result, and we support an extension of installment treatment to any transaction where a substantial portion of the purchase price is, in fact, fixed. Allocation of basis in such cases is again a technical problem, and can be left to regulation.

Definition of "Payment"

So far, we have discussed an extension of the bill to deal with deferred payment sales generally and have recommended that ratable inclusion of gain be the general rule in all deferred payment cases. Proration would apply to each "payment" on the buyer's obligation. The term "payment" has, however, acquired a technical meaning under current law, mainly in response to application of the 30 percent limitation upon the availability of the installment method in particular cases. ("Payments" in the year of sale may not exceed 30 percent of the "selling price.")

There are two problems in the definition of "payment" to which we wish primarily to direct comment.

(a) Receipt of Qualifying Property in a Like Kind Exchange

An exchange of like kind properties of unequal value plus additional consideration to equalize the exchange may not only qualify for nonrecognition under section 1031 but may also qualify for the installment method if the additional consideration received by the seller consists of an installment note.[32/] For purposes of the installment election, however, receipt of qualifying property in the year of sale is a "payment" to the extent of the value of the property,[33/] even though the amount of gain ultimately to be recognized on the transaction is reduced because of the like kind exchange. An example will make the problem clearer.

> T exchanges property P-1, having a basis in T's hands of $10x, for B's property P-2, worth $30x, of like kind and B's note in the face amount of $70x, due in equal annual installments over the ensuing seven years, plus interest. T realizes a gain of $90x on the exchange, but, due to the application of section 1031, only $70x (the assumed value of the installment note) 34/ is recognized. Thus, the gain to be recognized is less than the gain realized because P-2 is like kind property. Moreover, only the property P-2 was received by T in the year of sale. Nonetheless, T must recognize gain in the year of sale equal to 70/100 times $30x = $21x. In each subsequent year, T shall report 70 percent of each payment he actually receives.35/

We think that the nonrecognition aspect of the transaction should be taken into account, and receipt of the qualifying property should not be a "payment" for installment reporting purposes. If so, the selling price (for installment purposes) must be reduced to $70x (the gain to be recognized remaining at $70x, since the $10x basis does not exceed the value of like kind property received). One hundred percent of each cash payment must be reported as received. It will quickly be observed that the effect of our proposal is to defer taxation of the $70x gain until the additional consideration is actually paid. We believe that result is consistent with the policies implicit in sections 453 and 1031--to postpone taxation of the gain until the taxpayer receives the cash necessary to pay the tax.

(b) Ratable Reporting for Mortgages

The treatment of indebtedness in installment cases is complex, and hardly intuitive. It is with much trepidation that we make any recommendation at all in this area, and we would not do so but for the existence of a rule which tends to undermine the ratable reporting principle we advocate so strongly.

If an indebtedness of the seller is assumed by the buyer on the sale of property--or, as frequently occurs in real estate transactions, the property is transferred subject to a mortgage with which it is encumbered--a regulatory rule treats the assumption of (or the taking subject to) the debt as a "payment" only to the extent that the amount of that debt exceeds the basis of the property.[36/]

The reason for the rule is apparent when the buyer accepts the burden of a mortgage incurred at or before the original purchase of the property by the seller. In that case, the amount of the mortgage is reflected in the basis of the property, and, indeed, may be less than the basis.[37/] If so, then for the purpose of determining the gain element of each installment sale payment, the acceptance of the mortgage burden is treated as a recovery of basis and the amount of the mortgage is not included in the selling price.

> Example: T sold P(l) to B. P(l) had a value of \$100x, a basis of \$50x, and was encumbered by a mortgage of \$40x. B accepted the property subject to the existing mortgage and agreed to pay T \$60x, \$10x down and \$10x per year for the five ensuing years, plus interest.

> Under general income tax principles, the $40x mortgage is included in the amount realized by T in order to determine T's gain ($100-$50=$50).38/ If acceptance of the burden of the mortgage by B is also a "payment," then T could not report his gain on the installment method because the amount of the mortgage alone (without taking into account the $10x cash downpayment) exceeds 30 percent of the selling price.
>
> Under the regulation, however, acceptance of the burden of the mortgage is not treated as a payment as long as it does not exceed basis. The selling price is, however, reduced by the amount of the mortgage. Of each remaining payment, 5/6 is reported as gain ($50x/$60x).

One can appreciate that the rule is intended to permit a sale for deferred payments to qualify for installment reporting even though the transferred property may be encumbered. Its effect is to permit the seller to offset his basis fully against the mortgage before reporting gain, thereby deferring tax on the gain until cash payments are actually received ("basis-first rule").

That rule does have an important complication. When the mortgage exceeds basis, the excess is a "payment" at the time of the transfer. In the example, assume that the mortgage is $60x and that B agrees to pay T $40x in annual installments over the ensuing four years. In the year of sale, B's acceptance of the mortgage burden results in a "payment" of $10x even though there is no cash downpayment under this version of the facts. The selling price is reduced by the amount of the mortgage, but only to the extent of basis (the offset cannot exceed basis). Thus, 100 percent of all payments, as defined, are reportable as gain and T recognizes $10x of gain in the year the property is transferred.

The basis-first rule of the regulation applies to any encumbrance on the property itself and may apply to unsecured indebtedness assumed by the buyer in the transaction.[39] The source of the debt is not important. As a result, the seller may borrow money after acquiring the property, using the property as security. Receipt of the loan proceeds is not taxable, nor is the amount of the mortgage reflected in the basis of the property to which it applies. Post-acquisition borrowing of this type may give rise to an abuse illustrated by the following example: Suppose that T owns P, unencumbered, worth $100x and having a basis of $40x. T wishes to defer as much of the gain realized on sale of the property for $100x as possible. If B pays T $40x down--assuming that the 30 percent rule has been properly interred--T must report 60/100 of that payment immediately. The balance of the gain is reported as subsequent payments are made. T, however, being well informed, visits his friendly banker sufficiently in advance of the sale to allay suspicion and borrows $40x, giving in return a mortgage on P. T then sells P to B, subject to the $40x mortgage, and in return for B's $60x note payable in future installments. B, with the cash he would otherwise have paid to T as a downpayment, could pay off the loan immediately, but, as will be explained, will be well advised not to do so.

Although T is in exactly the same position under either set of facts ($40x cash in hand), the tax results will be quite different. In the second case, using the basis-first rule, T offsets his basis in P by the amount of the mortgage, resulting in no immediately reportable gain. The selling price is reduced by the $40x mortgage, and 100 percent of each subsequent payment made by B is reportable, but T has achieved his purpose--he has deferred tax on $24x of the gain, and the principle of ratable reporting has been violated.

Under current law, the Service takes the position that a mortgage placed on the property to be sold in contemplation of the sale--and not for independent business reasons--should be disregarded.40/ In the cases where it has litigated the point, however, its efforts have so far been fruitless.41/ In one of those cases, Albert W. Turner, the court emphasized the "economic reality" of the loan made to the seller three months prior to the sale, although negotiations for the loan and the sale were carried on contemporaneously. Presumably, a loan placed on the property before the sale but on the strength of the buyer's qualifications would be more vulnerable, but well-advised sellers should be able to avoid the problem without much difficulty.

Under the present state of the law, therefore, the Service's prospects for limiting efforts by sellers to avoid ratable reporting by use of the regulatory basis-first rule are not encouraging, which raises the question whether anything should be done in the current legislative proposal to alter the rule.42/ Even if ratable reporting is not accepted as the guiding principle, it may still be worth the effort to study the present rules on debt assumptions in installment sales to see whether they can be improved.

If, however, as we recommend, ratable reporting of gain is adopted as the general rule, serious consideration should be given to treatment of the acceptance of debt as a "payment," subject to the same proportionate reporting requirement as cash payments. The one case that we think might possibly deserve exception from such treatment involves the mortgage which was placed on the property by the seller in order to acquire it or to make substantial improvements to it, or the mortgage which encumbered the property when the property was acquired by the seller in the first instance. In those cases, the amount of the mortgage is reflected in the basis of the property. In other cases, whether the mortgage was subsequently placed upon the property or the indebtedness is trade indebtedness assumed by the buyer in the transaction, the debt is usually represented by the receipt of cash or the earning of income. Its assumption can appropriately be treated as a payment. We realize, of course, that we have drawn a distinction between the property owner who buys on credit and the property owner who "finances" his purchase from his own savings and then, subsequent to the purchase, "refinances" his purchase by mortgaging the property for up to its cost. After study, this distinction may prove to be unworkable, and we advance it only as a possible choice to do justice in what is admittedly a difficult situation.

Other means of distinguishing between indebtedness which is "old and cold" in the sense used here--not incurred in contemplation of the sale of the property--may be devised, but, in our judgment, those tests would not prove to be as satisfactory. Thus, an arbitrary aging period, perhaps two years, may be thought to be sufficient to protect the debt from the "payment" rule. A test based on a finding of tax avoidance purpose by the seller ("borrower")[43/] would surely be unsatisfactory, potentially increasing litigation and by the same measure decreasing the certainty of the tax treatment of the sale.

Further Changes in the Basis-First Rule: Novations

We would not go beyond the suggested amendment of the regulatory basis-first rule in making legislative changes in the current proposal, but that is not to say that other problems do not exist. Suppose, for example, the "old and cold" debt is paid off in the closing of the sale (for instance, but not necessarily, where the buyer has negotiated a new mortgage to replace the old one which is satisfied in an escrow). Generally, when a debt of the seller is paid by the buyer in the sale, the buyer has made a "payment" to the seller.[44/] But, from a policy point of view, it is doubtful whether such a situation should be treated any differently than where the seller's mortgage is simply assumed or the property is taken subject to the mortgage. From the seller's point of view, it makes little difference if the mortgage is paid off, taken subject to (if nonrecourse) or assumed by a financially responsible buyer. Only in the last case is there any possibility that the debt will be of any future concern to the seller.[45/] To treat the first case as a "payment" while the latter two cases are treated as basis-first situations makes very little theoretical or practical sense and ought to be reconsidered.

Wrap-Around Mortgages

Finally, no discussion of the mortgage problem is complete without some mention of the so-called "wrap-around" mortgage.[46/] The "wrap-around" mortgage is not mysterious.[47/] To illustrate, suppose the property sold is encumbered by an existing mortgage which, for one reason or another, neither seller nor buyer wish to pay off. Moreover, it might be to the seller's tax advantage if the mortgage were not assumed in the "sale" of the property. The buyer, instead of assuming the burden of the existing mortgage, gives the seller a note representing the buyer's promise to pay an amount equal to the first mortgage plus the balance of the seller's equity after the downpayment. Installments are large enough to cover the payments on the first mortgage, for which the seller agrees to continue to be responsible. Thus, assume that S has property with a value of $100x and a basis of $40x. It is encumbered by a mortgage of $75x. S agrees to sell P to B for $10x down and B's note for $90x payable over the next five years. The installments are large enough to enable S to make payments on the first mortgage.

Over the Service's opposition,[48] the parties will argue that the property has not passed subject to the mortgage and that the full amount of the buyer's note is an installment obligation. Recognition of gain, it is argued, is required only as the buyer makes payments on the note, _i.e._, on the "wrap-around" mortgage. In our example, 60 percent (60/100) of each of B's payments would be reported in the year the payment was made: \$6x in the year of sale, and \$10.8x in each of the ensuing five years. On the other hand, if the first mortgage had been assumed directly, \$45x would be a "payment" in the year of sale (\$10x cash and \$35x excess of mortgage (\$75x) over basis (\$40x)) and the full \$45x would be gain recognized immediately. The effect of the "wrap" maneuver is to defer the tax on the gain until payments are made on the buyer's note, even though the parties are (usually) careful to specify that responsibility for payment of the existing mortgage rests with the seller.[49] In effect, however, the buyer has, _de facto_, assumed liability for the first mortgage.

As we have described the problem, the disadvantage of the mortgage rule is avoidable by use of a properly structured "wrap-around" mortgage. It has been suggested that the _de facto_ assumption of the first mortgage should be recognized and taxed accordingly,[50] with only that portion of the buyer's note which exceeds the first mortgage treated as an installment obligation. There are sometimes good commercial reasons for the use of "wrap-arounds," and we are therefore reluctant to propose limitations on their tax effect without additional study. Moreover, the technical legislative problem here is more difficult than in other areas we have discussed, and likely to lead to more problems. Nonetheless, in the context of ratable reporting we think there is good reason for treating a "wrap-around" note as the acceptance by the buyer of the burden of the first mortgage and the creation of a second mortgage and believe that such treatment is a subject for fruitful study.

The Anti-Rushing Provision

As stated above, we have supported a limited version of the provision contained in the bill, on the ground that a narrower focus is necessary for proper application of the proposed rule. The original problem, however, arose in the context of a corporate tax problem which would remain unresolved should the anti-Rushing provision be enacted.[51/]

A shareholder owned all of the stock of a corporation. He wished to sell either the corporation or the assets it owned. If he sold his stock for deferred payments, it was clear that he could report his gain under the installment method. If the buyer did not wish to purchase stock, however, the corporation could then sell its assets to the buyer without recognition of gain, provided it then liquidated and distributed all of its assets, within one year, including the consideration received on the sale.[52/] If consideration received on the sale included an installment note, there would not be recognition of gain at the corporate level,[53/] but, under the general rule applicable to the liquidation of a corporation,[54/] the installment note would be property received by the shareholder in the liquidation, the value of which would be included in the amount realized.[55/] Gain on the liquidation would be recognized in full. As this illustrates, the deferral achieved by a direct sale of corporate stock is effectively precluded by the tax rules applicable to corporate liquidations.

In Rushing, the possible loss of the deferral following an asset sale by the corporation was avoided by the intervening sale of the stock to a family trust created for the purpose. Although the trust immediately received the liquidating distribution from the corporation, it realized no gain because its basis in the shares was its cost--the amount of the consideration it had promised to pay the original seller. The anti-Rushing rule, by requiring the seller to recognize the gain inherent in his installment obligation when the liquidating distribution occurs, effectively reinstates the result which had seemed inevitable before the ingenuity of counsel addressed it.

Section 337 is intended to produce the same result when the corporation sells its assets and liquidates as when the stockholder sells his stock. Immediate recognition of gain on the liquidation, however, results in an inconsistency. We submit that a shareholder should be permitted to defer his gain on liquidation if an installment obligation, received by the corporation upon the sale of its assets within the provisions of section 337, is distributed in liquidation. The actual mechanics are not difficult to develop. We agree with the description of the proposal contained in Professor Ginsburg's testimony.

CONCLUSION

We conclude as we began: first, by voicing our support for the continuing process of review and revision contemplated by the two bills now before the Committee, and, second, in favor of selection of the tax treatment of installment sales as the appropriate place to begin the process.

Successful continuation of the process now begun depends upon consideration of whole subject matter areas as the proper focus of reform, not just the individual points within each area which might be studied in isolation. Thus, for example, the 30 percent rule, identified as the primary problem in the proper tax treatment of deferred payment sales, represents but one change among several which, when combined, can produce the simplification which is the stated objective of the revision process.

We have made suggestions, but our suggestions are intended essentially to raise important issues for study by the Committee. We hope our recommendations will contribute to the formulation of effective revision. Whatever the outcome, we have indicated and re-emphasize our willingness to assist the staffs in whatever way possible to develop legislation consistent with the goal of simplification and clarification.

FOOTNOTES

[1]124 Cong. Rec. S5184 (Daily Ed. May 2, 1979).

[2]It is possible that deferral may be available to taxpayers using the cash method of accounting who receive nonnegotiable promissory notes or contract rights in the year of sale, since realization of such amounts may not occur at the time of sale. Nina J. Ennis, 17 T.C. 465 (1951). But see Warren Jones Co. v. Comm'r, 524 F.2d 788 (9th Cir. 1975) (cash-basis seller of real estate was required to take into account the fair market value of readily salable contract rights received in the year of sale); and Reg. § 1.453-6(a).

[3]See Baltimore Baseball Club, Inc., 481 F.2d 1283 (Ct. Cl. 1973) (baseball player contracts); 10-42 Corp., 55 T.C. 593 (1971); Rev. Rul. 69-462, 1962-2 C.B. 107, amplified in Rev. Rul. 71-595, 1971-2 C.B. 223.

[4]441 F.2d 593 (5th Cir. 1971) (deferred payment sales of stock to irrevocable trusts created for benefit of sellers' children eligible for installment reporting although stock was almost immediately redeemed pursuant to liquidation plans adopted prior to sales, the test being that the sellers did not directly or indirectly have control over the liquidation proceeds or possess the economic benefit therefrom). Accord, James H. Weaver, Jr., 71 T.C. #42 (1978); Clair E. Roberts, 71 T.C. #26; William D.

Pityo, 70 T.C. 225 (1978), appeal dismissed (5th Cir.). But see, e.g., Paul G. Lustgarten, 71 T.C. #25 (1978) (sale of securities to son, who was required by agreement to resell the securities, reinvest the proceeds in designated securities, and place the new securities in escrow, the court holding that the installment method was unavailable since the son was merely the father's agent); Philip W. Wrenn, 67 T.C. 576 (1976) (deferred payment sale to wife who immediately resold held not to qualify for installment treatment where no substantive, non-tax avoidance purpose for the transaction was shown).

[5]A "related person" is defined in the proposed amendment to be "a person bearing a relationship to the person disposing of the property which is set forth in section 267(b) or 707(b)(1)." Both sections deal with, among other things, the disallowance of losses on sales between what are therein defined to be related persons.

[6]See Ferguson, Freeland & Stephens, Federal Income Taxation of Estates and Beneficiaries, pp. 190-92 (1970).

[7]See Ginsburg, Taxing the Sale for Future Payment, Part 1, A Proposal for Structural Reform, 30 Tax. L. Rev. 469, 482 (1972), at which the following footnote appears:

> Section 212(d) of the Revenue Act of 1926 established a 25 percent initial payment limitation, justified as a way of

resolving a valuation issue relating to the presumed security for the buyer's obligation. S. REP. NO. 52, 69th Cong., 1st Sess. 19 (1926). The limitation was then raised to 40 percent in the Revenue Act of 1928 and newly justified as a way to distinguish situations in which the seller had, and did 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 30 percent limitation came into the law with the Revenue Act of 1934 and reflected a congressional intention to equate current payment of tax with current ability to pay the tax. H.R. REP. NO. 704, 73d Cong., 2d Sess. 24 (1934). More recently the Tax Court has purported to uncover a hitherto unperceived legislative concern with administrative convenience as an additional justification for the initial payment limitations. Ivan Irwin, Jr., 45 T.C. 544, 550 (1966), rev'd on another point, 390 F.2d 91 (5th Cir. 1968).

[8] Id. [9] Id. [10] See text at notes 36 to 50, infra.

[11] In the most obvious cases of abuse, the sale to the outsider has been fully negotiated before the sale to the related party occurs. See James H. Weaver, Jr., supra note 4, in which, after the sale of the assets of the corporation for cash had been negotiated, the sale of the corporation's stock to a related trust, the closing of the sale to the outside purchaser and the liquidation of the corporation all took place in less than 36 hours.

[12] I.R.C. § 267(b)(4).

[13] Rev. Rul. 56-222, 1956-1 C.B. 155, holds that section 267(a) does not disallow a loss sustained by the decedent's estate on the sale of property to an inter vivos trust that the decedent, as grantor, created for the benefit of his widow. But cf. Barnes v. United States, 222 F. Supp. 960 (D.C. Mass. 1963) ("the sale by

the trustee to the husband of a beneficiary was a sale 'directly or indirectly . . . between a fiduciary of a trust and a beneficiary of a trust.'").

[14]See Miller v. Usry, 160 F. Supp. 368 (W.D.La. 1958), a case which has been much criticized. The court in Miller was aware of the anomaly its decision created when it observed that the result would have been different if the installment obligation had been transferred to the obligor rather than having been cancelled.

[15]See Treas. Reg. § 1.453-8(b); Rev. Rul. 65-297, 1965-2 C.B. 152.

[16]See Robert F. Koch, 37 T.C.M. 1167 (1978), for a very recent case in which that position was upheld.

[17]The cost recovery method is available to cash method sellers who receive a promise to pay of insufficient value to justify imposition of the tax. Since, so goes the underlying theory, payment is in doubt, the recipient may offset his basis against the payments as they are made. Only when the total payments made to date exceed basis does the recipient report gain. Valuation turns on such matters of fact as the stability of the collateral and the marketability of the note. See, e.g., John McShain, 71 T.C. No. 89 (1979); Anthony D. Miele, 72 T.C. No. 24 (1979). It is not difficult to depress the apparent marketability of a note sufficiently at least to raise the factual

question. Eliminating the more difficult applications of that branch of cash method accounting theory is a worthy goal.

[18]The irony of the rule should not be lost. The taxpayer who tries to observe the law without artificially depressing the value of his buyer's promise to pay may make an honest error and lose the flexibility of a possible change in election should his original perception of events prove inaccurate, while the other taxpayer, artfully practicing the cash method, preserves his flexibility even though he knows that his initial gambit is questionable. Indeed, the practice of making an alternative election to use the installment method should the gambit prove wrong now seems to be acceptable to the Service. See Warren Jones Co. v. Commissioner, 524 F.2d 788 (9th Cir. 1975).

[19]One effect of an election is to require the submission with the "election" of information necessary to determine how much will be taxable in each year. The sanction for failure to make the election--by failing to provide the information--ostensibly is immediate taxation of the gain. The sanction, however, is uncertain at best, and, barring full reporting of the gain in the year of sale, not effective in preventing a subsequent correction of the omission.

[20]Professor Ginsburg's testimony is contained in the record of the hearing. The ABA Tax Section recommendation is found at 31 Tax Lawyer 1507-11 (1978).

[21] *See* Treas. Reg. § 1.453-6.

[22] Taxation of the collection gain should not be a problem now. Consider the well-known case, *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952). There, payment by shareholders of the liability of their liquidated corporation was held to be a capital loss because their liability grew out of the liquidation, thereby making the payment a loss sustained in an exchange. Certainly, the gain of the seller on collection of his buyer's obligation similarly stems from the original sale in which the face amount of the buyer's promise to pay reflects the bargained for consideration. Other than the technical reason usually given in such cases, there is no good reason not to find the source of the gain in the prior sale upon the same reasoning as that contained in *Arrowsmith*.

[23] The statement is accurate for noncorporate obligors. For corporate obligors, *see* section 1232.

[24] The Ginsburg solution to the taxation of collection gain is to amend section 1232 to make it apply to notes made by individuals, as well as corporations. That solution is broader than the present problem since it would apply to third party notes transferred by the buyer, not the maker, to the seller and valued on the sale at less than face. No reason appears why that solution is inappropriate, just that it seems broader than the scope of the present inquiry.

[25] Gralapp v. United States, 458 F.2d 1158 (10th Cir. 1972).

[26] The result recommended in the text would also impact upon the proposal to increase the threshold limitation on sales of personal property. If installment reporting is the general rule, then there seems to be no reason to restrict its application to sales of a certain size, and the proposal made earlier and in the Ginsburg memorandum, to eliminate any limitation, makes eminent sense. Concern for small sales, and an effort to reduce the complexities in such transactions might lead to modification of the basis recovery rules in some situations. That we would leave to regulations, subject to a statutory authorization to make de minimis exceptions.

[27] Ginsburg, Example 9, at p. 33.

[28] See Gralapp, supra note 25; In re Steen, 509 F.2d 1398 (9th Cir. 1975); Rev. Rul. 77-56, 1977-1 C.B. 135; Rev. Rul. 76-109, 1976-1 C.B. 125 (buyer's payment of expenses of sale will not disqualify installment election where all adjustments made before end of year of sale).

[29] In re Steen, supra note 28.

[30] Rev. Rul. 77-56, supra note 28. A transaction involving guarantees on zoning restrictions was approved in Private Letter Ruling, Doc. No. 7833084, which also described the adjustments to

be made in reporting gain should an offset be required against the selling price.

[31]See Rev. Rul. 72-570, 1972-2 C.B. 241.

[32]Rev. Rul. 65-155, 1965-1 C.B. 356; see Franklin B. Biggs, 69 T.C. 905 (1978), app. pending (5th Cir.); Albert W. Turner, 36 T.C.M. 1790 (1977).

[33]Albert W. Turner, note 32, supra; Clinton H. Mitchell, 42 T.C. 953 (1964).

[34]The note constitutes the receipt of "other property" and results in the recognition of gain on the sale to the extent of its value. Here, value has been taken as equal to face ($70x), a result which is consistent with the application of the installment method for reporting the gain represented by the note.

[35]See Rev. Rul. 65-155, supra note 32. In the example, the basis of P_2 is $~~15~~10x, reflecting the fact that $~~25~~20x of the gain is not recognized on the transaction. At this point it is worth observing that, whether or not the 30 percent rule is eliminated, adoption of our suggestion will permit qualification of a combination like-kind exchange and installment sale, no matter what the value of the qualifying property is relative to the total selling price.

[36]Treas. Reg. § 1.453-4(c). Technically, the regulation purports to define the "selling price" for the purpose of computing

the proportion of subsequent payments which are reportable gain. Its effect goes quite beyond that.

[37]If the property is depreciable, of course, the face amount of the mortgage may exceed adjusted basis when the amount of depreciation claimed exceeds mortgage amortization payments made to date.

[38]Crane v. Commissioner, 331 U.S. 1 (1947); for an extensive discussion of the problem of the assumption of debt in property transactions, see Halpern, Footnote 37 and the Crane Case: The Problem That Never Really Was, 6 J. Real Est. Tax 197 (1979).

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

[40]Rev. Rul. 73-555, 1973-2 C.B. 159. The statement in the ruling was made in the context of the assumption by the buyer of nonmortgage debts, trade account indebtedness of the business being sold, but the same principle would apply to debt which is specifically secured by a mortgage on the property.

[41]Albert W. Turner, 33 T.C.M. 1167 (1974), rev'd and remanded on another issue, 540 F.2d 1249 (4th Cir. 1976); Denco Lumber Co., 39 T.C. 8 (1962), acq. Denco involved financing obtained by the builder and seller of shell houses to low income purchasers. The financing exceeded Denco's cost and enabled it to continue construction. Sales of houses were "subject to" the mortgage placed on the properties by Denco a short time before (and in contemplation

of) sale. The Tax Court rejected the Commissioner's "substance over form" argument as "arbitrary and unreasonable."

[42]There is not much authority on this problem--and indeed the Commissioner has acquiesced in one of the cases he lost (Denco Lumber). While the acquiescence might be explained on the basis of a finding that the purpose of the financing arranged by the seller was not to avoid the 30 percent rule [query], one should not take the lack of authority as an indication that the problem necessarily is insignificant. It would be very difficult to identify mortgages as suspect from the information normally supplied in elections to report under the installment method. A statutory rule, with the type of mortgage which would not qualify for the basis-first rule clearly identified, may strengthen the Commissioner's hand enough to improve the audit situation, but, quite candidly, the difficulty in identifying those mortgages which are subject to immediate recognition does improve the attraction of an all or nothing rule. At the least, the audit problem needs careful consideration if the treatment of mortgages is studied.

[43]Section 355(a)(1)(B) could possibly serve as a model for a "device" restriction.

[44]Rev. Rul. 76-398, 1976-2 C.B. 130 (cancellation of unrelated indebtedness owed to buyer); David C. Maddox, 69 T.C. 854 (1978) (payment in the sale); George F. Muller, 38 T.C.M. 719 (1979) (same). The rule is based on the more general rule that

payment by the buyer of a liability of the seller in the sale is the equivalent of a payment directly to the seller. Rev. Rul. 76-109, 1976-1 C.B. 125; Earl C. Bostedt, 70 T.C. 487 (1978) (payment by buyer of seller's expense of sale).

[45]On prior occasions, the Tax Court seems to have believed that the continuing involvement of the seller was important in treating the substitution as an assumption. See Albert R. Richards, 3 T.C.M. 504 (1972); R.A. Waldrep, 52 T.C. 640 (1969), aff'd 428 F.2d 1216 (5th Cir. 1970).

[46]For a description of the "wrap-around" loan in another context (investment by a real estate investment trust), see Rev. Rul. 75-99, 1975-1 C.B. 197.

[47]For a "wrap-around mortgage" to work for tax purposes, at least in the Commissioner's view, the underlying debt obligation may not be secured by a traditional mortgage. In the conveyancing sense, for there to be a "mortgage" title must pass to the buyer-mortgagor who conveys a mortgage to the seller-mortgagee. The Commissioner takes the position that, if title passes, literally ownership of the property has passed to the buyer "subject to" the existing mortgage, no matter who agrees to make the payments, and the regulatory rule applies. The Commissioner's emphasis on the form of the transaction as a conditional sale has continued right up to the present as can be seen from perusal of the private letter rulings cited in note 48, infra.

[48] Losses in the courts have not seemed to dissuade the Service. See Stonecrest Corp., 24 T.C. 659 (1955), nonacq., appeal dismissed (9th Cir. 1958); Est. of E.P. Lamberth, 31 T.C. 302 (1958), nonacq.; United Pacific Corp., 39 T.C. 721 (1963), appeal dismissed (9th Cir. 1964). Compare Private Letter Rulings, Doc. Nos. 7814010, -011 (1978). In all those cases, the issue involved qualification of the sale under the 30 percent rule. Some of the difficulties in this area are thoughtfully discussed in J. Miller, Installment Sales of Mortgaged Realty--Another View, 6 J. Real Est. Tax 1 (1978). Again, as in the case of new mortgages placed on the property shortly before sale, there is not much authority. There are hints that the Service, when presented with the right case, will adhere to its passage of title criteria, however silly that distinction may appear. The lack of cases may result from the difficulty, on audit, in identifying "wrap-arounds" when the existence of the underlying first mortgage is not disclosed, as it apparently need not be.

[49] The arrangements usually allow the buyer to make payments directly to the first mortgagee if the seller does not do so, often through an escrow from which funds are not released to the seller until the mortgage payments have been made. If the parties go too far in their caution, and the buyer is authorized to--and does--make the payments which the contract apparently requires the seller to make, the "wrap" is vulnerable and the buyer may be

treated as having, in fact, assumed the first mortgage. See Floyd J. Voight, 68 T.C. 99 (1977), app. pending (5th Cir.).

[50]Ginsburg, Taxing the Sale for Future Payment, Part I, A Proposal for Structural Reform, 30 Tax L. Rev. 469, 488-90 (1975).

[51]Rushing v. Commissioner, 441 F.2d 593 (5th Cir. 1971), for which the device is named, involved the liquidation of a corporation which had sold its assets under section 337 for cash and installment notes. For a description of subsequent developments, see note 4 supra.

[52]See section 337.

[53]Sections 453(d)(4)(B); 337(b)(1).

[54]C.A. Simpson, 35 T.C.M. 710 (1976); Mercedes Frances Freeman Trust v. Commissioner, 303 F.2d 580 (8th Cir. 1962).

[55]Section 331(a)(1).

Senator BYRD. The committee stands in adjournment.

[Whereupon, at 4:20 p.m., the subcommittee recessed, to reconvene at the call of the Chair.]

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

AMERICAN FARM BUREAU FEDERATION,
Washington, D.C., June 20, 1979.

Hon. HARRY F. BYRD,
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The American Farm Bureau Federation is the nation's largest general farm organization. Farm Bureau has a membership of over 3 million families in forty-nine states and Puerto Rico.

Tax policy has a significant effect upon the economic well-being of farm and ranch families. When the Subcommittee begins its consideration of S. 1063, a bill to simplify the rules relating to installment sales, Farm Bureau urges your careful review of the effects this bill could have on farmers and ranchers. We refer specifically to the proposed prohibition of installment sales transactions between related parties.

The use of Section 453(b) of the Internal Revenue Code has allowed many farmers, and owners of other small businesses, to transfer the ownership of business property to their children in a manner that meets the financial needs 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 the funds to pay for the property. Without Section 453(b) the farmer would be faced with the prospect of paying a substantial capital gains tax because the total gain would be reportable in the year of sale. Of equal importance in many cases is the possibility that the purchaser might not have the capital to buy the property if the installment method were not available.

At a time when the future of family farming is being debated in many quarters, Farm Bureau requests that the Subcommittee consider the importance of installment sales to the transfer of farm properties from one generation of farmers to the next. We urge that S. 1063 be amended to allow continued use of the installment sales method in transactions between related persons.

Thank you for your consideration of our comments.

Sincerely,

VERNIE R. GLASSON,
Director, National Affairs.

STATEMENT OF THE COMMITTEE OF BANKING INSTITUTIONS ON TAXATION

The following comments and recommendations regarding the jointly sponsored bill entitled "Subtitle F Revision Act of 1979" (S. 1062 and H.R. 3900, respectively) are respectfully submitted by the Committee of Banking Institutions on Taxation. The Committee's membership consists of representatives of various Trust Companies and Banking Institutions and its objectives are (a) to cooperate in assisting in the administration of tax laws; (b) to disseminate among its members information pertaining thereto; and (c) to act as a clearing house for communications to or instructions from Federal and State tax authorities.

These comments and recommendations relate to Section 4 of the "Subtitle F Revision Act of 1979", wherein private foundation and charitable trust (exempt and nonexempt) report requirements would be simplified.

We applaud your efforts in this regard and heartily approve of the proposed combining of the Return of Private Foundation Exempt from Income Tax, Form 990-PF, and the Annual Report of Private Foundation, Form 990-AR, into a single return (Form 990-PF) containing the information presently required on each of these two separate documents.

The proliferation of returns required of private foundations is not only time-consuming but tends to add confusion to an already highly complex area. At present, one needs a chart to determine which returns are required of various types of charitable trusts.

The combining of these two documents (990-AR and 990-PF) should, therefore, result in improved tax reporting compliance by private foundations and also improve the Internal Revenue Service's audit capabilities. In addition, tax compliance would be enhanced since more information would be available for inspection by State officials and the public.

We have no objections to extending the requirements of filing a 990-PF to a nonexempt charitable trust described in Internal Revenue Code Section 4947(a)(1), i.e., one deemed to be a private foundation. It should be noted here that Income Tax Regulations Section 53.6011-1(d) presently require a nonexempt 4947(a)(1) private foundation trust to file Form 5227, Return of Nonexempt Charitable or Split-interest Trust Treated as a Private Foundation. The filing of Form 990-PF instead of Form 5227 makes sense since we would now have a uniform return for all private foundations, be they exempt or nonexempt.

However, the extension of the requirement to file Form 990, Return of Organization Exempt from Income Tax, to nonexempt 4947(a)(1) trusts looked upon as public charities, would be contrary to your intention of simplifying reporting requirements. At present, such trusts are only required to file a U.S. Fiduciary Income Tax Return, Form 1041, attaching thereto either a copy of the determination letter issued by the IRS stating that the trust is not a private foundation by reason of Section 509(a)(3) or a statement that they qualify as a public charity in accordance with the requirements of TIR 1111, as ultimately incorporated into the Income Tax Regulations Section 1.509(a)-4(i)(4).

Corporate fiduciaries, such as our members, have numerous nonexempt charitable 4947(a)(1) trusts classified as public charities as opposed to the few classified as private foundations. As such, the imposition of filing Form 990 would vastly increase our reporting requirements since Form 990 is most obviously more time-consuming and complex to prepare than Form 1041.

We, therefore, respectfully suggest that such trusts should not be required to file Form 990. However, in order to achieve your purpose of full disclosure, we suggest that in addition to filing a Form 1041 there be attached thereto a listing of the trust's assets as of the beginning and/or end of its taxable year setting forth the market values of said assets. Further, we suggest that the law be amended so that this Form 1041, along with its attachments, be made available for public inspection or to State officials.

To enhance your efforts in streamlining the reporting requirements for charitable trusts, we have a few suggestions in respect to Section 664 trusts even though S. 1062/H.R. 3900 did not address itself to this area. A Section 664 charitable remainder unitrust and annuity trust is presently required to file Form 1041-B, Form 5227 as required by Regulations Section 53.6011-1(d), and Form 1041-A as required by

Internal Revenue Code Section 6034. Once again, we have a proliferation of required forms and thus, we respectfully suggest the combining of Form 1041-B and Form 5227 into a single return (Form 1041-B) containing the information presently required on each of these two separate documents.

In addition, we respectfully suggest that a Section 664 trust should not be required to file Form 1041-A since the information requested is a duplication of that requested by Form 1041-B and further since one-half of this form, namely Parts 11 and 111, is not pertinent to a 664 trust.

Finally, since your efforts in streamlining tax administration for charitable trusts would result in the filing of only one return, we respectfully suggest one more step to complete your goal, i.e., providing for a uniform filing date for both exempt and nonexempt trusts, namely the 15th day of the fifth month following the close of the charitable account's taxable year.

Once again, in the sake of simplicity without sacrificing full disclosure, we urge that Form 1041 be retained as the reporting vehicle for nonexempt 4947(a)(1) trusts, classified as public charities, by adopting the above suggestions and by possibly additional pertinent questions to Form 1041.

Uncalled-for complexity in our tax laws will be the bane of self-compliance under which our present tax structure operates. Let's not needlessly add more complexity to an already complex area. If the corporate fiduciaries which we represent feel this way, imagine how individual trustees and corporate trustees in small organizations would feel, many of whom I would venture a guess are not even conversant with Form 990.

Respectfully submitted,

ALBERT G. DOUMAR,
Chairman of the Fiduciary Committee.

STATEMENT OF PHILLIP L. MANN ON BEHALF OF KENNETH LEWIS

Many substantive provisions of the Internal Revenue Code require a determination of the extent of a taxpayer's ownership of stock in a corporation. Recognition of only formal, direct ownership, however, would permit careful taxpayers to subvert the intent of these substantive provisions. Experience tells us that an individual may possess the real benefits of the ownership of, for example, stock formally owned by his wife, or by a corporation all of the stock of which is owned by that individual. Accordingly, the Code has developed rules—referred to as "attribution" or "constructive ownership" rules—to determine tax ownership of stock formally owned by another.

It is a commonly held view that efficient administration of the tax law[1] would be hampered if it were necessary to make a factual determination in each situation with regard to whether a taxpayer possesses enough of the attributes of ownership to be considered the tax owner of stock of another person. Over the years, numerous sets of constructive ownership rules have been developed, each intended to determine by application of mechanical rules when stock which is not directly owned by a person will be treated as constructively owned by him. The statutory draftsmen have produced different sets of mechanical rules for different substantive provisions, frequently through modifications of other sets. Today the commentators do not even agree as to how many distinct sets of rules are contained in the Code. There are, however, at least four major sets in sections 267, 318, 544, and 1563; these are modified and supplemented in innumerable other Code sections, frequently to such a degree that a derivative provision is realistically a separate set of rules.

The diverse rules provided by these various provisions have contributed considerably to the overall complexity of the Code. For example, the extent of the family whose stock will be attributed to an individual taxpayer varies enormously. Perhaps the widest attribution among family members occurs under the collapsible corporation rules intended to prevent the conversion of ordinary income into capital gain. For purposes of the section 341(d) modification to the rules of section 544, a taxpayer is considered to own stock owned by his brothers, sisters, spouse, ancestors, lineal descendants and spouses of such brothers, sisters, and descendants. Under the constructive ownership rules of section 318, however, a taxpayer's family includes only his spouse, children, grandchildren and parents. A taxpayer's family under the rules governing multiple tax benefits of controlled corporations (section 1563) may

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[1] Other areas of the law permit or require an inquiry into all the facts and circumstances as a basis for a decision on attribution of ownership. See, for example, Securities and Exchange Commission Release No. 34-7793 (33-4817, 35-15381, 39-227, IC-4483), January 19, 1966, relating to the determination of beneficial ownership of securities under section 16(a) of the Securities Exchange Act of 1934 and other provisions of the federal securities laws.

include his grandparents in addition to his section 318 family; however, under certain circumstances a taxpayer may exclude his spouse, adult children, parents, grandparents and grandchildren, leaving him with perhaps the smallest Code family.

Although attribution rules have long been thought to be a prime area in which simplification of the Code could be achieved, Congress has not had much success in attaining that simplification. As early as 1958, Fred M. Ringel, Stanley S. Surrey and William C. Warren proposed in an article in the Harvard Law Review that sections 267, 318 and 544 be replaced with a unified and revised set of attribution principles. Ironically, however, the basic principles of the Ringel-Surrey-Warren proposals were incorporated into section 1563, enacted in 1964, as an addition to, rather than a replacement for, the previously existing rules.

Ten years after this scholarly proposal, in 1968, the American Bar Association approved Legislative Recommendation 68-1 which proposed a revision of section 318 and the repeal of the other attribution rules. While the revised section 318 would be made generally applicable, the ABA proposal also recommended specific alterations of the constructive ownership rules applicable to particular substantive provisions.

I believe that simplification of the constructive ownership rules and rationalization of the policy behind them are important and timely subjects for Congressional action. Accordingly, I endorse the objectives of the ABA and the prior proposals. The implicit assumption of the ABA proposal that different substantive provisions may justify different attribution rules, however, needs to be studied carefully, since it leads to a continuation of much of the complexity which it was designed to eliminate.[3] The ABA's proposal for two different rules for attribution among members of a family and the policy issues they raise are the matters I would like to discuss today.

The constructive ownership rules began as rules to prevent avoidance of the personal holding company provisions of the Code. They continue today to prevent avoidance of a number of substantive provisions of the Code through dispersions of stock ownership which lack real economic substance. In general, attribution of stock ownership among members of a family appears justified where the relationship between the members is such that one member may effectively control the other in such a way that the members comprise one economic unit distinct from unrelated persons who invest in the same enterprise. Thus, for example, it appears reasonable generally to attribute stock owned by an individual's spouse or minor children to that individual. Decisions to attribute or not in the case of other family relationships require judgments based upon general experience and observation of human behavior rather than any theoretical principles which only tax experts can understand.

Under the ABA's proposed revision of section 318, ownership of stock would be attributed between parents and children only in the case of children under 21 years of age. As I said earlier, this principle appears sound. Minor children, as dependents, are likely to be under the effective control of their parents. Adult children may remain the natural objects of their parents' bounty and, in that limited sense, may enjoy an economic interest in the corporation under inquiry that is different from other unrelated stockholders. However, human experience tells us that adult children are rarely under the effective control of their parents, and that their personal and economic interests as stockholders as often diverge from those of their parents as they coincide. An assumption that adult children are invariably under the effective control of their parents is so often wrong it seems a poor basis for providing an invariable tax ownership rule.

Secondly, the ABA's proposed revision of section 318 would not generally require attribution among brothers and sisters but would require such attribution for purposes of the provisions relating to personal holding companies, foreign personal holding companies and controlled foreign corporation. Direct attribution among adult siblings appears generally unsound. Adult siblings generally appear no more likely to be in a position effectively to control one another than unrelated individuals. In general, an adult would appear to be even less likely to form an economic

[3] In addition, as a matter of drafting style, the process of changing (e.g., for purposes of the controlled foreign corporation or the personal holding company rules) basic attribution rules prescribed elsewhere in the Code seems unnecessarily cumbersome. If it is assumed that alternative, progressively stricter sets of rules are required for different Code provisions, a simple approach might be to set forth in one Code section two or three such alternatives and incorporate the appropriate alternative by reference directly into each substantive provision.

unit with his siblings than with his parents, for whom the ABA general rule recognizes that attribution is inappropriate.[3]

The ABA proposal with respect to parent-child and brother-sister attribution in the case of controlled foreign corporations is particularly inappropriate. Section 958(b) of the Code currently provides that the rules of section 318, which do not provide for attribution among brothers and sisters, generally apply to determine whether a United States person owns 10 percent or more of the voting stock of a "controlled foreign corporation" (as defined in section 958(a)). (Ten percent stockholders are required to include in their gross income certain amounts with respect to controlled foreign corporations whether or not distributed as a dividend.)

For reasons that are not articulated, the ABA proposal with respect to section 958(b) expands its own general rule to include attribution between parents and adult children. Further, it expands present law to require attribution among brothers and sisters. In explaining this departure from its general rule, the ABA proposal states that the "special rule for foreign personal holding companies has been adopted for purposes of *uniformity*" (italic added).[4] However, the "uniformity" spoken of here is with the rule for foreign personal holding companies. No reason is given for conforming the section 958(b) rule to the personal holding company rule, rather than the general rule, and I do not believe an adequate reason for this departure and the resulting complexity exists.

The ABA's unexplained departure from its own general rule and present law is inconsistent with Congressional intent at the time the controlled foreign corporation provisions were enacted in 1962. At that time Congress rejected proposals to include attribution among brothers and sisters. Further, in describing these provisions, the Report of the Committee on Ways and Means stated:

> Not all U.S. persons who are shareholders in such a controlled foreign corporation, however, are to have attributed to them the specified types of foreign income of a controlled foreign corporation. This is to be done only in the case of those having on any day during the year a stock ownership of 10 percent or more of the combined voting power of all classes of stock, or of the total value of shares of all classes of stock. This de minimis rule prevents the attribution of the undistributed income back to the shareholders where their interest is small and their influence on the corporation's policy is presumably negligible. H.R. Rep. No. 1447 (87th Cong. 2nd Sess), emphasis added.

The ABA's general rule must be bottomed on human experience and a common sense judgment that parents and adult children and siblings are not generally under common control. If that judgment is correct, the ABA proposal for a stricter rule with respect to section 958(b) is internally inconsistent. Such a rule appears particularly unfair and inappropriate in the case of the controlled foreign corporation provisions. These provisions already represent an extension of the normal United States principles of tax jurisdiction by taxing directly to United States persons unreceived earnings of foreign corporations. Under these circumstances, if any special attribution rules are to be applied it would be more reasonable that they be more limited, rather than more expansive, than the general rules.

In conclusion, it is appropriate for Congress to consider improvement of the Code's constructive ownership rules. They can and should be made simpler and fairer. While the ABA proposal is generally wise, it can be improved. There is no sound policy reason to have a harsher attribution rule for foreign than for domestic corporations. Further, there is no sound policy reason to attribute stock to persons not under common control, and neither adult siblings nor parent and adult-child relationships are common control today, if they were ever.

Statement of Calvin H. Johnston [1]

H.R. 3899 (May 2, 1979) and its companion bill, S. 1063 would amend section 453(b) of the Internal Revenue Code to repeal the requirement of current law that

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[3] It should be noted that the parent-child attribution rules of section 318 have the effect of requiring attribution among siblings where there is a living parent since the parent will be treated as constructively owning stock of each child and each child will be treated as constructively owning stock owned, actually and constructively, by the parent. The ABA proposal would eliminate this indirect sibling attribution in the case of adult children by eliminating attribution between adult children and parents. At a minimum, indirect attribution among adult siblings should be eliminated by eliminating attribution between adult children and parents where the parents do not themselves own stock or participate as directors or employees in the management of the corporation. See generally section 1563(e)(5) which eliminates attribution between spouses if such conditions, among others, are satisfied.

[4] The related rules of section 6046(c) referred to by the ABA proposal, dealing with the filing of information returns, present no policy basis for constructive ownership rules. These rules merely reflect the policy decisions of other Code sections in the return requirements.

[1] Associate Professor of Law, Rutgers Law School-Newark, 15 Washington Street, Newark, N.J.

not more than 30 percent of the selling price of an installment sale of property be received in the year of sale for the sale to qualify for the installment method of reporting tax. I urge that the 30 percent limitation by maintained and stronger limitations adopted. I urge that H.R. 3899, if enacted as compromise, should, among other things, make section 453 override the open transaction doctrine within its scope. I write to suggest that as proposed, H.R. 3899, is in violation of the spirit of true tax simplification.

1. Error of extending installment reporting. The section 453(b) election was enacted, in spite of its inconsistency with accounting treatment of installment sales, as a tax relief measure. Its use, however, was limited by Congress to cases in which payment of the tax in the year of sale would work hardship because the seller received too little cash in the year of sale. Thus, for instance, Congress in 1934 reduced the ceiling from 40 percent to 30 percent of the contract price received in the year of sale, saying, "the 40 percent limit results in unreasonable postponement of tax in cases where such tax can well be paid in the year of sale.[2]

H.R. 3899 would breach the hardship limitation and elevate section 453(b) to a rule available for all deferred sales without arguable hardship. General installment reporting would be objectionable because it would discriminate between investment in a vendee's note and investment elsewhere, because it would violate sound principles on the timing of tax and because it would exacerbate the problem of abusive tax shelters. As Congress has previously concluded, general use of section 453 would result in unreasonable postponement when tax could well be paid. Moreover S. 1063 would effect no simplication because all the legal issues arising in the determination of of the 30 percent limitation would still have to be settled to determine payments and tax due in any year.

Section 453(b) provides an inappropriate tax treatment for most sales of property in which the vendee gives an installment note as payment. Sale of property is a realization event at which the government becomes entitled to tax the economic appreciation that has previously arisen. The increase in wealth could have been taxed when it arose under a Constitutional and equitable tax system, although taxation is delayed, mostly for administrative convenience, until the wealth is realized. As shown, for instance, by *United States* v. *Davis*, 370 U.S. 65 (1962), realization is easily triggered once the economic wealth is there; certainly sale is a sufficient change of position to constitute realization.

Within this context deferring taxable income until cash comes in may not be wise. Cash accounting has been aptly criticized as "not counting your chickens until they become grandfathers."[3] Wealth kept just off stage as negotiable notes, ready to enter as cash whenever the cue is given, really is not any different than the cash a taxpayer has received and invested in property like the vendee's note. Moreover, negotiable or assignable notes are so like other property that they should be taxed when their value can be readily ascertained.

Given the essential equivalence between vendee installment notes and other property, section 453(b) works a discrimination. Thus, Professor Chirelstein notes, "[Under section 453(b)] property sellers who desire or are willing to invest in their vendee's installment obligations are taxed at one rate while those who sell for cash because they prefer to invest the funds received in securities issued by other borrowers are taxed at another higher rate."[4]

The discrimination arises because deferral of tax is equivalent to reducing tax, even when rates remain constant, because of the time value of money. Chirelstein concludes that no reason in policy justifies the discrimination and suggests that Congress did not understand the consequences when it adopted section 453(b).[5]

With this in mind, the relief from hardship accorded even by current section 453(b) seems inappropriately generous. If there is insufficient liquidity to pay the tax on a sale, then the remedy should be focused on the tax and not the taxable income. For instance, the hardship of illiquidity could appropriately be met by amending section 453 to provide that the tax payable in any year with respect to an installment sale would not exceed the cash (or forgiveness of prior indebtedness) received in that year from the vendee or a third party. It would be appropriate to provide fair interest on deferred tax so as not to recreate the bias current law gives against non-vendee investments. For those taxpayers who bear a tax rate in excess of 30 percent of the gross proceeds of a sale, section 453(b) as currently enacted provides inadequate relief under this rationale. However, repealing the 30 percent

[2] H. Ways and Means Comm., H. Rep. No. 704, 73d Cong., 2d Sess. at 24 (1934).

[3] Bittker, A Comprehensive Tax Base as a Goal of Income Tax Reform, 80 HARV. L. REV. 925, 968, n. 73 (1967).

[4] M. Chirelstein, Federal Income Taxation: A Law Student's Guide to the Leading Cases and Concepts at 239 (1977).

[5] Id.

limitation would give inappropriate tax reduction for taxpayers who have no tax hardship due to illiquidity.

Even if unpaid installments were not always immediately recognized by taxing notes, still as general rule the Internal Revenue Service seems entitled to larger claim against the first payments than section 453(b) allows. There is nothing sacred nor especially wise about a rule requiring the government to wait on the risks and delays of the payment in cash while the taxpayer who chose to invest in the installment notes is getting his investment out tax free. As a rule, taxation should follow the cash payments when the taxpayer is able to pay it, less the tax to which government is entitled be ultimately avoided. It is fair, for instance, to presume that the seller's basis remains intact in the unpaid installments where the installments are fixed. Under the Bedford rule for boot and under section 301, the first cash that comes out is taxable gain and the last or liquidating cash is return of basis. So similarly recovery of capital should be allowed only against the last payments on a fixed installment note. If the taxpayer's assumed risk in his vendee's installment notes means the taxpayer's basis in the sold property and basis for taxed amounts is not returned, then tax recognization of the loss is certainly appropriate and that loss provides adequate provision for the recovery of taxpayer's capital. Since the tax rates on gain never exceeds 100 percent, taxing all of the first cash as gain would never place the taxpayer in a position where he had insufficient liquidity to pay the tax.

In sum, section 453(b) is questionable enough on its merits that extension is unwise.

One of the collateral difficulties arising from the extension of section 453 is that it would exacerbate the tax shelter problem, which is the paradigm example of the pernicious results of complexity in the tax law. Abusive tax shelters, not controlled for subsidy purposes, arise in part because of the anomaly in our tax doctrine under which the vendee of property immediately includes the full face amount of liability in basis and starts depreciating it, whereas the vendor need not pay tax on the liability until it is much later reduced to cash payment. The buyer gets advance credit for his payments and can depreciate them well ahead of the seller's recognizing gain. That anomaly means that the government probably loses revenue whenever an installment sale of depreciable property is made. The government's loss is a tax savings which is kept within the corporate or natural family in non-arm's length sale. Even in an arm's length sale, however, the government's loss can be split between the parties in their bargaining. Extending section 453 would extend the "float" available under current law.

There is, of course, no question that the 30 percent rule itself is a poorly constructed limitation to serve its function. The 30 percent limitation is avoidable by changes in form which have no effect on the underlying economic facts.[6] Arguably because the limitation looks only to events in the year of sale, it's too flawed in conception ever to be adequately enforced. The conclusion that should result from this, however, is to rework the limitation to meet the illiguidity problem and not to repeal the limitation. The limitation is one of those restrictions on overly generous tax treatment enacted to prevent the error in section 453(b) from becoming a flood gate. If the restriction is leaky, then the remedy is to replace it with a sound dam.

Repeal of limitation would, in fact, effect no significant simplification of the law of deferred sales. Most of the serious problems in the interpretation of the 30 percent limitation would still need to be addressed, even without the 30 percent limitation, to determine how much that must be paid in any year. Thus the difficult current problems such as (a) the pre-sale incurring of liability to take advantage of the assumption of liability rules under section 453, as (b) the vendee's assumption (or argued non-assumption) and payment of the vendor's liabilities, and (c) the vendor's receiving tangible benefits which might or might not constitute a disposition of the installment notes, would still be with us.

There is no question that a careful review of the law of those issues is long overdue, but if that law were to be simplified and made more rational, it is possible that on many issues taxpayer's would find stricter rules and not relief as the rules are adjusted to accord more closely with the underlying economic realities. Two examples should suffice: Taxpayers have a reportable position under current law that a wrap around mortgage is not an assumption of the vendor's prior mortgage and can not lead to a "payment," even though for all practical purposes, the wraparound vendee will bear the burden of the existing mortgage. Moreover, taxpayers can avoid reporting as payments closely pre-sale mortgages discharged in the sale. Given the low audit coverage, the tax lottery often gives the taxpayers the benefit of

[6] See, Ginsburg, Taxing the Sale for Future Payments: A Proposal for Structural Reform, 30 TAX L. REV. 469 (1975).

rules they themselves thought of only as a litigation or opening bargaining positions. A simplification which adjusts the law to reality is important in this area, but it is possible only by strengthening the rules by which "the government defends itself against the inventive spirit of harassed taxpayer." [7]

In sum, in the name of ensuring sound consistent reules for the entire tax system, Congress should reject H.R. 3899 and work for stricter limitations on the use of section 453.

REPLACING THE ELECTION AND THE OPEN TRANSACTION RULES

If some unsound liberalization of the 30 percent limitation is necessary in the name of political compromise, nonetheless H.R. 3899 should be amended to rationalize the law of deferred sales in other ways. For instance, in the name of simplification alone, H.R. 3899 should cause section 453 to replace the open transaction rule when section 453 could be applied. Thus it seems necessary to repeal the elective aspect of section 453 and make it obligatory within its scope.

Under current law, under the "open transaction" doctrine, if a vendee's note has no ascertainable value then the vendor need report no tax, absent a section 453 election, until the payments in cash exceed the taxpayer's entire investment in the property sold. This rule is applicable even when the vendee's total promise is fixed. However, for the same reasons that it is inappropriate to have pro-rata recovery of capital and gain, it is doubly unwise to defer the government's claim to the very end of a stream of fixed payments. The cash received at the start of the installments is an appealing candidate for taxation. Some would argue that deferring tax when cash is in hand works a discrimination in favor of those taxpayers with established wealth who have a high basis in property and against those entrepreneurs who have little basis.

Moreover the open transaction doctrine makes it advantageous for a taxpayer to arrange his affairs to receive nonmarketable consideration in the sale since the taxation of marketable notes, either under section 453 or the closed transaction rule, is so less generous. That means that the tax law is systematically prejudicing the taxpayer against making his vendee's notes marketable. Taxpayers can make notes nonfungible by negotiating odd provisions that are not commercially tolerable in an efficient market; through such "fungicides" he can avoid tax. As a matter of economics, it is clear that negotiable notes would improve the vendor's position, since subsequent events might make him disparate to turn the notes into immediate cash. But still the tax advantages of the open transaction doctrine are so very generous that too many taxpayers are tempted to give up the economic rationality of marketability for the tax advantage of deferral.

Computation of tax under section 453 does not require that the value of the vendee's notes be ascertained. Thus section 453 can be applied for transactions which would qualify for the open transaction doctrine, even though the taxpayer would not elect section 453. To reduce the bias against marketability, section 453 should be applied even against the vendor's interests, if it can be. Ideally section 453 should be expanded to cover contingent or uncertain payments in some manner, so that there is no tax bias in favor of contingencies to the sale price, but the proponents of H.R. 3899 have decided that working out rules for contingencies is too ambitious a project at this point and for the present that decision, while not ideal, is defensible.

Moreover, the elective aspects of 453 creates burdens on a taxpayer which should be reduced by the process by simplification. Under current law, a taxpayer must compute whether section 453 election is advantageous according to the multiplicity of facts in his present and future position. He, for instance, must make the difficult legal and factual judgment as to whether a court would find his vendee's notes have ascertainable value and guess at that value in order to determine whether section 453 is more or less generous than the alternatives. He must estimate his tax bracket in future years to figure whether deferral would be swamped by the detriment of shifting taxable income into high bracket years. Those judgments cannot usually be made without the help of expensive tax advisers. Those taxpayers who do not have sophisticated tax advice by contrast are often trapped into a less advantageous alternative. Simplification, thus, would be furthered by abolishing the elective aspects of section 453.

Expanding section 453 without abolishing the open transaction doctrine is no compromise at all. The proponents of section H.R. 3899 suggest that the bill is a compromise because the bill would increase the threshold for qualification for

[7] Wurzel, Tax Basis for Assorted Bargain Purchase or the Inordinate Cost of "Ersatz" Legislation, 20 TAX L. REV., 165, 166 (1964).

section 453 from $1,000 to $3,000 sales.[8] They suggest that the raising threshold is required to reduce the administrative burdens on small sales. The increase to $3,000 is no compromise. The $1,000 was adopted in 1926 when the predecessor of section 453 was first enacted. Inflation alone since then would mean that a threshold would have to be far in excess of $3,000 today to have the same meaning in current dollars. If the proponent's intent to ease administration is serious, then that rationale should carry the threshold even higher than the inflation adjustment to perhaps $10,000 or $20,000. The burden of the I.R.S. and taxpayer of keeping accurate accounts of installment sales and note dispositions is indeed onerous enough to justify that raise. However, raising the threshold so high would dramatize the discriminatory impact against poorer taxpayers and spotlight that section 453 at its core as too generous and discriminatory to be wise.

H.R. 3899 and the simplification process. The extension of section 453 would be an error on its merits. Probably more importantly, however, is the harm to the policy of true tax simplification which H.R. 3899 would effect. H.R. 3899 is intended to be the first instance of a new review lasting several years intended to effect significant tax simplification. Simplification, however, would be off on the wrong step if the concept is used in partisan fashion to mean repeal of restrictions on over generous tax provisions. Simplification, if it is to come, must come as a balanced, even elegant compromise between competing interests. If simplification is used as an excuse or make weight to justify unsound tax relief, then the drive for simplification is bound to fail in its far more important goals.

I thank the Committee for the opportunity to present this testimony.

Statement of Jay S. Goldenberg

INTRODUCTION

This statement is directed to the proposed new Section 453(b)(3), denying installment sale treatment to transactions between related parties.

This provision is designed to cope with a particular tax planning technique which is disapproved of. However, it is much more restictive than the problem requires, affecting probably 99 "innocent transactions to strike at one "guilty" one.

Such a broad attack on intra-family installment sales will severely restrict the ability of family members to sell farm and business interests to one another, encouraging sale to outsiders and conflicting with Congressional policy of seeking to preserve the family business and farm.

It is questionable whether the technique in question need stimulate such concern, as it primarily creates for owners of other assets an advantage already present for owners of publicly traded securities.

If, however, it is concluded that as a matter of policy this technique should be restricted, it is possible to do so in a more precise manner with less drastic side-effects.

This commentary is more fully developed on the following pages.

I. THE PROPOSED SECTION 453(B)(3) WILL AFFECT 99 "INNOCENT" TRANSACTIONS FOR EVERY "GUILTY" TRANSACTION IT LIMITS

Under the proposal, paragraph (3) provides that Subsection (b) of Section 453, dealing with use of the installment method for return of certain dispositions—i.e., installment sale treatment—"shall not apply to a disposition directly or indirectly to a related person." Related person is broadly defined by cross-reference to Sections 267(b) and 707(b)(1).

The reason for this provision was explained when the bill was introduced as follows:

"Under present law, a tax-planning technique involves selling appreciated property on the installment basis to a related party, such as a family trust, and then having the property sold by the related party at little or no taxable gain because the cost basis for the second sale would reflect the entire purchase price under the installment sale. In this situation, the appreciation has been realized within the related party group but gain is recognized for tax purposes only as the related party purchaser makes installment payments to the original seller."

In summary, the transactions which the provision *seeks* to attack are those in which the property is soon resold, so that "the appreciation has been *realized* within the related party group" (italics added). However, the transactions which the provi-

[8] Long, Statement of Introduction of S. 1063, 125 Cong. Rec. (Daily Ed) No. 54 at 55184 (May 2, 1979).

sion does in fact attack are those involving any installment sale within the related party group, regardless of whether the property is in fact resold, even if the appreciation has not been realized.

Without engaging in extended statistical surveys, it is probably safe to say that at least 99 percent of installment sales between related parties are for the purpose of transferring interests within the related group with no intent, and no result, of resale outside the group. The result is to penalize all these innocent transactions in order to strike at the 1 percent which are in fact reselling.

II. DENYING INSTALLMENT SALE TREATMENT TO TRANSACTIONS BETWEEN RELATED PARTIES WILL INHIBIT RETENTION OF FARMS AND BUSINESS WITHIN THE FAMILY

Even without tax considerations, there would be installment sales. They arise from the economic reality that many buyers of all types of property—from clothing to homes to businesses—are unable to pay at once the full price for their purchases. It is very common for purchasers of farms or businesses to pay for them on the installment basis out of their earnings. This arises not from tax considerations but from the inability of the purchaser to pay full price.

The installment sale provisions are in the Code as relief to sellers. For example, consider the owner of property with a basis of $20,000 which he sells for $100,000 to be paid in annual installments of $5,000 (plus interest). His ultimate gain will be $80,000, but he will receive only $5,000 the first year. If he had to recognize all the gain on entering into the sale he could conceivably be liable for as much as $22,400 (last year it could have been $30-40,000) tax while having only $5,000 with which to pay the tax. To complicate his situation further, if the purchaser ruined the property and went bankrupt, the seller might never even receive any of the $80,000 gain on which he'd been taxed. Relief is afforded the seller by permitting him to report the gain as received—i.e., each payment is proportionately both return of capital and gain, so that he need pay the tax only.

It is undeniably true that many sellers may be prompted by tax considerations to exercise their unquestioned right to structure the transaction to defer receipt because it is to their tax advantage to do so. It is also true that the vast majority of such transactions are so structured because of the inability of the purchaser to pay the full price immediately.

The installment sale rules enable sellers to sell to those who must pay in installments. In the example above, if the seller were forced to recognize all the gain immediately, he could not afford to sell to a buyer who could not come up with at least 22.4 percent of the purchase price. A year ago he might have been unable to sell to a buyer who could not come up with 30 to 40 percent of the purchase price.

If a seller will receive installment sale treatment by making an installment sale to A, but will not receive it if he makes an installment sale to B, it is to his economic advantage to sell to A. If, furthermore, B is unable to come up with sufficient cash for an initial payment to enable to seller to at least pay the taxes engendered by the transaction, it is not merely economically advantageous to sell to A rather than B—it is economically compelling.

This lengthy exposition has been as introduction to pointing out the effect of denying installment sale treatment to transactions between related parties on family farms and businesses.

This provision would create a situation in which it would be economically disadvantageous to sell farm and business interests to family members rather than outsiders. If the family purchasers couldn't even come up with enough down payment to enable the seller to pay the tax the first year, a sale to a related party would be economically disastrous.

It is probable that if Committee members were to consult farm and business groups in their states, they would find that the majority of sales between parents and children are "bootstrap" installment sales, in which the children make small down payments and pay off their parents over the years from the earnings of the farm or business.

Similar comments could be made with respect to most transactions between related parties: they are structured as installment sales because of economic necessity.

If Congress denies installment sale treatment to transactions between related parties it will economically encourage sales to outsiders—normally owners of other businesses and farms. This will mean decline of family owned and operated farms and businesses, increasing the degree of consolidation in the economy.

This is in direct conflict with the Congressional policy of encouraging the retention of farms and businesses in the family. That is the purpose of Section 303—to permit redemptions for taxes rather than having to sell to outsiders—and Section 2032 A—to limit the valuation of business and farm realty.

By this provision, Congress will in the long run do more to weaken the family farm and business than those sections do to protect them.

III. THE TAX PLANNING TECHNIQUE UNDER ATTACK MERELY AFFORDS TO SELLERS OF OTHER TYPES OF PROPERTY BENEFITS SIMILAR TO THOSE AVAILABLE TO SELLERS OF PUBLICLY TRADED SECURITIES

In selling the property on an installment basis, the seller gives up immediate receipt of the proceeds. If the property is subsequently resold the proceeds are available to related parties but not to the original owner. In the example used before—if the property were resold by the related party, that party might receive the proceeds and pay an installment to the original owner. They might have $100,000 within the group, but the original owner will only receive $5,000 initially.

Contrast this with the results if this had been $100,000 of listed securities. The owner could have walked into a brokerage office and sold the stock short against the box. He would have owned the securities, offset by an equal short position to leave him economically neutral, and received the proceeds of $100,000. Under current margin rules he could have withdrawn 50 percent or $50,000.

Thus the second person could have had 50 percent of the proceeds available to him personally without being forced to recognize gain—even if he held the position forever. He would have made himself economically neutral with respect to the property's changes in value and could have, at his leisure, closed his position in installments to suit his fancy—with the possibility of changing his approach periodically as he sees changes occur in the economy.

The first would have had 100 percent of the proceeds available within the related group but only 5 percent to him personally. In fact he would have had 3.78 percent available since he would have had to recognize a portion of the gain the first payment, and with each subsequent payment. He would have been locked into a payment program determined initially.

One must wonder what policy justification can be made for barring the first approach while permitting the second.

IV. IF POLICY REASONS REQUIRE AN ATTACK ON THE TECHNIQUE, A MORE PRECISE METHOD IS AVAILABLE WITH LESS DRASTIC SIDE EFFECTS

The stated goal is to strike at situations in which property is sold on an installment basis to a related party and soon resold. The necessity thereof is questionable, and certainly the denial of installment sale treatment to all transactions between related parties has disastrous effects disproportionate to the "evil" sought to be cured. If it is felt that this technique must be attacked, it would seem more appropriate to use an approach more specifically geared to the problem.

The problem does not arise from the installment sale to a related party but from the subsequent resale.

Congress coped with a similar problem in 1976, when it enacted Section 644. That section deals with a sale by a trust, within two years of the transfer in trust, of property which had substantially appreciated at time of transfer. In such event the trust was to be taxed on the gain at the rate which the transferor would have paid had he sold the property.

It should be possible to provide that if property is sold on an installment basis to a related party and is resold to an unrelated party within two years then the original seller would recognize receipt to the extent of proceeds received by the intervening party.

It would be inappropriate to tax the gain to the intervening party since that party's only gain is the increase over the purchase price, on which it must pay anyway. In the case of Section 644 the transferee has the transferor's low basis and recognizes gain, the only issue being the rate of tax on such gain.

This method still has problems. It subjects the initial seller to a tax on unreceived proceeds, resulting from a decision of another party. It is really questionable whether the problem is serious enough to warrant this. The main advantage over the approach proposed in the bill is that at least it injures a lesser number of innocent parties, and does not have the adverse effects on family businesses and farms previously discussed.

ARTHUR ANDERSEN & CO.,
Washington, D.C., June 14, 1979.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management Generally, Committee on Finance, Washington, D.C.

DEAR SENATOR BYRD. We respectfully submit the following comments in connection with your Subcommittee's hearings on the portion of S. 1063 which proposes certain changes to Section 453(b) of the Internal Revenue Code.

Before commenting on this specific legislation, we commend the Subcommittee for commencing a review of proposals to make complex provisions in the Internal Revenue Code more understandable and more effective. There are a number of other areas, aside from the installment sales provisions, where unduly complex procedures have become part of the tax law, and basic tax policy objectives could be accomplished in a simpler and more efficient manner. We urge the Subcommittee to attempt to identify provisions like these and to enact changes to make them more effective.

Section 1 of S. 1063 would deny installment method reporting for all sales made directly or indirectly to certain related parties as defined therein. As explained in the introductory remarks to the bill, this proposed change is intended to deny a tax planning technique under which an installment sale between related parties, followed by a resale of the property, results in little or no gain taxed on a current basis. We respectfully submit that the provisions in the bill are too broad and would prevent legitimate deferred payment sales between related parties where deferral of tax is appropriate.

As a general rule, gain realized on the sale or exchange of property is included in gross income in the year of sale. However, as evidenced by the legislative history of Section 44(b) of the Internal Revenue Code of 1939 (the predecessor of current Section 453), Congress recognized the hardship involved in immediately taxing gain where payment for the property sold was to be made in the future. Therefore, Congress provided relief for deferred payment sales by allowing the seller to recognize income only as payments are received. This same relief should be available where sales are made between related parties unless by resale or otherwise some member of the related group receives a greater part of the sale price in cash or marketable assets than has been remitted to the original seller.

Since the subsequent resale seems to be the problem in this area, we believe that legislation should be confined to the perceived abuse. We strongly urge, therefore, that the related party provisions of S. 1063 not be enacted as proposed, but that section 453(d) of the Internal Revenue Code, relating to dispositions of installment obligations, should be amended. The amendment might provide that the subsequent resale of property within one year after a deferred payment sale between related parties should be treated as a disposition by the original seller to the extent the related party receives cash or marketable securities in excess of the amount already remitted to the original seller during the taxable year.

Recognition of gain by the original seller on resale of the property by the related parties should not prove to be a hardship. If the original sale is legitimate, the seller would probably have to release his collateral before a resale could be accomplished. To the extent the related party receives cash or readily marketable securities, a seller on an arm's length basis would normally demand payment and so should the original seller.

If the related party is "at risk" for one year or more, a legitimate sale should be inferred. It is unlikely that a taxpayer would incur the economic risks of holding property for over a year solely for the purpose of deferring a tax liability.

We believe that our suggested amendment to Code Section 453(d) addresses the concerns toward which the proposed Section 453(b)(3) is directed, and yet continues to permit the benefits of installment sales treatment between related parties where tax deferment is appropriate.

We will appreciate your careful consideration of our comments as you act upon this legislation.

Very truly yours,

WILLIAM C. PENICK.

STATEMENT OF THE GOVERNMENT RESEARCH AND DEVELOPMENT CORP.

We appreciate this opportunity to participate in the presentation of testimony in this hearing on Tax Simplification.

Tax Simplification is a must in our country if we are to survive as a free and vibrant economy. It is a problem of equal status with our energy and economic problems. In fact, as now constituted, it holds the strings of control over these problems and just about every action our individuals and businesses take. The noose has been consistently and inexorably tightened since the first modern income tax law was enacted in 1913.

The noose was tightened by two principal factors (1) legislative action and following (2) executive action. In the beginning everyone thought the law was simple. On the outside it was. However, one idea which was part of this law that would make it imcomprehensible in 1979 was the fact that it was based on Net Income. It was a fatal error which plagues us today in a way which many would say makes us a third rate nation in tax administration.

If the sponsors of the Underwood-Simmons Tariff Act had substituted the words "Gross Income" or "Gross Receipts" instead of "Net Income" and if such a definition has been rigidly adhered to over the years, we would today have an income tax system which would be the envy of the world. Our leadership in the tax field would be equal to that in space technology, energy production and mass produced automobiles. Instead, because of our Net Income Tax (NIT) system we have over 6,000 pages of fine print, including the Code and pursuant regulations. This is not all. We have countless private and public IRS rulings that bear on individual situations. These rulings are largerly subjective and are made by IRS personnel to fit the situation as the IRS person sees it. And, this is not yet all. There are thousands of rulings on deductions made by individual IRS auditors, which, if it were physically possible to bring them all together for comparison, would doubtless be conflicting in a very large number of cases.

It seems to be the thrust of this hearing that tax simplification of our present NIT system can be made in incremental steps. The present tax system was made complicated in just such incremental steps. This took 66 years. Trying to simplify the NIT system in just such incremental steps is going to take as much if not longer as soon as the Congress passes one of these incremental simplification measures. A special interest lobby will come forth the next year and exert pressure to have it changed. To the surprise to some and of no surprise to others, the hoped for simplification has turned into yet another complication. History shows this to be true.

Mr. Lubick's testimony suggests that two major reasons for tax complexity are (1) legislation to accommodate special interest and (2) that the tax code is being used to perform government functions other than raising revenue.

The second of these reasons is self-evident to almost everyone. The tax code is being used to pressure every individual and business in the country into certain economic or social patterns. Even the IRS does this itself. Witness the proposed regulations with respect to the tax status of private schools in the matter of segregation. Unfortunately any tax system can be used in this way. The best way to mitigate and monitor such activities is to bring them up in the sunshine. Under our NIT system everything is hidden under the "deduction" system and impossible of accurate compiling. Under the Gross Income Tax (GIT) system such activity could be monitored "by the numbers" and even computerized. Such compiling would give the Congress a simple way to evaluate every program.

The first of Mr. Lubick's reasons are a direct result of our NIT system. The reason special interests are in Washington and consequently make the law more complex every year is that they are all looking for more and more deductions to fit their special situations. This is an inherent defect of the NIT system. Under the GIT system the need for such special interest legislation would disappear.

Mr. Lubick further suggests that we should perhaps adopt more general legislation and that specifics be left to the discretion of the IRS. A few short thoughts show the IRS already has more discretion over our individual and business lives that even a force like the FBI. It has a unique position in our governmental structure. It can invade anyone's privacy with impunity. It's rulings are rarely subject to review. The Office of Management and Budget is supposed to control the amount of time and effort Americans must spend filling out Federal forms. According to the Federal Reports Act of 1942, any Government agency wishing to collect information from 10 or more persons must obtain approval from the Regulatory Policy and Reports Management Division of OMB. The agency must specify the estimated respondent burden in terms of the total number of manhours required to complete the form(s). The IRS is exempt from this requirement. Clearly such exemption has made the IRS feel free from almost any control at all. Yet, the IRS is not entirely responsible for this state of affairs. They have proliferated the forms in an effort to properly administer our present incomprehensive NIT system. A police force like the IRS should be honored by giving them a tax system with which they can comply with OMB's reporting requirements just like any other agency. If this is done the IRS would be justified in having discretionary powers. The GIT system would provide such an atmosphere.

One aspect of our tax legislative and executive action is the almost total absence of members of the general population in the planning process. The planners are usually either lawyers, economists, tax practitioners or academicians. We could achieve much better tax legislation and execution if there were more engineers, logicians, mathmaticians and others who have been especially trained in a practical logical fashion.

Approaching tax simplification in an incremental manner is the only practical way to do it. We do not feel however that the incremental approach under our present NIT system will do the job. As discussed previously, every incremental step under our present NIT system is going to end up as another complication. We believe the effective way to achieve simplification is to (1) resolve to implement a simple tax system like GIT and (2) to approach the introduction of the new system in an incremental way. If such an approach to simplification were adopted we would get simplification in a quantum leap.

As an extension of this statement we attach two publications. One, entitled, Toward a Rational Tax System. This gives an overview and perspective of our NIT system from its inception in 1913 up to the present. The other is The Income Tax-Our National Problem, Edition 79-1. This is a collection of letters which provide a view of how GIT would apply to many current problems.

Thank you for the opportunity to present our views.

TOWARD A RATIONAL TAX SYSTEM

—— Jim Jones

"If both you and your spouse had dividend income from jointly or separately owned stock, you may each subtract up to $100 of dividend income even if you file a joint return. However, neither of you can use any part of the $100 exclusion not used by the other in the case of stock owned separately."

----Instructions for Form 1040, 1978

In a recent speech, Commissioner of Internal Revenue Jerome Kurtz cited statistical evidence from the Department of Health, Education, and Welfare that the basic filing requirements of the Form 1040 (U.S. Individual Income Tax Return) were beyond the comprehension of a large portion of the adult population.[1]

While many taxpayers quarrel with the amounts the Government extracts and many quarrel with the waste that seems inevitably to accompany Government spending, the real quarrel--the issue that gets taxpayers' backs up--is the staggering burden of dealing with the Internal Revenue Service (IRS). To fill out an endless array of tax forms, to maintain ever-growing stacks of yellowing receipts, and otherwise to comply with IRS rules and regulations has, for many, become a year-round activity.

This back-breaking burden--one that weighs as heavily on individual citizens, comparatively speaking, as it does on big business--is not the fault of the IRS. It results from a long history of action by Congress in passing a never-ending stream of tax legislation, the sum of which--the tax "system"--has no rhyme, no reason, no rational basis to it at all. And it is the task of making this "system" work that falls to the hapless IRS, which often finds itself in the frustrating position of clarifying and simplifying its tax forms and instructions at the same time Congress is discussing new and even more complicated tax provisions.

The Start of Something Big

When, on October 31, 1913, President Wilson signed into law the Underwood-Simmons Tariff Act, he set in motion a Federal income tax system that today has become a crazy quilt of short forms, long forms, schedules, deductions, preferences, exemptions, and exclusions that virtually no one can understand. Indeed, in a 1975 address to the Tax Foundation, then Secretary of the Treasury William E. Simon said, "I'm not even sure the IRS experts fully understand the system anymore. How can they when they are dealing with a tax code and regulations that exceed 6,000 pages of fine print?"[2]

The 6,000 pages began as only 14, which specified who was to pay the new tax, how much was to be paid, and when it was to be paid. There was surprisingly little public opposition to the new income tax, perhaps because it was not due until 4 months later, on March 1, 1914, and because it was applicable only to those relatively few persons in the highest income brackets. The first year, less than one-half of 1 percent of the population was required to file an income tax return.

To administer the new tax law, Congress appropriated $800,000, most of which went to devising an income tax form and to recruiting and training clerks to inspect the completed returns.

The 34 agents of the Bureau of Internal Revenue had their hands full that first year.

Compliance with the new law was uneven--not everyone understood who was required to file a return and who was not. Of those who filed, few could read between the lines of the vague new law, to determine what was meant by income or what constituted property.

Other problems arose because the income tax was assessed on the basis of net rather than gross income. Many of the first income taxpayers hadn't kept their accounts to show net income. Others hadn't kept receipts to prove deductions. No one seemed to know for certain what deductions they could legitimately claim And because there were no legal precedents for identifying allowable deductions, taxpayers were left in the very favorable position of deciding for themselves what part of their income was net.

The first income tax form itself left many taxpayers confused. Consisting of three pages, the return looked remarkably similar to those in use today. Although it did give some thought to the matter, the House Committee on Ways and Means decided that it would not unduly burden taxpayers to fill out a tax return. In recommending the bill to the House, the Committee stated that "...those citizens required to do so can well afford to devote a brief time during some one day in each year to the making out of a personal return of income...." The "brief time" required to fill out the return apparently was not so brief, however. Even some of the income tax's staunchest supporters in Congress gave up in despair on filling out their own returns and asked the sergeant at arms and his assistants to do the job for them.[3]

From A Little Acorn

There soon developed the need to clarify the income tax law, to increase the Government's tax revenue, and to explain the recordkeeping and reporting requirements of various new taxes. It was not long before the 14 pages of the original income tax law became several hundred. Nor was it long before nearly every American earning income was drawn into the tax system.

In 1914, the corporation tax was merged into the new income tax law. In 1916, with the United States about to enter World War I and in need of greater revenues to finance the war effort, Congress passed a new revenue law. Although the new law did not change who was exempt from paying income tax, it did double the rates for those individuals and corporations already paying the tax. Among other changes under the new tax law, manufacturers of munitions were assessed a special additional tax of 12.5 percent on their net profits, thus introducing the principle of the excess profits tax.

Perhaps the most significant change in the income tax law was in the definition of "income." The 1913 Act had defined income as including proceeds from "any lawful business carried on for gain or profit." Mindful of the urgent need for additional revenue to finance participation in the war, Congress simply dropped the word "lawful" in the 1916 Act.

The Revenue Act of 1916 was soon found inadequate and was revised by the War Revenue Act of 1917. The 1917 Act, by lowering the level of exclusion, made many more Americans subject to the income tax.

Numerous revenue acts followed, each with a new set of even more intricate provisions requiring additional taxpayer effort. By the mid-1930s, employment taxes made it necessary for employers to record and report to the Federal Government the wages they paid their employees. As additional employees and businesses became subject to the Federal Insurance Contribution Act (Social Security), the Federal Unemployment Tax Act, and the Railroad Retirement Act, new records had to be kept, new reports filed, and new taxes paid.[4]

In 1939, to simplify compliance, Congress undertook to codify systematically all the old and new laws. Tax legislation passed after 1939 became amendments to the basic code.

With the outbreak of World War II and the need once again for greater revenues, the Government broadened the tax base to include nearly all persons earning income. Additional tax legislation inaugurated the "pay-as-you-earn" system, whereby employers were required to withhold Federal income taxes from their employees. Thus, monthly and quarterly reporting and payment cycles were added to the employer's yearly tax responsibilities.[5]

To integrate all of these changes, the tax code was again overhauled in 1954, and it is this code plus all of the subsequent tax legislation that are in effect today. Examples of subsequent legislation include the Tax Reform Act of 1969 (referred to in the profession as the "Lawyers and Accountants Relief Act") and the 400 pages of the Tax Reform Act of 1976. However, to comprehend fully the provisions of the income tax would also require knowledge of the several hundred volumes of court decisions and IRS[6] rulings that have interpreted the tax code. There are, in addition, many rulings that have never been published.

Recognizing the patchwork of laws, regulations, clarifications, and interpretations that is the Federal tax system, former Treasury Secretary Simon concluded that it was high time the Nation had "a tax system which looks like someone designed it on purpose."[7]

Is Aspirin Deductible?

The confusion and complexity of the IRS code is reflected in the forms both individual and business taxpayers must fill out. The Tax Reform Act of 1976, for example, added five new entries to the Form 1040 and eight to the Form 1040A, otherwise known as "the short form."[8] In 1978, the booklet of instructions accompanying Form 1040 numbered 28 pages.

The IRS is responsible for almost 80 percent of the total reporting burden imposed by Federal agencies on individuals and businesses.[9] This burden translates into both time and money.

The Office of Management and Budget estimates that the standard individual tax form (Form 1040) takes an average person nearly 3 hours to fill out.[10] This does not include the time needed to gather information or to keep records throughout the year.

Business taxpayers must spend even more time filling out Federal tax forms. In 1977, businesses spent a total of 109 million manhours filling out employee wage and tax statements (Form W-2) alone. At a minimum, most businesses are also required to file an Employer's Quarterly Federal Tax Return (Form 941) and a statement of Withheld Income and FICA Taxes (Form 501). Further, all incorporated businesses must file a U.S. Corporation Income Tax Return (Form 1120), the corporate equivalent of the Form 1040. Proprietors of unincorporated businesses typically file a Schedule C (Profit or Loss From Business or Profession) along with their personal income tax return (Form 1040).[11]

To fill out all of these forms is, for many businesses, a major expense. For the largest businesses, to fill out Federal tax forms and information returns means the full-time, year-round services of teams of tax lawyers and accountants. In 1976, for example, it cost one large multinational corporation $136,960 to prepare the 18 different Federal tax reports it was required to file. This breaks down to an average cost of $7,609 per report.[12] Small businesses are hit hard, to. The National Federation of Independent Business (NFIB) found that, in 1976, small businesses nationwide spent more than $11 billion to have their Federal tax forms prepared.[13]

For individual taxpayers, the many different kinds of Federal tax forms mean reading and understanding instructions for several different tax forms, simply to determine which to fill out. Often, this is no small task. When the Commission on Federal Paperwork submitted the instructions of the Short Form 1040A to a "readability comprehension" study, it found that to comprehend 90 percent of the instructions would require a college-level reading ability.[14]

Moreover, to fill out even a single Federal tax form may require reading and understanding several different booklets the IRS puts out each year. In 1978, the IRS published some 92 of these "self-help publications," aimed at enabling taxpayers to fill out their own returns. Such publications included Tax Information for Divorced or Separated Individuals (Publication 504), Tax Information on Moving Expenses (Publication 521), and Highlights of 1978 Changes in the Tax Law (Publication 553).

Where Do I Sign?

There is considerable evidence, however, that these publications have been less than successful in reducing the complexity of the tax forms, instructions, and mathematical calculations. According to the IRS, 42 percent of all individual taxpayers had their 1977 Federal tax forms prepared by a professional tax preparer. Because only those preparers who were paid are required to sign the return, this figure does not include the sizeable percentage of taxpayers who had their forms filled out by a friend or family member who is "good at figures."

Americans spend approximately $500 million each year for the services of professional tax preparers.[15] H &R Block, the Nation's largest professional tax preparation service, reports that it processed more than nine million 1978 Federal tax returns. Block bases its rates on the complexity of the return. Individuals with uncomplicated returns, who took the standard deduction, paid an average of $22 to have their tax forms filled out. Those who itemized their deductions paid an average of $45.

The Biggest Losers

According to Block, the company serves mainly those taxpayers earning between $8,000 and $25,000 per year. Those in the higher brackets tend to employ private accountants.

While it is at best unclear why millions of Americans should have to pay someone else to figure out how much taxes they owe, the need for simplification of the present tax system is perhaps most poignantly demonstrated by those at the lower income levels. It is in this population, which generally tends to be less well-informed and less able to employ others to prepare tax returns, that faces the greatest struggle at tax time. And all too often, because low-income taxpayers cannot understand the instructions, they miss the opportunity to take advantage of provisions from which they could benefit.

This is true, too, of older Americans, who, to obtain a retirement credit, must fill out either Schedule R or Schedule RP. Just as the section of the IRS code that deals with this credit is complicated, so too are the schedules. It has been estimated that as many as half the elderly who could use the provision do not, because of its present complexity.[16]

Out of Control

It is ironic that a good chunk of the Federal tax dollars Americans pay each year goes toward printing the very forms, instructions, and other IRS materials that are too complicated for many to understand. In fiscal 1978, the IRS spent $34 million to print and mail all its tax forms and instructions. It spent another $3 million to print and mail its various self-help publications.

The budget of the IRS ($2.15 billion in fiscal 1979) also goes toward paying the salaries of some 87,000 employees, many of whom staff IRS information centers around the country, answering questions from taxpayers year-round. Others are employed to make sure the more than 670 million tax and information returns the IRS receives each year are filled out correctly.

In theory, the Office of Management and Budget is supposed to control the amount of time and effort Americans must spend filling out Federal forms. Under the Federal Reports Act of 1942, any Government agency wishing to collect information from 10 or more persons must obtain approval from the Regulatory Policy and Reports Management Division of OMB. The agency must specify the estimated respondent burden in terms of the total number of manhours required to complete the form. Unfortunately, the IRS is exempt from the OMB clearance requirement. Consequently, in 1979, Americans will spend more than 600 million hours filling out 310 different tax and information return forms.

Starting Over

There is no question that the time has come for simplifying the entire Federal tax system. Already it has become a matter for debate whether the Government is serving the people or the people are serving the Government.

Tax simplification is possible. But it is not likely to occur until the Congress and the President understand how urgently it is needed and how much American taxpayers want it.

Efforts to simplify the tax system are not new. Various proposals have sprung up in nearly every session of Congress since the first modern income tax law was passed in 1913. But, for the most part, tax legislation has been aimed at simplifying only particular provisions of the tax law. For example, the income averaging rules were simplified under the Tax Reform Act of 1969 and the Revenue Act of 1971 simplified some aspects of the depreciation rules.

This piecemeal approach to simplification has not worked. The tax statutes have become even lengthier and more difficult to comprehend. And with new tax legislation now being passed almost yearly, it has become all but impossible to keep track of the changes in both the law and the forms.

It is time for a new tax system.

In Search of A Better Way

It should be for the Government--and not the taxpayers--to come forward with a better way to design and manage the Federal revenue-collecting function. Congress and the IRS are the experts, citizens are not.

In the absence of such reform, however, it falls to the citizens to propose their own. One of these is the Gross Income Tax (GIT) system, a simplified and equitable approach to tax collecting and administration that is described in detail in the following essay.

The simplicity of the GIT system would greatly reduce the cost of collecting revenues. It would provide Congress with an easy and effective method for setting the national tax rate, which in turn would be levied uniformly on all tax-paying entities--thus eliminating many of the preferences that benefit certain taxpayers today. The system would nonetheless provide the Nation with the necessary revenues to maintain the national defense, provide for social programs, and operate the Government.

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Whether the GIT system is adopted or some other simplified system is adopted is not the crucial issue. What is crucial is that some new and rational system be adopted, some system that has a basis in common sense.

Business managers and individual taxpayers across the Nation are fed up with the time-consuming, dollar-consuming task of filling out the endless IRS forms, and they are fed up with maintaining stacks of tax records--whether in the vast computer banks of major multinationals or in kitchen drawers at home.

The United States enjoys a richly deserved worldwide reputation for producing the best managerial talent of any advanced industrialized nation. This is the country that designed systems to develop the atomic bomb and to put the first man on the Moon. Yet this Nation has not been able to come up with a tax system that any but a handful of lawyers and accountants really understands.

There can be no doubt that Congress possesses the ingenuity to design a simple, rational tax system. Its ability year after year to legislate new tax loopholes for one group or another is evidence of that. The time has come, however, for Congress to apply that ingenuity to creating a system that will take the "ouch" out of the tax bite not just for some but for everyone.

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— THE INCOME TAX —
Our National Problem

PUBLICATION NO. 79-1

Government Research and Development Corporation

VOX POPULI

A COLLECTION OF LETTERS EXPLAINING HOW TAX POLICY CAN BE UNDERSTOOD BY THE AVERAGE CITIZEN.

Government Research and Development Corp.

An Agency of the Individual American Citizen

P. O. BOX 786 • 309 MAIN STREET • BLANCO, TEXAS 78606

A collection of letters during the period April 1977 and May 1979.

A copy of each letter went to the following officials at the time of writing:

All Congressmen
All Senators
The President
The Vice President
All Cabinet Members
All Treasury Officials
involved in Tax Matters

Illustrative Gross Income Tax Form on pages 22 and 23.

Get with GIT and away from NIT

WOULD YOU BE IN FAVOR OF CHANGING OUR INCOME TAX LAWS SO THAT:

- *An estimated 90% of all forms and internal paper work required for income tax preparation by business can be eliminated?*
- *No individual wage earner would have to pay an income tax directly or even file a return?*
- *Every Corporation, Company, or Individual operating as a company or any other business entity would pay an equal fair share?*
- *Income taxes are removed from subjective personal determination which causes major inequities in tax collection?*
- *Our government would be able to reduce its work force and costs involved in tax matters by an estimated 70%.*
- *Our government would have more than ample money for its operation without having massive overhead cost in collection of the money?*
- *There would be absolutely no "loop holes" which allow some taxpayers to avoid practically all taxes even though incomes can be in the millions of dollars?*
- *Our government could easily audit accounts to insure that correct taxes are paid?*

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• PREFACE •

The American public is being swallowed up by a self perpetuating and increasingly complex income tax system. The system eats up countless manhours (dollars) doing jobs which are artificially created. One writer estimates that $21,000,000,000 in manhours are being wasted every year. And this does not take into account the other billions that are paid to accountants, lawyers and other operators who have intergrated into an entire industry which has been artificially induced and produces an abnormal redundancy in the overhead of our nation's businesses.

One way to equate this is to note 21 billion dollars could provide 2,625,000 jobs at $8,000.00 each per year and the accountants, lawyers and others could go to work for commerce and industry doing economically productive work.

These things could be accomplished if our income tax system was changed to a gross receipts tax system similar to, but more comprehensive than, many state sales tax systems. These are easy to prepare and very few gripes are heard about the complexity of sales tax returns.

This idea has been given much thought and it appears that the system is not only workable but if we do not do it there will be a massive breakdown of our income tax structure.

1. It could cover every income producing entity in the country.

2. It could be painlessly phased in from the present system.

This has been discussed with hundreds of people and over 99% are in favor of such a plan.

Almost everyone in favor of such a change had complaints about the complexity of the forms necessary to file their income tax (and other government forms) under our present system.

We do not believe the forms can be simplified under present income tax laws and regulations. The Federal Tax Guide issued by Commerce Clearing House consists of a 2¼" thickness of 9 lb paper printed in a 9" x 6" sheet. It is a real mishmash of arbitrary regulations issued in response to laws passed by Congress. It is admirable that the IRS *even tries* to issue simple forms to cover such a monstrosity of legislation. Title 26 as published in the Code of Federal Regulations is even more horrendous and inequitable. Each week the Internal Revenue Service issues a bulletin. This bulletin lists an average of 20 to 25 new rulings and regulations. Common sense

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dictates that any law which requires this many clarifications simply cannot be a good law.

Forms in any operation should be designed to

(1) Leave a path of simple condensed information which will lead the user *directly* to the bulk source of the entire information file, so that the condensations can be easily researched for correctness or clarification.

(2) Be an index or check list so that all points covered in the bulk source of information are delineated in the form.

Forms which *do not meet* these conditions would leave an "open loop" situation. If the form(s) *meet* the condition a "closed loop" system is developed. Industrially all companies strive to develop "closed loop" paper work so that anyone can come in at anytime and tell with minimum effort what has transpired. If companies did not work on this principal a bureaucratic software operation would develop; the same as exist in so many of our governmental operations. A forward going company which recognizes this paper work build up as a *symptom* of a more serious problem, will move quickly to isolate and eliminate the problem. When this is done the paper work simplifies itself; so to simplify our tax forms we need to eliminate the problem.

The problem is that our income tax laws are based on Net Income. Net income is a figure arrived at by a taxpayer and his accountant and depends primarily on the ingenuity of the taxpayers accounting and investment system. This fact alone makes it a highly inequitable system. It also *imposes an incalculable amount of software overhead* in running any business, large or small.

The problem can be easily eliminated by going to a system based on Gross Income. It is not only workable but mandatory at some time in the future. Based on discussions we have had with lawyers, accountants, business executives and others, we are either going to have a massive breakdown of the entire system or a taxpayers revolution. In fact it appears to be well on the way in its passive stages.

There are some who say that the logistics and organizational problem in a change over make it an impossible task. This is simply not true. The change over could be made easily and simply by the operation of dual systems for a short interval of time, allowing the taxpayer an option of systems until they are equalized in terms of money produced and an adjustment of individual equities.

Jim Jones

• OPEN LETTER NO. 1 •

In reading many news releases it appears that creative thinking on our income taxes does not extend beyond the present tax system based on Net Income Tax (NIT).

We believe there can never be even an approach to equity under such a system. The system has its inherent weakness in that deductions (and tax preferences) are frequently determined internally by the taxpayer himself. The theory is that these deductions are controlled by the IRS. The fallacy of it is that the IRS can not possibly hope to rule on so many of the variations that constantly occur. One has only to look at several issues of the weekly Internal Revenue Bulletin to see what an enormously complicated job it is to make rulings on the few major ones that appear in the Bulletin. These rulings of course do not cover the thousands of rulings made everyday by field examiners on a routine and many times on a strictly arbitrary basis.

There is one way to eliminate these vast, costly and inequitable rulings. That is to adopt a Gross Income Tax (GIT) system.

• OPEN LETTER NO. 2 •

A recent dispatch by New York Times News Service stated that Senator Russell B. Long and Senator Edward M. Kennedy had written a letter to Treasury Secretary W. Michael Blumenthal urging, among other things, that the scope of the investment tax credit be expanded.

The thrust of one of the suggestions seemed to be (1) to expand the investment credit to companies which may or may not make a profit and (2) to expand the credit to include capital outlays other than machinery and equipment as now being allowed under our NIT (Net Income Tax) system.

The first of these ideas would be automatic under a GIT (Gross Income Tax) system as we propose. Please note line 21 of the illustrative sample of a GIT return on pages 22 and 23 of this booklet. Please note particularly that the investment credit would be out of Gross income and has no reference to Net profits. The purpose suggested by Senators Long and Kennedy would be admirably served by a GIT system.

The second of the proposed ideas could be easily implemented by expanding line 21 to more than one line to include such specific investment credits as, say, "Investment Credit—Machinery & Equipment," "Investment Credit—Buildings," and/or "Investment Credit—Saleable Inventory Increase." It's simply another inherent advantage of a GIT system.

We think the points make by Senators Long and Kennedy about the inequitable treatment between companies reporting a profit and those reporting a loss is extremely well taken. What makes this even more important is that net profits reported by a company are largely controlled by the companies themselves. This is accomplished in most part by allocating the manner in which a company's funds are spent.

Under GIT the government would receive its money off the top; the investment and other economic incentives would have been served and a company would then be free to spend its money without government interference. An even more important advantage would be the ease with which our Congress could control our tax and economic goals.

• OPEN LETTER NO. 3 •

An article appeared on page 106 of the August issue of Fortune called "The Hand Principle." This article is quoted on page 7 of this booklet.

Judge Hand is correct in stating that no one should pay more taxes than the law demands. However he has missed the point completely by assuming that (1) the law is understandable and administratable and (2) that the law applies equally to all taxpayers.

The current income tax laws and regulations are neither understandable, administratable or equitable to taxpayers. The first two thoughts are generally acknowledged: The last idea is acknowledged in groups of taxpayers depending on that group's ability to finance research of the tax laws for that particular group's benefit. This results in many taxpayers "arranging one's affairs to keep taxes as low as possible." The bad part of this is that "arranging one's affairs" in this way is not "arranging" at all. It is taking advantage of tax laws and regulations which have been written to allow a shifting of the tax burden from one segment of society to another. As in so many judicial opinions Judge Hand was thinking of the technicality of the law and not of the effect or equity of the law.

Also on page 68 of the same issue of Fortune there appears a letter from Senator Russell Long correcting certain tax information reported by Fortune in a previous issue. The interesting part of that letter was the editor's footnote to it in which reference was made to the impenetrability of the U.S. tax code.

There is one way to correct both the tax code's inpenetrability and its equity to ALL groups. That is to enact a Gross Income Tax (GIT) system and scrap the present system based on Net Income (NIT). The new system could be easily phased in over a period of time and all parties — the government and the taxpayer would have many more billions to spend on useful purposes.

• OPEN LETTER NO. 4 •

A cardinal principal, accepted by virtually everyone, is that an income tax should be progressive; that is it should be based on the ability to pay.

One great discrepancy of our present Net Income Tax (NIT) system is that just the opposite happens. The greater one's resources, or ability to pay, the greater is the ability to avoid taxes. This is particularly true with large BOE's (Business Operating Entities). A small BOE or an individual wage earner does not have the resources to hire lawyers and accountants to seek out the thousands of loopholes which exist under the present NIT system. These loopholes are inherent in any system based on a Net Income. Also smaller BOE's cannot hire lobbyists to furnish rationalizations for further amendments to the tax laws for their special cases.

A Gross Income Tax (GIT) System would be far more progressive than NIT and would spread the tax burden around the way it should. The spread would be popular with large BOE's as well as small BOE's because the extra amount they pay in taxes would be more than offset by the overhead savings made, and an economic profit would be made by everyone, including the government.

NIT is regressive, extremely hard to administer, wasteful in overhead costs, and frustrating to anyone who wants to pay his fair share.

GIT is progressive, relatively easy to administer, less in overhead costs, and is easy to understand. With GIT all the cards are out on the table and not hidden behind thousands of individual bookkeeping systems designed for a tax consequent operation instead of an economic operation as a BOE *should* operate.

We hope Congress will give support to this progressive change in our income tax system. At some point in the future it will become mandatory. Since 1913 the income tax laws have become increasingly complex every year. The only basic difference between 1913 and 1977 is that we have more population. Businesses

continued on page 8

From the August issue of Fortune magazine.

THE HAND PRINCIPLE

"Press Secretary Jody Powell says that President Carter is paying taxes he doesn't owe because "appearances as well as reality" must be considered. The reality is that the President owed no federal income taxes for 1976—mainly because of a sizable investment tax credit taken by the family peanut business. But, Powell suggested, paying no taxes would be bad for appearances. Accordingly, the President has made a voluntary contribution of 6,000 to the U.S. Treasury (and has said that he won't claim that payment as a deduction on his 1977 tax return).

What is Carter trying to tell us? On the face of it, he appears to be saying that businessmen and wealthy individuals who merely pay the Treasury what they owe may not be doing enough—that there may be a moral obligation to pay more. If that's not the message, it is hard to discern any meaning in the Presidents's own example.

But if that is the massage, then Carter is trying to overturn a principle that is of profound inportance—and not only to businessmen. As Judge Learned Hand stated the principle in 1947: "There is nothing sinister in so arranging one's affairs to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant."

——*From page106*

Russell Long Replies

"The Letters sectionof June issue of Fortune carried a letter from Mr. Owen Markel of Wichita, Kansas, and your editorial comment, which conveyed the impression that I proposed an amendment to a tax law for the benefit of my relatives. As I could have told Mr. Markel or any member of your staff, what I did was exactly the opposite.

Here are the facts: Senator Robert Dole of Kansas proposed a routine amendment to the Tax Reform Act of 1976 to restore to the beneficiaries of distribution trusts certain benefits erroneously denied them by the Tax Reduction Act of 1975. After the Dole amendment was approved by the Finance Committee, I learned that it might benefit some of my relatives, and I announced that I would oppose restoration of the benefits.

Defending his amendment, Senator Dole argued that its defeat would force an unintended hardship upon a considerable number of people. Therefore, I proposed an amendment which provided that the favorable treatment restored by the Dole amendment would not apply to my daughters, my nieces and nephews.

My amendment was clearly discriminatory and unfair to my relatives. It is in the law because I did not want it said that I was seeking a special advantage for a relative.

If Fortune had offered me an opportunity to correct its error before subjecting me to unfair criticism, it could have avoided this needless departure from its usually high standards.

Russell B. Long
United States Senate
Washington, D.C.

From page 68 ——

Senator Long is correct, and Fortune regrets its error, which was an unfortunate consequence of the near impenetrability of the U.S. tax code."

still operate today as they did then, with only one exception. That exception is that today there has been developed a modus operandi based on taxes rather than economics as it was then. This complicated development is a direct result of the law itself. The complications are inherent in any NIT system. The best that can be done with *any* income tax system based on *net income* is to apply another amendment which *will again increase its complexity and unfairness.*

• OPEN LETTER NO. 5 •

There are several fundamental, key elements in a GIT (Gross Income Tax) system which are different from a NIT (Net Income Tax) system.

One of these is the elimination of so-called "double taxation." Under GIT double taxation of corporations and individual investors in those corporations would simply vanish or cease to exist. Under NIT, most present proposals to eliminate "double taxation" include either a merger of corporate income tax with a corporate investor's income tax or an elimination of the corporate investor's income tax on that portion of his income which is attributable to corporate sources. If this is done a specially favored class of investors (and taxpayers) will be created. Other types of investors would not have this advantage. As soon as mass information makes this fact known to entrepreneurs and other types of investors, there will be a great public outcry to "equalize" things for *all* investors. The ultimate result, if Congress stays with NIT will be more band-aid legislation and further complications of the law and inequities. It will be a classic example of more loopholes (and one of the largest) in a system which has been for years inequitable and impossible to administer.

For illustrative examples *see* top of page 9.

Let's get rid of double taxation the easy, sensible way and get with GIT and away from NIT.

• OPEN LETTER NO. 6 •

There are several fundamental, key elements in the GIT (Gross Income Tax) systems which are different from the NIT (Net Income Tax) system. In our last letter we discussed "double taxation" of corporations and individual corporate investors. Another *key element* of GIT is the idea of *Allocation.*

Under the NIT system when the government collects income tax and FICA from an individual the primary source of these funds is the *Gross Income* of the employer. Under GIT this money would be *allocated* from the Gross Income Tax paid by the BOE (Business Operating Entity) on the basis of employee information filed by the BOE at the time his Gross Income Tax return is filed. Please note line 28 and 29 of the illustrative Gross Income Tax Return shown on pages 22 and 23 of this booklet.

This particular idea is the largest money, time and paper saving feature of the GIT system.

(a) For the employer there would be the elimination of all W-2 forms, quarterly *reports to the government,* and all information would be consolidated to once a year.

(b) For the employee there would be a complete elimination of filing either an income tax return or W-2 forms. The savings for the country's individual taxpayers would run into billions, *not to mention the mental duress of millions of taxpayers which comes one time each and every year.*

(c) For the government the allocation principal would give complete control on

Comparison of Investor Types

(All of whom have $100,000 each to invest)

Investor A: Takes his $100,000 and purchases a hardware store. He pays full tax on his profits. He's an entrepreneur and labors very hard for any profits made.

Investor B: Takes his $100,000 and puts it in a savings account. He pays full tax on the interest earned. He does not have to labor, but his money does.

Investor C: Takes his $100,000 and invests it in corporate stocks. If Congress exempts all or part of his dividends, he neither labors nor pays a fair share as investors A and B do.

Investor D: This one is a corporation and takes its $100,000 and invests it in another corporation (or it may reinvest in its own operation). If Congress exempts all or part of the corporate tax load, the difference must be made up from investors like A and B. Investor A is going to be particularly incensed because he is a hard working entrepreneur competing against the tax favored corporation.

GIT will eliminate these discrepancies but NIT cannot functionally ever do so.

how the money is collected and at vastly reduced cost. *For Congress in particular it would give simple and complete control* over the funding of social goals like social security, health care or any other goals determined by Congress. See lines 31 and 32 of the Gross Income Tax Return on pages 22 and 23 of this booklet.

The present NIT system is easily the most wasteful system in government today in terms of overhead in its administration. Even the waste of HEW would pale into insignificance if the true cost of income tax collection were known. The true cost will never be known because the administrative costs are only the tip of the iceberg. The really big costs are the taxes lost because of loopholes, and these loopholes are not stastistically reported by the taxpayer or the government. Some say that the exemptions and loopholes are necessary to accomplish certain social and economic goals. The fallacy in this is that with loopholes under the NIT system only certain classes of taxpayers can take advantage of them and the real goals are only partially realized. The GIT system can also be used for these purposes but with much more effectiveness and at a vastly reduced cost.

Let's get businesslike and eliminate NIT. It's a plaything we can no longer afford.

• OPEN LETTER NO. 7 •

Recently Mrs. Juanita Kreps, Secretary of Commerce gave ah interview with the Hearst newspapers in which she discussed the economy and related taxes.

One of the ideas she favored was to put money back in wage earners pockets by reducing his or her tax, with emphasis on reducing payroll tax. She indicated that this would stimulate hiring. One easy way to do this, and give complete control by the government to insure equity, would be to go to a Gross Income Tax (GIT) system.

Under this system an employer would report employee earnings to the IRS who would allocate his FICA and income tax share from the employers tax payment. See line 30 and 31 of the illustrative GROSS INCOME TAX RETURN on pages 22 and 23.

At any given time of the year the government could survey its economic resources, the job situation and the health of the Social Security System. If so deemed by Congress they could rebate a specified amount back to the employer. This would be split with the employee, in proportion to each one's input. The double effect here of putting money back in the wage earner's pocket and in the employers pocket would (1) put more real money into circulation and (2) encourage the employer to hire more people.

All of this would be done on a very low expense basis under GIT. Under our present NIT (Net Income Tax) situation, to accomplish the same thing would require a large wasteful accumulation of paper work.

Another beautiful aspect of such stimulation, is that the Gross Income Tax Returns could be staggered so that there is a steady income to the government and a steady, uniform stimulation to the economy. *Booms and busts* could be more *easily controlled.*

We think that the earlier we get with GIT and away from NIT, the better off we will be, from largest corporation down to the individual.

• OPEN LETTER NO. 8 •

Chairman Al Ullman's Ways and Means Committee held a public hearing on October 6, 1977 to discuss (1) the carry over basis provisions and (2) the postponement of the effective date of the generation-skipping trust provisions of the Tax Reform Act of 1976. *Both of these topics relate to the very complicated and almost incomprehensible logic of our gift and inheritance tax laws.*

This part of our tax law has long been a major source of inequity, litigation, tax machinations, and many times, heartache for survivors of persons who die, leaving estates to be divided.

If the transaction *is viewed for what it actually is*, the problem could be solved very easily by applying the principals of GIT (Gross Income Tax).

The transaction is (1) a forced transfer of assets by the deceased to one or more other parties and (2) it has monetary value which can be determined the same way it is now — its true value.

In essence then, the receiving party (an heir) becomes a BOE (Business Operating Entity) and would pay a regular Gross Income Tax. In the case where estates are so large that the raising of cash to pay the taxes would be an extreme hardship, Congress could make a provision for extended payments. See line 16 & 17 of the illustrative example of a Gross Income Tax Return on pages 22 and 23.

Another way to put it would be to consider inheritances and gifts as one time windfall income and payments would be tailored to fit the recipients individual financial situation.

We hope you, our legislators and executives, will study this idea, see the logic of it and incorporate it into beneficial legislation by changing our tax system from NIT to GIT.

• OPEN LETTER NO. 9 •

A recent speech by Bennett E. Bidwell, vice president in charge of sales for Ford Motor Company, commented on the strangling effect of excessive government controls on the nation's free enterprise system.

One of the largest regulators for the automotive and all other businesses, large or small is the IRS. The IRS in its efforts to interpret the effect and intent of the law, constantly issues new regulations which are now so voluminous that no one in the country, including the IRS itself, can adequately understand them.

The main reason for this is the fact that our income tax law is based on net income. Under this system what is "net income" is in large part the result of accounting systems set up for the *primary purpose of tax mitigation*. Since this will vary with every individual company, large and small, *the regulations* must be varied to *fit an interminable number of situations*.

What is happening is that the governmnet is *reacting* to *individual* situations, and they can never catch up. These individual situations change too fast.

The best way to eliminate such a method operation is for us to change from a Net Income Tax (NIT) to a Gross Income Tax (GIT). The government would then have more simple and direct control and could *act* instead of *react*. Hence fewer regulations would be needed.

Lets get with GIT and away from NIT.

• OPEN LETTER NO. 9A •

Many news references to President Carter's proposed tax reform package indicate that fringe benefits such as expense accounts will be taxed for the first time.

"Expense account living" has been attacked many times in the past, primarily because of abuse of such tax write-offs. What it amounts to is that *all* the taxpayers shoulder the expenses of the relatively few who can take advantage of such write-offs, and who abuse that advantage.

"Expense account living" is a direct result of our NIT (Net Income Tax) system. The more a BOE (Business Operating Entity) can expense off, the lower its taxes will be. This is an inherent defect of any tax system based on net income. It's a situation that will grow and grow, as long as the NIT system exists. Even if the President succeeds in imposing taxs on such expenditures, a BOE will will find other deductions to accomplish the same results. It's an inherent tendency (and defect) in the NIT system.

If we would go to a GIT (Gross Income Tax) system, these defects would essentially disappear. A BOE would pay its tax right off the top with no complicating factors and the government would have no further interest in how the BOE spends its money. The BOE could operate on an economic basis and go back to the business of making money, providing jobs and dividends instead of looking for ways to avoid taxes.

• OPEN LETTER NO. 10 •

The September 23, 1977 issue of the U.S. News Washington Letter on page 2 discussed the federal paper work burden. They state that the annual expense of this is $100 billion per year. They also state that the U.S. Paperwork Commission will recommend that all legislation be assessed for its paperwork burden. This should especially apply to tax legislation, this grand-daddy of all paper producers.

Most discussions about federal paperwork seem to tend toward recognizing the burdens put on industry and commerce by making energy, OSHA, and other special type reports. As burdensome as these forms and reports may be, they pale into insignificance when compared to the paperwork caused by our Net Income Tax (NIT) system. The paperwork caused here is not only the forms, but the monstrous records and supporting paper required to effect the law. And even more significantly, the paperwork required by NIT affects not only BOE's (Business Operating Entities), but affects *every individual* in the nation who has an income tax liability.

The paperwork is not only imposed on the public by NIT, but it also causes a tremendous amount of paper and record keeping by the government. If it were not for the complexities of the NIT system the IRS could probably do with a computer 80 per cent less than the size they now contemplate will be necessary in the near future.

An easy way to eliminate this grand-daddy of all paper producers is to get with GIT and away from NIT.

• OPEN LETTER NO. 11 •

A recent dispatch by United Press International discusses the disparity between taxes paid by single persons and married persons, depending on the way they file their income tax returns.

In this dispatch they quote a Ways and Means Committee spokesman who says "It is difficult under our progressive tax system, to devise a schedule that is absolutely, fair to everybody".

The statement by the Ways and Means spokesman pre-supposes that our Net Income Tax (NIT) system is a progressive one. Actually our NIT system is the exact opposite of this. A tax system which is progressive, as everyone acknowledges, is a system which assesses according to the ability to pay.

Under our present NIT system, the better the taxpayer has an ability to pay; it seems that the structure allows him to pay less on true percentage basis. For example Senator Moynihan recently advocated a $500 tax credit for persons sending their children to college. There is a relatively small percentage of people who elect or even need to go to college. It would be a good assumption that those who do so elect are probably in higher income brackets. This will, if passed, immediately make our system regressive instead of progressive as it was intended. The same problem exists on a major scale in business situations.

We sympathize and agree with Senator Moynihan's arguments on his bill, but we categorically disagree with using our tax system to effect the results he desires. We would much prefer to see that the government offer competitive scholarships which could be used by the winners to attend the college of his or her choice, whether public or private.

So, we have two ideas here, (1) how to help those who want to attend private schools and (2) how to make the income tax system progressive. The answer is (1) to provide scholarships and (2) to adopt a Gross Income Tax (GIT) system.

A GIT system is progressive, equitable and will provide the tax stability and maturity the country needs.

• OPEN LETTER NO. 12 •

In the President's news conference of Oct. 27, 1977 he named three points, which he said a tax reform package must fulfill.

(1) "One is improved equity, which means more progressivity, and an end to many of the unnecessary tax incentives and loopholes."

A simple and easy way to accomplish this first objective is to go to a GIT (Gross Income Tax) system and away from a NIT (Net Income Tax) system. The present NIT system is regressive because the taxes paid are largely determined by the taxpayer himself. The larger the income the more resources a BOE (Business Operating Entity) has to find the myriad loopholes which exist. Some of these loopholes are private and can be created by the taxpayer himself.

(2) "Secondly, to create investment capital."

This is an extremely important point in that it, if accomplished, can create the jobs (and more tax revenue) upon which we all exist. It is the factor which makes our growth exponential instead of straight line. This can be accomplished readily under the GIT system. A BOE can operate on its own internal economic basis instead of a tax basis. Capital formation thus becomes a function of its sales and managerial ability rather than its tax manipulation ability.

(3) "and third, to greatly simplify the entire tax structure."

The GIT system is a natural to accomplish this objective. GIT as we have outlined in previous communications would eliminate at least $100 billion in paper work costs, just in elimination of individual tax (and W-2 forms) returns alone. A close perusal of our illustrative Gross Income Tax Return will, upon reflection, show this. See pages 22 and 23.

We urge that these proposals be introduced and passed as legislation at the earliest opportunity. Each minute's delay costs us a least $190,000.00 What can we buy for $190,000.00? You name it.

• OPEN LETTER NO. 13 •

A columnist recently stated that tax disputes have given many harassed citizens a glimpse of the other face of Uncle Sam when he scowls. Some citizens say they have been bullied and browbeaten by IRS collectors. He says that "revenue agents naturally defend themselves against charges of wholesale callousness." The IRS points out that, "since Biblical times, the tax collector has always been the most disliked of officials. It is their duty," they point out, "to rake in money on which national security and domestic service depend," and "every defaulting dollar means a dollar that some other citizen must pay."

We have talked to many of our citizens and we believe the tax collector is not disliked because he collects the taxes per se. He is disliked because he is the personification of an unfair and inequitable tax system, NIT. He is, in short, the scapegoat of bad tax laws.

The statement "every defaulting dollar means a dollar that some other citizen must pay," could be translated to apply to the NIT system itself to say: "Every legally defaulting (loophole) dollar means a dollar that some other citizen must pay."

There is a practical, easy, way to collect either the legal or illegal defaulting dollar. That is to go to a GIT (Gross Income Tax) system and away from a NIT (Net Income Tax) system.

(1) It would be easier for the IRS to collect the money and they would have at least 80 million less people to say "they are the most disliked official."
(2) The government could collect more money at much less cost.
(3) The tax load would be spread around to more people, and would not be overly burdensome to any one.
(4) The quicker the GIT system gets started, the quicker we see 80 million brand new smiling faces.

• OPEN LETTER NO. 14 •

The country is constantly being apprised of the ups and downs of the economy and that the way to eliminate the very large rises and dips, is to manipulate taxes.

The key words used are "tax cut." They have been used so much that they have become just a political cliche. The effect of tax cuts on the economy, we think, are minimal. The things that make business transactions operate fast (high economy) or slow (low economy) are (1) salesmanship and long term marketing effort, (2) confidence in our government and (3) freedom from bureaucratic control.

The first of these is strictly an economic function of the BOE (Business Operating Entity). It is this ingredient that separates the men from the boys on the competitive front — if no government interference (or many times assistance) exists. We assume good financial management exists.

The second of these is where so many businessmen throw in the towel. No businessman or individual knows what the government expects of him. There are so many laws and regulations which deal with and help (or hurt) special groups that the average person thinks that the government operates for a special few and not for the general public good. Nowhere does this manifest itself as much as in the tax structure.

The third of these — bureaucratic control — is where our government is unique. On the tax question our bureaucrats get down to *individual* observance and action. It is the only activity of government where this is so, on such a large scale. As a converse idea, consider the letting of government purchase contracts. Here the government does not want to be burdened with details so it lets 90% of its contracts to 10% of the country's BOEs. These BOEs then handle the details of subcontracts, down to the smallest individual. The contrast is (1) in collecting the money we create a vast bureaucracy to deal with *individual* situations and (2) in spending the money we deal with generally large situations and let others deal with the *individual* details.

The way to correct these situations and make the economy more stable is to go to GIT and away from NIT.

(1) A company could operate on an economic, sales oriented basis, instead of tax oriented.
(2) The GIT system would be simpler and a BOE would know where he stands, with resultant better confidence in our government.
(3) Our largest and busiest bureaucracy, the IRS, could turn its attention to a larger number of problems of a more productive nature. More money would flow with less cost.

We hope some legislator will introduce legislation soon to accomplish this most progressive step.

• OPEN LETTER NO. 15 •

On page 53 of the book "Federal Tax Policy"* there appears these words:

"Reform of the tax process is still needed: first to permit Congress to concentrate on major policy issues rather than on details of the tax law; second, to give better representation to the public interest in the deliberations of the Ways & Means Committee and the Finance Committee; and third, to accelerate action on tax changes to combat inflation or recession."

There *is a reform* that could easily be enacted by Congress which would serve all the above purposes admirably. That is to replace our present NIT (Net Income Tax) system. Our present NIT system can never adequately serve the purpose set forth; it's too cumbersome and complicated.

If a GIT system were enacted:

1. The simplicity of it would enable the Congress to see the total picture instead of the obfuscatory maze of details now present in the NIT system. Policy would then become a forceful, positive action instead of the hysterical reactions now taking place every year.
2. Public representation could be better and be of infinite value to the Congress. According to the sources we access to, it appears that there are over 45 lawyers and economists who do most of the technical writing of our income tax laws. There is not one single representative of the public on the staffs of Ways & Means, Finance or the Joint Committee. This is prima facie evidence that our laws are going to be complicated. A GIT system would go a long way to making the law intelligible to the average citizen.
3. Acceleration of tax changes to combat inflation or recession could be easily made under the GIT system. This could be done by proper application of lines 21 through 24 of the illustrative Gross Income Tax Return on pages 22 and 23. Congress could vote to make changes on these lines alone and completely eliminate the endless amendments now being used for this purpose. A talley of the Digest of Public Bills and Resolutions for the 94th Congress shows that of all bills and amendments introduced, approximately 10% cover proposed detailed changes in the income tax law, an incredible percentage.

Lets get sensible *now.* Get with GIT and away from NIT.

• OPEN LETTER NO. 16 •

Inflation is a word used often, but rarely defined. To most people and apparently to some experts, it simply means excessively rising prices.

We believe that rising prices are inflationary when they are bloated by costs which do not add to the intrinsic value of a commodity. If the price rises are caused by things which add to the intrinsic value of a commodity, then they are not inflationary.

Some things which add costs, *but not* value are:

1. Excessive Taxes.
2. Excessive Interest Rates.
3. Excessive Profits.
4. Excessive Wages (labor input).

* Federal Tax Policy, Third Edition, Editor Joseph A. Pechman, The Brookings Institute.

5. Excessive Overhead by Bureaucratic Regulations.

Some things which add costs and value are:

1. Normal Profits.
2. Normal Wages (labor input).
3. Normal Government Guidance to see that we have a productive society for the *common* good.

Much is said about "indexing for inflation" to prevent automatic tax increases because a taxpayer would be pushed into "higher brackets" by "inflation."

If we had a Gross Income Tax (GIT) system such indexing would not be necessary. Such step-wise tax increments would not exist. There would be a simple functional relationship between the amount of taxes owed and the gross receipts of a BOE (Business Operating Entity). It would almost be a straight line relationship of the form $y = m x + b$. What could be simpler to adjust for "inflation"?

As Mr. Pechman said on page 6 of his book, *Federal Tax Policy:

"It (the book) was prepared in the belief that tax policy is too important to be left solely to the experts, and that taxation can and should be understood by the interested citizen."

Let's get with GIT and away from NIT and the interested citizen *will* understand our tax laws.

• OPEN LETTER NO. 17 •

President Carter's tax proposals for consideration this year included a crackdown on foreign tax breaks and on entertainment deductions by businesses. According to a United Press report, Ways and Means Chairman, Al Ullman quickly dismissed Mr. Carter's proposals as "too complex and controversial to consider this year".

The reason they are too complex and controversial is that our income tax laws are based on *net* income. That fact alone makes *any* proposal complex and controversial.

Foreign tax breaks, entertainment or *any* other kind of deduction is made for one *single purpose* - to make the ratio of taxes paid to gross income approach a minimum amount. Every BOE (Business Operating Entity) has a different individual situation and hence a different approach to meeting this ratio goal. The deductions they take are going to be myriad and in an attempt to control the situation the government is going to pass complex laws (amendments) and the IRS is going to issue even more complex regulations.

All of this is man made and completely unnecessary. What is even worse it is inflationary. It is an added cost to business which must be added to prices, but it does not add to the intrinsic value of the product or service.

We can eliminate all of this very easily. We can base our income tax on a Gross Income Tax (GIT) system instead of our present Net Income Tax (NIT) system.

The most statesman-like action of the century would occur if our Congress would enact an income tax law based on gross income.

* Federal Tax Policy, Third Edition, Editor Joseph A. Pechman, The Brookings Institute.

• OPEN LETTER NO. 18 •

In a recent United Press dispatch Rep. Charles Vanik, D-Ohio, stated that 168 major companies had an effective 1976 income tax rate of 13.04 percent; that 17 paid no tax at all and 41 paid rates of less than 10 percent. All these companies mitigated their tax liabilities through deductions and other methods acceptable through legislative or regulatory fiat.

These are extremes and it is certain that many thousands of other companies pay various tax rates between such extremes and the maximum required by law, if no deductions or loopholes were utilized.

There are two very salient points which should be realized here.

(1) The percentages quoted are based on net income. These percentages are practically meaningless because they provide *no standard of comparison.* Each company has *its own way* of arriving at what is net income. Consequently, 10% net income for one company is quite different from 10% net income for another. Then, to compare tax percentages for such apples and oranges is useless. The proper comparison would be to quote taxes paid as a percentage of gross income. This would then give all BOE's (Business Operating Entities) in the country a common denominator and the percentages would have meaning.

(2) Each of these companies employ large expensive staffs to discover and implement the devices which may be used to lower their tax liability and further the government has to spend extremely large sums to monitor such activities. This is because the tax system is based on *net income.* The determination of net income is highly subjective with individual companies and many times really not capable of being reported in hard bookkeeper's figures. Although the bottom line may show overall profitability, many individual management policy decisions are not explicitly shown on company books. For example, should a company purchase its operating premises (building) or should it lease? If it leases, it deducts as an operating expense. If it purchases, after the premises have been paid for, it may use the rental money saved for advertising, inventory additions or many other purposes to increase that bottom line profitability.

All of this could be easily eliminated by going to a Gross Income Tax (GIT) system and eliminating our Net Income Tax (NIT) system.

Let's go America, are we ready to put away childish things and grow into fiscal manhood?

• OPEN LETTER NO. 19 •

One segment of our economy which is clobbered hardest by our NIT (Net Income Tax) system are our large corporations. By their very size they are hard to control from a profitability stand point and require a high degree of accounting reliability from an economic operating point of view. This is the part of the business which relates to the growth of the business and allows it to produce more product (GNP), hire more productive people, pay more dividends and plough more money back into the business. Our NIT system of taxation is another accounting requirement within these same businesses and is aimed solely at setting up additional accounting practices which are, in effect, adversary relationships to our tax system.

These practices are a major added expense to the company and do not add one iota to the profitability of the company or to the GNP, which adds jobs and dividends.

Another major effect of the NIT system on large corporations is the fact that there is no direct *functional relationship* between a company's income, measured in any standard (gross *or* economic net) of income. Everything is done in a step wise, piecemeal fashion. That is, the companies accountants each year ask, what deductions or advantages can we make this year? Consequently, there is no smooth curve relationship which could be applied as a common denominator for all companies and which can be changed from year to year on a *functional* basis.

What is clearly needed is a tax system that provides the *functional smooth curve relationship* and which also allows the company to operate on an economic basis instead of a tax consequent basis. If such a system were instituted the accountants used in the tax overhead operation could be utilized in more interesting areas of showing their companies how to maximize profits from an economic standpoint.

The GIT (Gross Income Tax) system would provide just such an environment. If a corporation's staff mathmetician attempted to draw *any* kind of a functional curve relating its taxes and income (either gross or net) he would pronounce it an impossible practicality. Under the GIT system he could easily write a simple equation of the form

$$y = mx + b$$

y = tax owed, dollars ($)

m = tax rate in decimal percentage

x = total gross income

b = intercept of the y axis which is a function of tax credits taken. (lines 21 through 24 of the Illustrative Gross Income Tax Form, pages 22 and 23)

As an example of this note fig. A, B & C illustrated on page 19.

(1) A is a company which takes no credits whatever and b is zero, so it is taxed on its total gross income.

(2) B takes, say investment and employment credits, so his intercept is a negative value and his taxes do not even start until his gross income equals his credits.

(3) C takes, higher credits than B, including, say some for export sales. This company's b is going to have a higher negative value than B's.

The important thing to remember here that under the GIT system a *functional relationship* has been established for which a curve can be written, with its complete predictability and understanding. With such predictability and understanding a fair and equitable tax law can be written by Congress which can be easily modified from year to year to fit national economic and social requirements. For, clearly the government could use this type curve on a cumulative national basis as well as a company would use it on an individual basis. Such use by the government would give much greater control over boom or bust cycles and inflation.

Something should be done soon on our present NIT system or we will be devoured by it. We hope the Congress and the Administration will act at an early date.

• OPEN LETTER NO. 20 •

Mr. Hobart Rowan of the Washington Post has indicated in a dispatch appearing in the February 2,. 1978 issue of the Houston Chronical that Treasury Secretary

continued on page 20

TAXPAYER A

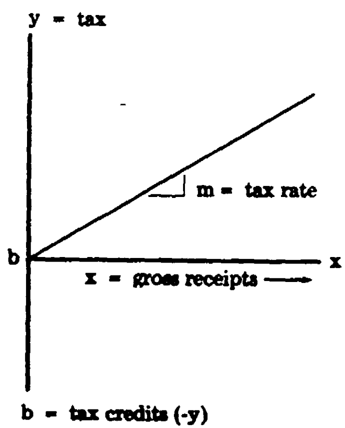

Figure A

TAXPAYER B

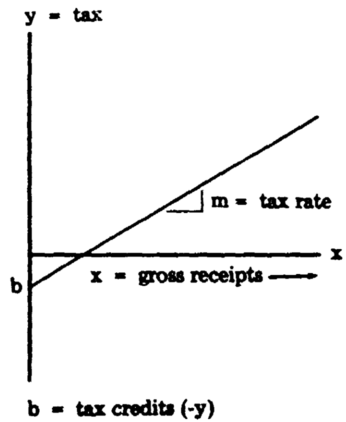

Figure B

TAXPAYER C

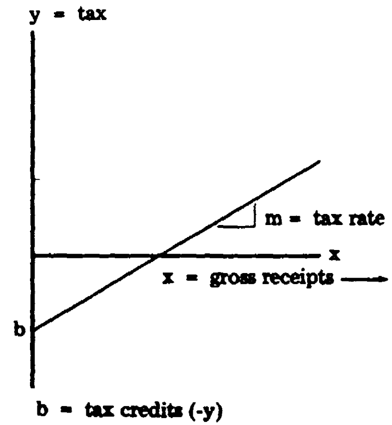

Figure C

Blumenthal is hinting that President Carter is having second thoughts about financing Social Security payments with higher payroll taxes.

This is a step that should be taken in conjunction with a tax system that can serve multiple purposes in a simple manner. Social Security is a tax, pure and simple; instead of the "insurance" system that some suggest.

There is a simple system which can serve this purpose. That system is a GIT (Gross Income Tax) system based on gross receipts instead of a NIT (Net Income Tax) system based on a net income.

Under the GIT system a BOE (Business Operating Entity) would pay a simple gross receipts tax and from this tax an *allocation* would be make by the IRS for the share of funds due the Social Security system for its continuing and sound administration.

The most attractive part of this GIT system is that it is simple enough to be monitored by Congress on a month to month basis without getting mired down in details which have no functional relationship with each other.

We hope the Congress and the Administration will recoginize the efficiency of these ideas at an early date and incorporate them into some solid legislation to effect the purposes desired.

• OPEN LETTER NO. 21 •

The March 6 issue of U.S. News & World Report (page 58 & 59) discussed the fact that the IRS now publishes its Forms 1040 and 1041A in three new languages — Chinese, Vietnamese, and Spanish. Futher, the IRS requires persons using these forms to fill them out at IRS taxpayer assistance offices, where the answers are then translated to English and entered on the standard English forms.

The bureaucratic cost of this practice is going to be enormous and the taxes collected will probably be far less than the cost of the collection.

This is but one among many secondary effects and costs of an income tax based on the net income tax (NIT) system. A primary effect and, indefensible, cost of our NIT system *is the fact that individual wage earners must file a return at all.*

There is a better and less-costly way. That is for the nation to go to an income tax based on a gross income tax (GIT) system.

Under the GIT system the individual wage earners taxes would be paid into the Treasury by the principal of *allocation*. This *allocation* would be made solely by the IRS. Such procedure would:

1. Eliminate a wage earner's paperwork by 95% or more.
2. Reduce the employer's paperwork in preparing W-2 Forms and reports to the IRS by at least 90%.
3. Reduce the governement's paperwork by 70%.

It is admirable that the government (IRS) tries to help our citizens who do not speak or read English. However, an even more admirable effort would be to help these same citizens to be literate in the language of their country. If a person cannot read, speak and think in English in America, that person will be at a disadvantage and a liability forever.

America, lets get with GIT and away from NIT today and restore our leadership among the world community.

• OPEN LETTER NO. 22 •

A new cliche term, "perks" has burst upon the national scene. This is a contraction for the word "perquisites" which is defined in one dictionary in two ways:

1. "Something in addition to one's regular pay for one's work, as a tip."

2. "A prerogative or right due to one's status, position, etc."

U.S. News & World Report (March 27, 1978 issue; page 33) has a discussion of the popular use of "perks" which seems to conversely define them primarily as sales tools to win and influence customers by our country's businesses.

No one can seriously challenge the fact that entertainment of customers is a powerful tool for increasing sales. However, what the article fails to mention is "who pays for these perks?"

Under our net income tax (NIT) system a good portion of the perks are paid for out of government funds by means of deductions which lessens a company's tax liability.

If we would go to a gross income tax (GIT) system, *the government would get its money right off the top and would have no further tax interest in how a company spent its money.* The company could then spend as many dollars as it chooses on perks, or anything else. The company would then be operating on an economic basis instead of a tax consequent basis.

We hope our legislators and other officials will soon see the efficiency and fairness of the GIT system and enact legislation to get us on the track to tax leadership and statesmanship.

• OPEN LETTER NO. 23 •

One negative aspect of our net income tax (NIT) system, which does not seem to have received much attention, is the fact that it creates an atmosphere of thought, which in turn promotes an economy of waste in our country. One could describe it as the "write it off your tax" syndrome.

Such a way of thinking is an inherent byproduct of our NIT system. It applies to large, one time, wastes, or to small continuous waste practices. Of particular interest at this time is how it affects our energy situation. A little thought and reflection by almost any business executive would reveal several situations in his own company where this syndrome exists and which affects energy consumption.

If we had a gross income tax (GIT) system, such a "write it off attitude" would not exist and the BOE (Business Operating Entity) would operate on an economic instead of a tax consequent basis.

We hope our national leaders will soon see the good sense of the GIT system and get the ball rolling. The first official who gets such legislation passed will be a statesman of historical importance.

• OPEN LETTER NO. 24 •

Mr. George Will in a recent column stated that Justice William Rehnquist has turned toward a subtle problem. In a speech Justice Rehnquist noted that America has become an "adversary society." "Increasingly, disputes are resolved in courts or other hearings, and there are social risks involved in promiscuous use of adversary proceedings."

One area of national endeavor which causes this atmosphere to a very high degree is our net income tax (NIT) system. It is a system which has grown not by clear, logical thinking. Rather, the system has simply grown hodge-podge through a series of laws, amendments and regulations to cover whatever brush fire situation exists at the time.

continued on page 24

OUR INCOME TAX - Isn't it time for the system to grow up to maturity? Our present "System" is such a mishmash of arbitrary laws and regulations that it borders on infantilism in its logic. A Gross Income Tax system would provide the needed maturity. Note the simple tax form below

This ID number would cover every tax-paying entity whether a corporation, division of a corporation, a professional investor or an individual operating as a free enterpriser

When this return is filed and paid, a business operating entity (company) can spend its money any way it sees fit. It will not have to be examined by or get permission from the government on how its money is spent. This will free the BOE (Business Operating Entity) from the massive overhead costs of seeking deductions or other tax avoidance devices, businesses could operate freely on an economic basis rather than a tax consequent basis

Gross Income Tax Return

Name ____ Type of Business Entity ____ (1)

Address ____ City ____ State ____ Zip ____ (2)

Taxpayer ID No. ____ Period of Return From ____ to ____ (3)

Gross Income

Sale of Goods	$ ____	(4)
Sale of Services	____	(5)
Sale of Combination of Goods and Services	____	(6)
Rentals of Real Estate	____	(7)
Sale of Real Estate	____	(8)
Rentals of Other Chattels	____	(9)
Dividends from Stocks	____	(10)
Sale of Stocks	____	(11)
Interest from Bonds	____	(12)
Sale of Bonds	____	(13)
Interest Received on Loans	____	(14)
Interest Received on Savings Accounts	____	(15)
Inheritances (market value)	____	(16)
Gifts (market value)	____	(17)
All other Income not reported above	____	(18)
Salaries or Wages (record only amount received above $25,000.00)	____	(19)
Total Gross Income	$ ____	(20)

Those two lines whenever either is applicable to an individual would put that individual in the category of a BOE (Business Operating Entity). The application of the GIT principal would then allow the government to collect taxes readily without the present equities of the inheritance and gift tax "System"

This line provides for the cases where an employee is paid an amount far in excess of what would be expected in wages for ordinary manual or mental input by that employee. Such cases would be considered "Sale of Expertise" and would then come under the concept of a BOE. Any amount above $25,000.00 per year would be considered "Sale of Expertise"

Gross Credits

Investment	____	(21)
Employment	____	(22)
Export Sales	____	(23)
Other Approved Credits	____	(24)
Total Gross Credits	$ ____	(25)
Taxable Income (deduct total Gross Credits from total Gross Income)	$ ____	(26)
Total Tax Due (1% of Taxable Income)	$ ____	(27)

This section provides the means for inducing those national goals which make our nation more economically and socially productive

Because this tax is taken right of the top, the so called "Double Taxation" is eliminated

If GIT is adopted, it is estimated that the tax rate would be nominal for every BOE (Business Operating Entity) and would not be burdensome to any one probably 1% or less of gross income

Total Wages Paid to Employees for Year of Return	$ ____	(28)
Total Number of Employees	____	(29)

This section would be used in making the allocations for employees tax contributions and FICA. In practice it would be reported on a separate sheet to account for partial years employment and raises during the year for individual employees

FOR IRS USE ONLY

Allocation for Employee Tax Contribution	$ ____	(30)
Allocation for FICA	$ ____	(31)
Allocation for Health Care	$ ____	(32)
Allocation for General Revenue	$ ____	(33)

This section would be used by the Internal Revenue Service in making the allocations as shown in the box. These allocation percentages would be monitored and changed on a yearly basis by Congress

This section would-

1. Eliminate the necessity for making out millions of W-2 (and related support paper work) forms by all BOE's (Business Operating Entities) in the country
2. Would eliminate millions of income tax returns by individuals each year
3. Would finance the Social Security Program out of the same fund from whence it now comes, but by a more direct and less costly route. These funds are the gross income which a BOE uses to pay his share and also the wages from which the wage earner pays his share. It all comes from the same pot.
4. Would give our Congress complete control and efficiency in any social system which must be separately funded.

This type of tax system would allow at least ten times as many audits by our government as our present system allows. An audit would be simple and would not make the taxpayer dependent on the subjective and arbitrary decisions now necessary with our present NIT (net income Tax) System"

Gross Income Tax

1. It is fair and equitable to every taxpaying entity, whether it be a corporation, an individual business man, an investor or a wage earner
2. It is a progressive tax based strictly on the ability to pay
3. It is easy to administer, with no large software overhead requirement.
4. It is a true and equitable way for companies to accumulate capital. This encourages retainage of funds for expansion investment, thereby creating more jobs.
5. It would eliminate the so called "Double Taxation" of corporations. This would again encourage retainage of funds for expansion because there would be no conflict between paying out for dividends versus retaining money for internal use
6. It would eliminate 80% of the paper work for business entities.
7. It would eliminate 100% of the paper work for individuals.
8. It would allow business entities to operate on an economic basis rather than on a tax consequent basis.
9. It would raise more revenue than our present "system" allows, without substantive objections from the general public.
10. It would give equal opportunity to all business taxpayers. Large firms can employ lawyers and accountants to circumvent the present system. GIT would eliminate this discrimination without penalizing either the large or the small company.

BEST COPY AVAILABLE

If one takes a reflective overview of this situation, there has clearly been established an adversary relationship between our citizens and the tax system. This applies to both the BOE (Business Operating Entity) and the individual wage earner.

This adversary relationship is at present mostly benign and becomes a confrontation in a small percentage of cases. However, the increasing complexity of the laws and regulations promise to make the confrontations more frequent.

A simple way to make our society a cooperative one in the matter of income taxes is to get with GIT and away from NIT. Lets make our citizens *want* to pay taxes by making it simple and practical. GIT will do this.

• OPEN LETTER NO. 25 •

Senator Floyd Haskell of Colorado held a hearing in Colorado Springs with regard to tax reform. Senator Haskell stated that "by reform I mean returning the tax system to one which is *simple, fair* and *progressive.*" His discussion during that hearing was aimed at the necessity of simplification.

The media and others are constantly stressing the "complexity of the forms." Senator Haskell seemed to be getting to some logical thought of this when he further stated, "Is the problem the forms or is it the underlying Tax Code?"

In line with Senator Haskell's thinking, we have brought up the subject in prior communications that *forms are only a sysmptom* of a much worse problem and that is the Tax Code itself. The Tax Code is the result of bills passed by Congress; the regulations and resultant forms are issued by the IRS in response to these laws.

There is a way to meet all three of Senator Haskell's desires. If we go to a gross income tax (GIT) system it *will* be *simple;* it *will* be *fair* and it *will* be *progressive.*

As a nation we should address this problem without further delay. Our present net income tax (NIT) system only gets more complicated by the day. Complexity is an inherent defect of the NIT system.

Get with GIT and away from NIT

• OPEN LETTER NO. 26 •

U. S. Senate Candidate Bob Krueger in a recent campaign statement, proposed a restructuring of our income tax system. As part of that proposal he suggested that all individuals making $40,000 to $99,999 per year pay at least 5 percent of their *gross* income in personal income taxes, regardless of the exemptions for which they may apply. (The newspaper report containing Krueger's proposal is reprinted on the following page.)

This is a signal suggestion in that *gross* income would be taxed instead of *net* income. It is a safe bet that any person in such an income range would be a BOE (Business Operating Entity) as well as a wage earner. By logical extension, this idea could be projected and enhanced to include all BOE's and a general system based on *gross* income, such as we propose, would become a happy reality.

The GIT (Gross Income Tax) system would be simple, fair and progressive. The present NIT (Net Income Tax) system is none of these things.

Krueger offers proposal to restructure taxation

By JON FORD
Political Editor

U.S. Senate canidate Bob Krueger Tuesday proposed income tax legislation to insure that Americans in income brackets over $40,000 pay their "fair share."

Krueger announced his so-called "fair share tax plan" at a news conference outside the Austin branch post office at 4300 Speedway. He later addressed a law school student group at the University of Texas.

The 21st District congressman from New Braunfels, who has Democratic opposition for the party nod to face incumbent Sen. John Tower, said he is introducing a bill to require all individuals making $40,000 to $99,999 a year to pay at least 5 percent of their gross income in personal income taxes, regardless of exemptions for which they may qualify.

The bill would require those earning $100,000 or more to pay a minimum of 10 percent of their earnings in federal taxes.

Krueger said corporations making that much money already are in 47-percent tax brackets.

He admitted that the legislation would not increase federal income appreciably, but said it is designed to guarantee that all Americans pay a share in supporting the government. That burden has fallen mostly on middle-income families, he said.

"With the increase in Social Security taxes, I believe a tax cut is essential," said Krueger. "However, we cannot afford to reduce our income without reducing our spending."

Krueger said he also will release major position papers on health care, military and defense, education and older American programs during the closing weeks of the primary campaign. He called on his Democratic opponent, Joe Christie, to make his own stand clear on those issues.

About $16,110 in income tax was withheld from Kruger's congressional salary last year, he said.

A small group of Christie supporters silently handed out a "notice to Texas taxpayers" during the Kruger news conference to emphasize Christie's past charges that Krueger's congressional staff has been doing campaign work.

"This is to notify you that by payment of your (income) taxes you have become an involuntary contributor to the Senate campaign of Congressman Krueger," the release, printed on the back of a Christie letterhead, stated.

"The following persons have campaigned for Congressman Krueger while being carried on his congressional payroll and drawing salaries that your tax dollars paid: Nina Guinn, Garry Mauro, Mary Dutko and John Wasson. Others to be named later," it said.

The notice also was distributed at post offices over the state.

Krueger has maintained that his staff members are doing campaign work on their own time.

Reprinted from the Austin American-Statesman, April 19, 1978.

• OPEN LETTER NO. 27 •

A considerable amount of time is being spent in discussing inflation as it affects our income tax structure. In the Congress there seems to be a movement to "index" for the *seeming* disparity between the rate of rise of gross income and the rate of change in the tax rate.

The Austin American Statesman on 9/23/77 ran a column (see top of page 27) by Mr. Chris Whitcraft, Financial Editor, which stated that "Income equivalent of $15,000 in 1955 is $32,900 in 1976. That's a jump of 120 percent. But taxes rose from $1,540 to $6,600. That's a soaring 330 percent."

This is a perfect example of how comparisions of percentages are highly misleading. Percentages, because they are *rates* can be *logically compared only* when they apply to the same base.

Mr. Whitcraft arrived at his percentages as follows:

Equation 1

$$\frac{100(B - A)}{A} = C \quad ;\text{Substituting} \quad \frac{100(32{,}900 - 15{,}000)}{15{,}000} = 119.3\%$$

Equation 2

$$\frac{100(E - D)}{D} = F \quad ;\text{Substituting} \quad \frac{100(6{,}600 - 1{,}540)}{1{,}540} = 328.57\%$$

Where

A = 1955 Gross Income
B = 1976 Gross Income
C = % Increase in Gross Income
D = 1955 Taxes
E = 1976 Taxes
F = Pseudo % Increase in Taxes

The commanding point to note here is that 1955 and 1976 *gross income* are compared and 1955 and 1976 taxes are compared. However, there is no *relating* of the two.

The meaningful way to compare 1955 taxes to 1976 taxes are as follows:

Equation 3

$$\frac{100(A - D)}{A} = G \quad ;\text{Substituting} \quad \frac{100(15{,}000 - 1{,}540)}{15{,}000} = 8.97\%$$

Equation 4

$$\frac{100(B - E)}{B} = H \quad ;\text{Substituting} \quad \frac{100(32{,}900 - 6{,}600)}{32{,}900} = 8.0\%$$

Equation 5

$$\frac{100(H - G)}{G} = J \quad ;\text{Substituting} \quad \frac{100(8.97 - 8.0)}{8.00} = 11\%$$

Where

G = Actual Tax Rate for 1955
H = Actual Tax Rate for 1976
J = Actual % Increase in Taxes

Equation 5 shows that the *actual* 1976 rate is only 11 percent above the 1955 rate.

If we want to get honest with ourselves and stop the mental aberrations of our present tax system we will turn from a net income tax (NIT) system to a gross income tax (GIT) system and prosper as we've never prospered before.

"*Indexation*" is a term and action that would do nothing more than churn an already too complex tax system.

Inflation is stiff but hidden tax

By Chris Whitcraft
Financial Editor

Inflation creates wealth for the Internal Revenue Service

Ideas such as indexing to reduce taxable income and assets to the extent they have been inflated by general rises in prices, don't get anywhere in Congress

That is because one unspoken rule of Washington games is that no tax reform can cost the Treasury any revenue

So insulated, inflation functions as an ever stiffer yet hidden tax The most highly visible inflation tax is on personal income

The "progressive" tax system levies taxes at higher and higher marginal rates as income goes up Inflation caused higher hikes in current dollar income pushes wage earners into higher marginal tax brackets This forces them to pay out larger shares of income in taxes than if there hadn't been inflation

The tax bite added by inflation can be substantial, report economists for Citibank of New York in a September *Letter*

As an example they cite a family of four that earned $15 000 during 1955 Assume income just kept pace with inflation over the next 21 years Gross income would buy neither more nor less in 1976 than it did in 1955 Ignore tax law changes to reach pure effects of inflation

Income equivalent of $15,000 in 1955 is $32,900 in 1976 That's a jump of 120 per cent

But taxes rise from $1,540 to $6,600 That's a soaring 330 per cent

This happens because the family marginal tax rate the highest at which an extra dollar of income is taxed jumped from 22 per cent to 36 per cent

So combined inflation and tax progressivity reduced family real after tax income by 11 per cent even though real gross income was constant

The tax impact of inflation on capital is more far reaching

The inflation premium built into interest rates, underdepreciation of business assets, and capital gains tax all designed as levies on income from capital have become taxes on wealth

Reprinted from the Austin American-Statesman, September 23, 1977.

• OPEN LETTER NO. 28 •

The April 24, 1978 issue of Business Week had a letter to the editor from Mr. Allan H. Kaplan of Chicago which aptly illustrates why our net income tax (NIT) system is such a childish exercise in thought rationalization. A copy of this letter appears at the top of page 28.

The letter shows how a BOE's (Business Operating Entity) taxes can in a large degree depend simply on the company itself. This letter illustrates vividly the regressive nature of our tax system. If a BOE is large enough and has enough income it can mitigate its tax load in a way a smaller BOE can never do, and this idea is multiplied thousands of times in other ways every day.

Let's get with a tax system based on gross income (GIT) and away from one based on net income (NIT) and the BOE can spend its money any way it chooses without government interference. Everyone will profit, including the government.

• OPEN LETTER NO. 29 •

In the May 5, 1978 issue of the San Antonio Express, there appeared a dispatch under the Washington Star Service byline which commented on a report by the Common Cause lobby called "Gimme Shelters." This dispatch is shown on page 29.

This report described how numerous "tax preferences" were carried out in the period 1971-1976 under provisions of law without any recorded votes in the House Way and Means Committee, the Senate Finance Committee, the House floor or the Senate floor. These "tax preferences" are also called "tax expenditures," "loop-

Justifying First Class

I read "Corporate flying: Changing the way companies do business" (Transportation, Feb. 6) with great interest and came to an interesting conclusion.

First, the Carter Administration has perceived that if an executive chooses to fly first class so as to get a little more room, peace, and quiet to work on a plane, those motives are suspect, and he should be precluded from doing so. On the other hand, if an executive is lucky enough to work for a corporation substantial enough to fly its own plane, apparently a complete and justifiable corporate outlay shall be allowed. Apparently the answer is, you can justifiably incur the business expense of flying in first-class comfort only if you can afford your own plane. Another example of egalitarian populism!

Allan H. Kaplan
Chicago

Reprinted from the letters to the Editor, Business Week, April 24, 1978.

holes" or "tax incentives." The report further stated that during the six year period *no testimony* on 38 of 86 loopholes was heard by the Finance Committee and on 25 of these items by the Ways and Means Committee.

The fact is, that these preferences had to be initiated by *someone* in Congress and indications are that they were carried out in an "arbitrary and undisciplined manner." What is really important is that they are incapable of being monitered by the full Congress. This is because of their addition to the complexity of the net income tax laws and their relative impenetrability to the ordinary interested observer.

This condition may be corrected very easily. That is to adopt a Gross Income Tax (GIT) system. With the GIT system Congress can do its job easily and efficiently in the *sunlight* and it *won't need* a sunset law for "tax preferences."

• OPEN LETTER NO. 30 •

Senator Lloyd Bentsen's newsletter of March, 1973 has an article entitled "Going to War Against Government Regulation." This article is reprinted on page 30 of this booklet.

Senator Bentsen said that his hearings, beginning in April, on this subject would be the first phase of an all-out assault on the steadily intruding role of the government. The hearings will be the first skirmish in the battle to wrest power from bureaucrats and return it to the people.

The largest regulator of all is that which is spawned by our income tax system, the Internal Revenue Service. Because our tax system is based on *net income*, Congress cannot write laws which cover all the individual details which arise under such a system. Consequently, the IRS is forced to put their own individual and most times arbitrary interpretations on the law. This procedure transcends the entire spectrum of the American economy, ranging from the largest corportation to the smallest individual. No other bureaucracy in the government wields such regulatory control over our citizens' lives.

Group urges close study of tax shelters

Washington Star Service

WASHINGTON — Congress should monitor tax preferences and automatically repeal those that cannot be justified, Common Cause urged Saturday.

"Congress and its tax committees have irresponsibly abdicated their duty to oversee tax expenditures and determine whether their continuation is justified," Common Cause President David Cohen said in releasing the study by the "citizens' lobby."

Charging Congress with "negligence," the study said the tax legislation process is "arbitrary and undisciplined." There is only "minimal oversight" of how tax preferences work, and hearings are "stacked with those who benefit," it said.

The organization analyzed congressional handling of tax expenditures, defined as incentives or preferential tax provisions provided through special tax credits, deductions, deferrals, rates or exclusions from income.

Since these provisions reduce potential federal revenues, they have as much impact on the budget deficit as direct federal spending, but they are not subject to systematic evaluation, the study said.

Little oversight

"Once a tax benefit is enacted, there is a minimal chance of oversight and an even smaller chance that the benefit will be taken away," it said.

"Items in the tax expenditure budget continue year after year without either (tax-writing) committee determining that the particular tax expenditure is effective, efficient or wise."

Common Cause used an outdated table prepared by the staff of the congressional Joint Taxation Committee in analyzing tax expenditures. Although the committee staff says it is not possible to derive a meaningful total by adding up individual tax expenditures on the list, Common Cause stated the total for fiscal 1979 as $136 billion.

To support the charge of negligence, the study said more than $161 billion of tax expenditures were carried out in the 1971-1976 period under provisions of law adopted without any recorded votes in the House Ways and Means Committee, the Senate Finance Committee, the House floor or the Senate floor.

No testimony was heard during that six-year period by the Finance Committee on 38 of 86 tax expenditure items, and by the Ways and Means Committee on 25 of the items, the study said.

When the committee did hold hearings, most of the witnesses had "direct financial interests in the continuation or expansion of the tax expenditures," the study said. It said 65 percent of the witnesses before the Finance Committee and 45 percent of those who testified before the Ways and Means Committee represented "private commercial interests."

Only 4 percent of the witnesses before the Finance Committee and 12 percent before the Ways and Means Committee represented "citizen groups," and 10 percent of the witnesses at the Senate hearings and 17 percent at the House hearings were experts from research organizations or universities, the study said.

It said the Finance Committee approved creating and expanding many more tax expenditures than the Ways and Means Committee, and the Senate committee recommended fewer decreases than the House panel.

Common Cause recommended applying the "sunset" principle to tax expenditures. Provisions would expire automatically on a set schedule unless Congress acted affirmatively to extend them.

Reprinted from the May 7, 1978 issue of the San Antonio Express.

Going to War Against Government Regulations

An elderly couple in Arizona, operators of a "mom and pop" auto business, testified before the Federal Paperwork Commission that they spend an average of 15 hours every week preparing federal reports.

An Army veteran made a 130-mile round trip to complete paperwork at a Veterans Administration office, only to be told a few months later that he had to make the trip again to provide the same information for a different program.

According to a recent study at Washington University in St. Louis, federal regulation of business cost over $65 billion in 1976; $3 billion of that to support regulatory agencies and more than $62 billion for business and industry to comply with the regulations issued by these agencies.

As Vice Chairman of the Congressional Joint Economic Committe I will hold hearings in April on government regulation and the extent to which it inhibits the performance of our economy, making it more difficult for the individual American to succeed.

The hearings are but the first phase in an all-out assault on the steadily intruding role of the government. They will be the first skirmish in the battle to wrest power from the bureaucrats and return it to the people.

The goal is to find the worst, the most cumbersome, the most senseless regulations and repeal them.

This is a battle in which you have a vested interest and an important role to play. It is an issue in which your representatives in Congress are going to need your help and support.

Please write me and list those regulations and requirements that cause you the most problems. And then, we'll go to work to weed out the worst of the lot.

Reprinted from Senator Lloyd Bentsen's newsletter, March 1978.

• OPEN LETTER NO. 31 •

IRS Commissioner Jerome Kurtz in a recent address to the Twelfth General Assembly of the Inter-American Center of Tax Administrators, discussed the increasing complexity of our income tax system and the effect of this complexity on the attitude of the taxpayer. Some exerpts of that address appear on page 31 of this booklet.

Mr. Kurtz has done a good job in explaining why our present system based on net income (NIT) is failing on a broad and ever increasing scale. Although Mr. Kurtz does not specifically acknowledge this failure, evidence abounds to show that this is so.

There is a way for our income tax system to be both equitable and simple. That is to go from a net income tax (NIT) system to a Gross Income tax (GIT) system.

True thinkers with absolute mental integrity will generally acknowledge and advocate this. A good study of our past letters and the illustrative GIT form on pages 22 and 23 will easily produce this conclusion.

We hope some statesman in Washington will come forth at an early date and make his name immortal.

• OPEN LETTER NO. 32 •

Chairman Al Ullman of the Ways and Means Committee has just appointed two task forces to study (1) Employee Fringe Benefits and their tax treatment by the IRS and (2) Employee/Independent Contractors as they relate to the income tax system.

Fringe benefits are primarily used by businesses as added inducements to hire and keep good employees. It is simply a part of an economic action by a business which may or may not be caused by competitive or other economic factors. However, if they become a focal point for more complications of our net income tax (NIT) system, the result is going to be more complexity and further erosions of our legislator's ability to control our Internal Revenue bureaucracy.

There is a way for Congress to get a handle on this mushrooming problem. That is to change from the NIT system to the GIT (Gross Income Tax) system. If this were done the government would get its money without the massive adminstrative cost of monitoring "fringe benefits" and businesses could grant any fringe benefits it wants on an economic basis instead of a tax consequent basis which is now nec-

Kurtz on Tax Complexity and Tax Fairness

The following is excerpted from the May 23, 1978 address by IRS Commissioner Jerome Kurtz before the Twelfth General Assembly of the InterAmerican Center of Tax Administrators.

It is essential in a tax system based on voluntary compliance that taxpayers have confidence in the fairness of the System. While all taxpayers will never be convinced that they are treated fairly by the System — no System is completely fair by any standard, and opinions differ as to what is a fair tax System — a minimum requirement for taxpayer confidence is that decisions governing tax liabilities are made in a way designed to achieve fairness.

A taxpayer can better accept a decision — including an adverse decision — if he or she is convinced that the decision was reached in an atmosphere that was open, in which all sides were heard, and where the basis for the decision was known. Action affecting taxpayers that are arbitrary, or that appear to be reached in an arbitrary way, will quickly erode respect for the fairness of the System, increase resentment for the burden of taxation and consequently diminish voluntary compliance.

Our tax System is enormously complex. Many would say, with justification, that it is excessively complex. Over the years, our tax System has been called on not only to provide rules to govern the taxation of extremely complex business and personal financial arrangements, but also to provide incentives and rewards for a long list of nontax goals.

[We pay a high price] in complexity for using the tax System to achieve nontax goals, and for allowing the tax System to become overly refined in its definition of taxable income, even if those refinements are designed to achieve greater equity. Complexity hurts voluntary compliance because taxpayers will tend to resent a tax System they cannot understand.

While progress towards simplicity is not impossible, it is very difficult, each taxbenefit, no mater how complex, develops a consitituency of support from its users and little opposition from those interested only generally in simplification. Those interested in the complex provision, and their representatives, well understand the provisions and it is difficult, if not impossible, to rally popular support for a reform position which is virtually incomprehensive except to the initiated — those who are benefiting from the complexity.

Moreover, complexity breeds complexity. As a tax System becomes less comprehensible to the average person, it becomes easier for those seeking special benefits to obtain them by amendments to the tax code, because the complexity of the tax law hides the real effect of many special interest provisions from public comprehension and hense from public disapproval.

Reprinted from Tax Analysts And Advocates' "tax notes," Volume VI, Number 23.

essary, and seems to be headed for escalation in the future because of this Congressional study.

We ask that the task forces appointed by Mr. Ullman make it a number one priority to study in detail the GIT plan and recommend that it be adopted, so that these frivolous tax questions would cease to exist.

• OPEN LETTER NO. 33 •

A news story appearing in the July 8 issue of the Austin American-Statesman under the byline of the Washington Post reported on the current unemployment situation. The first six paragraphs are illustrated in box below.

These first six paragraphs discussed the booming economy and "inflation." The story stated "The booming economy is continuing to create more jobs — and more inflation," and in the third paragraph "That same strong economic expansion kept inflation at a high level. The (Labor) Department said wholesale prices rose 0.7 percent in June, about as fast as in May."

This is a common, and even prevalent, mis-understanding of what inflation is. The implication of this and most other stories is that rising prices cause inflation. Rising prices are a *result* and not a *cause* of anything. If prices rise because of a better or more quantitative input of capital and labor, this is not inflation. Such inputs may or may not result in price increases. If such input results in more efficient manufacturing processes the price may well decrease. A good example of this is the price of electric motors which have decreased steadily for the last few years.

We ask then why do overall economic prices go up? The answer lies primarily in our government. The cost of bureaucratic regulations and administration of

Unemployment at 4-year low of 5.7 percent

Washington Post Service

WASHINGTON — The booming economy is continuing to create more jobs — and more inflation.

The Labor Department reported Friday that more than 700,000 persons found jobs in June, pushing the unemployment rate down to 5.7 percent from 6.1 percent. It was the first time in almost four years (since October 1974) the jobless rate has been below 6 percent.

That same strong economic expansion kept inflation at a high level. The department said wholesale prices rose 0.7 percent in June, about as fast as in May. That works out to a seasonally adjusted annual rate of 8.7 percent.

Food prices remained the villain, increasing 1.1 percent. But non-food prices, which economists consider a better barometer of inflation, rose 0.6 percent. That is a little less than May's 0.8 percent, but still considered high.

Even though economists think food inflation will moderate substantially during the next six months, they fear that food rises that have already taken place will be echoed in the industrial goods sector as workers receive large cost-of-living increases.

Administration economists expect the strong growth of recent months to taper off in the final months of the year. There is a lingering fear that the June reports of strong job gains and high inflation will encourage the Federal Reserve Board to boost interest rates even higher in its attempt to fight inflation.

Reprinted from the July 8 issue of the Austin American-Statesman.

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our laws to business is so enormous that this cost is added to the price of the product and no *intrinsic value* is added.

Our most costly bureaucracy is the Internal Revenue Service. Eighty percent of governmental paper work (forms only) is generated by our tax laws. This does not include the cost of record keeping which is charged directly to individuals and businesses in order to comply with our tax laws.

There is a *better way* to control a large amount of our inflation. Let us change now from a Net Income Tax (NIT) system to a Gross Income Tax (GIT) system and make the cause for most inflation vanish.

• OPEN LETTER NO. 34 •

Back in early 1976 when we began a study of our income tax system, Mr. Irwin H. Schuler of the IRS Committee studying forms simplification invited comments from the public on how forms may be simplified. We wrote him a letter essentially stating that forms *could not be simplified* under our present Net Income Tax (NIT) system. This is still true. This letter is printed on pages 4 and 5 of our Publication 78-1. Paragraphs 5 and 6 of this letter are reprinted in the box on page 34.

Paragraph six of this letter stated that "Based on discussions we have had with lawyers, accountants, business executives and others, we are either going to have a massive breakdown of the entire system or a taxpayers revolution. In fact it appears to be well on its way in its passive stages."

The revolution has now passed the passive stage and has surfaced in California under the bellwether vote, popularly called Proposition 13. However, the newspapers and most bureaucrats are calling this a revolt against *property tax*. The *property tax* issue is only a small part of the revolution.

Again we have discussed this with many men on the street — accountants, lawyers, retired military personnel, legislators, just about all types of people — and the concensus is nearly 100% that the revolution is against government regulations and interference. Property taxes in California was merely a vehicle to vent the popular anger. The bureaucracy, our legislators and our governing bodies are using our taxing system to effect this regulation and interference. The California vote was a signal call to our lawmakers to trim the bureaucracy and un-necessary services or the *taxpayers will*. The *cliche tax cuts* now being discussed will not suffice. *Tax cuts are not the issue*. The *issue is governmental regulation* which is being effected with our tax system by our bureaucracy.

In the matter of income taxes, there is a fair and simple way to eliminate 80% of federal government regulations. That is to go from a Net Income Tax (NIT) system to a Gross Income Tax (GIT) system.

We should become world leaders in this without delay.

• OPEN LETTER NO. 35 •

A classic question about a NIT (Net Income Tax) system as opposed to a GIT (Gross Income Tax) system is: but wouldn't a high net income producer be treated to an unfair advantage under a GIT plan?

The answer to this question on both an economic ahd an arithmetic basis is no — and a little true thought reveals this.

The answer is in one sense, psychological, in that over a long period of time, under NIT, we have been conditioned to think that the less profit a company makes,

THE FOLLOWING PARAGRAPHS ARE REPRINTED FROM THE LETTER ON PAGES 4 AND 5 OF OUR PUBLICATION 78-1.

"The problem is that our income tax laws are based on Net Income. Net income is a figure arrived at by a taxpayer and his accountant and depends primarily on the ingenuity of the taxpayers accounting and investment system. This fact alone makes it a highly inequitable system. It also imposes as incalculable amount of software overhead in running any business, large or small."

"The problem can be easily eliminated by going to a system based on Gross Income. It is not only workable but mandatory at sometime in the future. *Based on discussions we have had with lawyers, accountants, business executives and others, we are either going to have a massive breakdown of the entire system or a taxpayers revolution. In fact it appears to be well on the way in its passive stages.*"

the less the company's "ability to pay." Upon honest reflection, what NIT actually does is to subsidize the less profitable company. Companies have three major influences that affect profitability — (1) the company's sphere of business, e.g., a service company such as a law firm which may have an inherently high net as opposed to a grocery company which may have an inherently low net (2) management practices which may produce either a positive or negative net and (3) outside influences beyond the scope of management control which can again produce a positive or negative net.

With respect to the first of these, it must be realized that an entrepreneur has the freedom to enter any business he chooses and this should be done in an economic or personal preference basis. If he enters either a low or high net income type business that decision should not be shadowed by how his taxes are figured. The motive for any free enterprise business should be *economic* profit instead of *tax* profit. The *tax* profit motive is rampant in the country today because of our NIT system. Just look at the mergers where companies are looking for "tax loss write-offs" as a major goal.

As for the second of these, if the "ability to pay" premise is pursued to its ultimate and consistent line of thought, the company which has been mis-managed and produces a loss (negative profit) should be paid by the government for its failure to produce a profit. This is, in fact, exactly what happens when a profitable company takes over a loss company and mitigates its own tax load with that loss.

The taxpaying public would be better served if the rationalization "expenses lessens the ability to pay" were changed to the true thought that all of a company's internal economic expenses *(even overhead)* are designed to enhance the ability to pay through increased *sales (gross receipts).*

This brings us to item (3). The only expenses a company incurs which do not help sales (gross receipts) are those imposed by the government(s) in record keeping and the reporting thereof. According to figures gleamed from the Congressional Paperwork Commission and Senator Bentsen's office, 80% of required government paperwork and record-keeping is generated by the Internal Revenue Service, in its efforts to adminster NIT laws. GIT would almost entirely eliminate this very costly and inflationary (non-productive) cost.

We hope our government leaders will spend some goodly amount of time in studying these fundamental ideas. When that is done the true answer will come like a vision from behind a cloud and reveal the true worth of GIT.

Is someone in Washington ready to be the statesman of the century and get legislation passed for the GIT system and be a world leader in progressive taxation instead of a follower?

	BUSINESS OPERATING ENTITY (BOE) A	BUSINESS OPERATING ENTITY (BOE) B	BUSINESS OPERATING ENTITY (BOE) C
Gross Sales	$10,000,000.00	$10,000,000.00	$10,000.000.00
Net Profit	0.02	0.50	(-) 0.02
Approximate Tax (NIT)*	187,500.00	372,000.00	(-) 187,500.00
Tax (GIT)	100,000.00	100,000.00	100,000.00

Basis: No direct tax credits are considered here.

* Based on 48%

• OPEN LETTER NO. 36 •

That our country needs a better system of taxing our economic growth and output is illustrated by the recent proposals for a Value Added Tax (VAT).

There are many defects to such a tax.

1. VAT is a *hidden tax* on the individual consumer and highly *inflationary.* Such a tool easily lends itself to abuse by extracting large sums from the consuming public *without their explicit recognition* of the fact.

2. VAT would be yet another taxing system parallel to the already perverted NIT (Net Income Tax) system. Since the VAT system would introduce thousands of new and artificially induced transactions (the deductions for cost of goods), it is a safe bet that it would be perverted also in a relatively short time.

3. VAT would add still another bookkeeping chore for the nations businesses and result in still more regulatory action to enforce. The goal of any taxing system should be *less* and *not more* regulatory activity for our business and individual citizens. Such extra regulatory activity would simply fuel more inflationary government costs with additional *implicit taxation* to all sectors of the economy.

4. Some proponents of VAT say that the regressivity of the system could be corrected by a system of tax credits. This one activity alone would make VAT an adminstrative nightmare just as onerous as our present NIT system. Tax credits and deductions made in such a voluminous and hidden way will result in *two* (VAT *and* NIT) systems incapable of being properly and fairly administered. Any rebate or credit system not tied directly to the payer of record (the one who files the tax

return) will be obfuscatory and of little real value to the intended beneficiary.

There is a way to tax the country's growth which will either eliminate or mitigate all the defects listed above. That is to go to a GIT (Gross Income Tax) system. A study of the GIT system will make these truths increasingly clear.

European-Style Tax 'Inflation-Maker'

By BERNARD D. KAPLAN
The San Antonio Light's Paris Bureau

PARIS — Americans should be warned that the European-style Value-added tax Sen. Russell Long has proposed for the U.S. is great for governments, but very bad for taxpayers.

It may also be the biggest inflation-maker that the mind of man has ever devised.

That has been the experience here ever since this form of taxation was invented in France 26 years ago and gradually adopted by the other nations of the European Common Market

Long suggested last week that a Value-Added Tax be considered as a partial substitute for the present payroll tax. The proposal was quickly endorsed by the chairman of the House Ways and Means Committee, Rep. Al Ullman.

Long, chairman of the Senate Finance Committee, likes VAT for the same reason European officials do. It rakes in a pile of money at relatively little administrative cost. It is also extremely difficult to evade. That makes it the tax collector's dream levy.

But it is socially regressive and almost totally unfair in its application to the population as a whole.

As European experience has shown, it is a constant stimulant to inflation Many economists regard it as the primary cause of the heavy rate of inflation in countries like France, Sweden and Belgium as long ago as the early 1960s when inflation in America and other non-VAT nations was very low.

Heinz Moll, a German economist who is one of VAT's sharpest critics, told The Light in a telephone interview that "if you Americans are foolish enough to legislate a VAT, you will be digging your own graves . . . It would be a decisive step toward creating bureaucratic control of your economy which, up to now, you have been wise enough to avoid."

The notion, advanced by VAT's American advocates, that it is nothing more than a sales tax writ large is highly misleading. It is both much more far-reaching than a sales tax and different from the latter in principoe.

Value Added Tax operates as its name suggests. At each stage of production, it is applied at a certain fixed percentage rate to a product's increasing commercial value.

For manufactured items, like a car or TV set, the tax imposed initially on the raw materials. It is subsequently reimposed as many as six or seven times until the item reaches the retail purchaser.

In that way, the whole of the steadily mounting tax load ultimately cascades down on the consumer. What adds insult to fiscal injury is that the consumer never knows how much tax he is paying. Unlike a sales tax, VAT is neatly hidden away in the purchase price.

This is probably just as well as it has been calculated that, in France where VAT ranges from 7 percent to 33 percent depending on the type of product, the levy on consumer goods accounts for an average of eight weeks' earnings of a French worker

VAT is paid not only on manufactured goods and food, but also on services, for example, by plumbers or TV repairman. Beginning next year, it will appear on doctors' bills, adding 15 percent ot the total cost

'IF you Americans are foolish enough to legislate a VAT, you will be digging your own graves,' Heinz Moll, a German economist,

The French government thus derives fully a quarter of its income from VAT, compared to 7 percent from personal income tax. Which is precisely the point as far as the government is conecerned. VAT was dreamed up in the first place because income tax evasion was so widespread in France that an evasion-proof tax was desperately needed.

It later spread to other European countries partly because it brought tears of joy to the eyes of revenue inspectors and partly because of French insistence.

Successive French governments demanded that VAT be adopted throughout the Common Market as a way to guarantee its permanence here. The European-community nations are committed to making their tax systems uniform at some date in the not too-distant future. (The chief difference between VAT's application in France and elsewhere is that most countries employ a single rate, instead of the flexible rate used here.)

Value-Added Tax may be hard to evade, but tinkering with it is something else again.

Some businessmen have been accused of using it as a cover for price gouging. Since manufacturing processors are reimbursed for their tax as thay pass the product along to a further stage of manufacture, others have been accused of doctoring their books to claim bigger reimbursements than they are entitled to.

"No tax system has even been devised that could not be violated," a French Finance Ministry spokesman said. "But the difference between VAT and other taxes is that, even when that happens, the state collects what is due to it. The cheaters do not reduce the revenue, as occurs if they successfully cheat on personal income or corporate taxes."

That is another way of saying that, whoever gets away with anything, it is never the guy at the end of the VAT line. Meaning the consumer.

Reprint from the October 17, 1978 issue of the San Antonio Light

• OPEN LETTER NO. 37 •

A question frequently asked is: How would you change from a NIT (Net Income Tax) system to a GIT (Gross Income Tax) system? And, what about the notions like depreciation and capital gains tax ideas which have been built up over a long period of time?

Of course the reason these things (and other devices) exist is *because* of our NIT system itself. A fundamental thing to remember is that the GIT system does not *need* such devices to try to attain fairness and equity. So the first hurdle is to get the factual frame of mind established that *no one is really losing* anything by going to GIT and the ultimate end gain is substantial — for the government, for the individual and for small and large businesses.

The way to make the change over is for Congress to set a five year period during which BOE's (Business Operating Entities) would be allowed to report either way, whichever would be most advantageous to them. During this period, Congress would gather the data from GIT returns and in a relatively short time would be able to project a GIT rate which would raise the necessary revenue to operate the government after total conversion to GIT.

Everyday we delay and stick with our expensive and "muddle through" NIT system will be our national loss. We hope a statesman will come forward shortly and make his name immortal and once again make our country a leader instead of a follower.

• OPEN LETTER NO. 38 •

An article appeared in the Tuesday March 6 issue of the San Antonio Express concerning President Carter's plan to propose legislation to streamline the regulatory process of our government agencies. This article carried the New York Times Service byline and is reprinted in the box at the end of this letter.

One of the most significant thoughts expressed in the story was contained in the first paragraph. It proposes that regulatory agencies be *required* to more carefully consider *less costly alternatives*, to proposed new regulations. If this is done, and it should be, the agencies would be assisting the Congress in getting good legislation passed instead of copping out by saying "we are simply interpreting the laws which Congress passes and administering them by issuing clarifying regulations."

Where this is particularly true is in the administration of our income tax laws by the Internal Revenue Service. When they are questioned about why they do not put forth ideas to improve our tax laws they simply say "we do not make the laws, we just enforce and administer them." This new regulatory law would make it *incumbent* on the IRS to *suggest better alternatives* (tax systems) to the Congress. No one would be in a better position to do this than the IRS. They can see weaknesses of the present NIT (Net Income Tax) system better than any one.

There is a better system than our present NIT system. That is the GIT (Gross Income Tax) system. GIT would be easier and less costly to administer and would be fair to everyone. The government would then be serving our business and individual citizenry instead of the citizenry serving the government through wasteful tax recordkeeping and reporting.

The first public official who gets legislation passed to change over to the GIT system will receive undying thanks from a greatful nation.

Bill to overhaul U.S. regulatory process planned

New York Times Service

WASHINGTON — The White House is planning to propose legislation this month to streamline the regulatory process by improving co-ordination, reducing procedural delays and requiring more careful consideration of less costly alternatives to proposed new regulations.

For example, the bill would require agencies proposing new rules either to select the least expensive means of meeting the goal or to explain in writing why that approach was unworkable.

"This is a carefully designed push to make regulation cost-effective," a White House official said.

A draft of the Regulation Reform Act of 1979, currently circulating on Capitol Hill for comment, was obtained by The New York Times. White House aids cautioned that changes might be made on the basis of the comments before the final version was released.

The proposal is thought to have reasonable prospects in Congress, largely as a result of the current concerns about the economic burden of regulation.

Administration officials maintained that the White House bill was needed because it would contain improvements over the Senate version and because the House might not act without such a push from the administration.

The new legislation represents one of several efforts under way in the administration to improve the quality of regulation and reduce the costs.

Although not currently part of the legislation, the White House is circulating with the bill a proposal to reconstitute the semi-moribund Administrative Conference of the United States, which now has only advisory powers, into a new Office of Regulatory and Statistical Management.

The new body would have a formal role of co-ordinating and overseeing.

• OPEN LETTER NO. 39 •

Sometimes voices out of our past can provide great leadership for the future of our country.

General Andrew Jackson was a great leader during his time. When he was elected as our President he made the following statement in his inaugural address:

> "As long as our government is administered for the good of the people, and is *regulated by their will;* as long as it secures to us the rights of property, *liberty of conscience* and of the press, *it will be worth defending.*"

Our government has departed from this plilosophy in many ways, especially in the matter of taxation.

Just about everyone agrees that the present "system" of income taxation is a mess (or worse), and further, that the "system" has every citizen in the country serving and *reporting to the government* instead of the way a tax system should be — and that is, the government should be serving its citizens and the *reporting should be from the government to the citizens* (business and individuals) instead of the present system which requires the citizens report to the government.

In the case of our income tax situation this can be accomplished in a large measure by going from the NIT (Net Income Tax) system to the GIT (Gross Income Tax) system.

We hope some statesman in Washington will perceive the truth of these ideas at an early date and pass legislation to effect the necessary changes.

• OPEN LETTER NO. 40 •

When a business manager begins the planning of a new enterprise, or the reorganization of an existing one, he goes through a thought process that encompasses two basic thoughts; (1) how can we *plan* the administration of this organization so that overhead is a minimum and consequent profits are a maximum and (2) once the most efficient plan has been decided on, how can we operationally *administer the plan* so that once again the overhead is a minimum and profits are a maximum.

When a government department manager begins the planning of a new enterprise (a governmental operational entity) or the reorganization of an existing one he *should* go through a similar thought process. However, there is one important exception, and that is, there are no products to sell and hence no economic profit motive is evident.

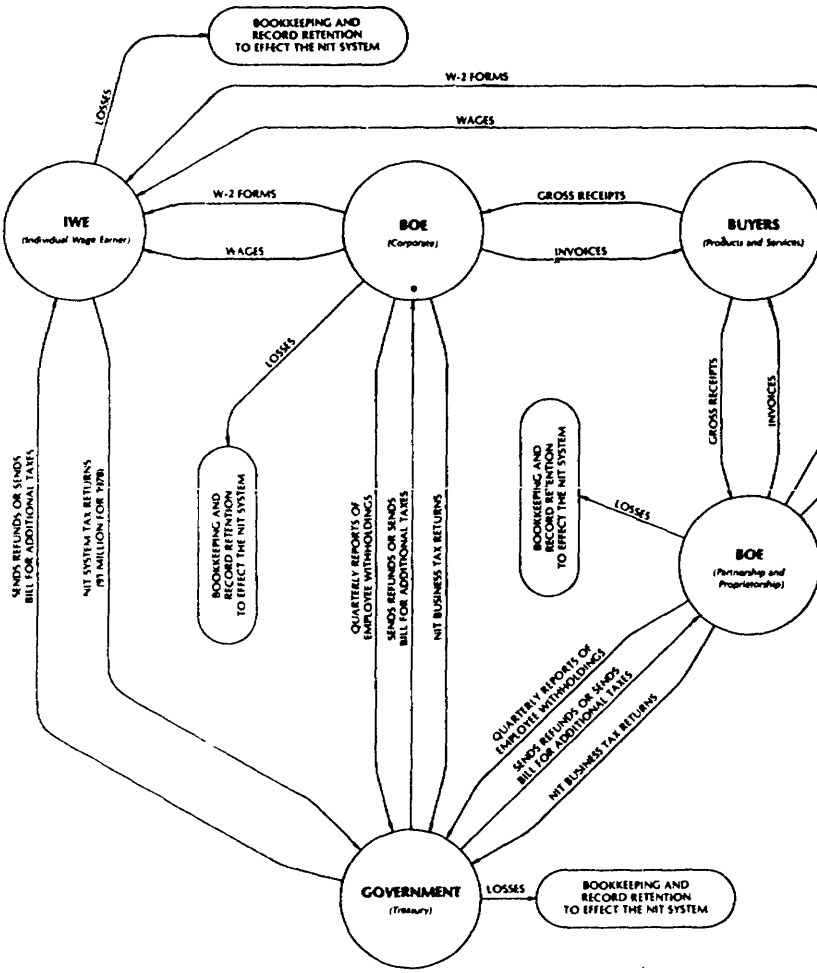
When a government department manager plans a new department we would hope that the *plan* is a good efficient one. Only time can tell whether this is so or not. Where our Federal Executive Branch is particularly deficient is in its failure to constantly review and reorganize its departments and operations so that both the *plan* and the *administration of the plan* is efficient. Some times the Executive Branch is not entirely to blame because of the imposition of certain restraints of law by the Congress.

An excellent example of error in planning by both the Congress and the Executives is in our income tax laws. Our Congress has passed an income tax laws based on net income (NIT) and each year pass additional changes to make it more complicated. The Internal Revenue Service trys to comply by issuing hundreds of new rulings and regulations every year. The IRS is constrained to try to follow these constant new changes to the present NIT (Net Income Tax) laws.

The error with Congress is they have not considered *new plans*, only changes to the *old plan* which has proved itself to be patently inefficient and wasteful. For the Executive Branch the error has been in the *planning of the administration* of the NIT law which Congress has dealt it. As noted by Senator Russell Long in his address before Tulane Tax Seminar (Nov. 30, 1978) the Ruml plan of World War II was instituted, which put the income tax on a pay-as-you-go basis by withholding tax from workers pay checks. Since that time no creative thought has surfaced to evidence a constructive change in this emergency war time measure. In fact, this costly and wasteful plan has been refined by the IRS so that now a large bureaucratic organization has evolved which costs our country billions of dollars to support. Reference to Figure A will graphically show this costly network.

There is a way to rid our country of both a bad *plan* and bad *administration of this plan* and that is to go from a NIT (Net Income Tax) plan to a GIT (Gross Income Tax) plan. A comparison of Figure A and Figure B will reveal this.

We hope our legislators will put political expediency behind them and bring the GIT plan to statesman-like fruition at an early date.



NIT SYSTEM
ADMINISTRATIVE WORK FLOW

Figure A

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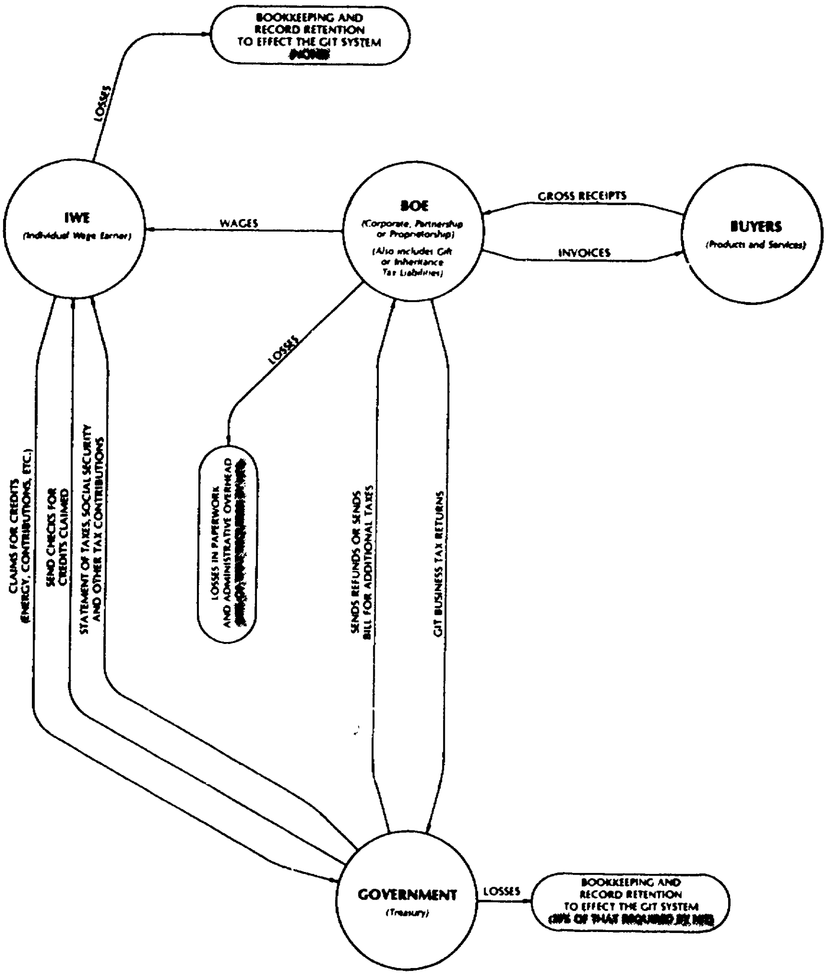

GIT SYSTEM
ADMINISTRATIVE WORK FLOW

Figure B

41

• OPEN LETTER NO. 41 •

One statement sometimes made with respect to our present NIT (Net Income Tax) system is the conscious effect it has on individuals when money is with-held from paychecks. It is said that such consciousness makes the individual more cognizant of his financial input to our government and hence a braking effect if too much money is raked in. However, *it seems to us* (and this has been supported by interviews) *that making 85 million citizens miserable on April 15* every year is a *poor way* to make the individual conscious of his government. Also, it is highly debatable whether the individual actually carries much weight in the spending habits of the government.

There is a way for the individual taxpayer to *feel the effect* of his input without all of the April 15 *misery* and that is to go from a NIT system to a GIT (Gross Income Tax system. The *Principal of Allocation* (see Open Letter No. 6) could then be applied. Under practical operation the IRS would send a statement to each IWE (Individual Wage Earner) informing him of his share of individual taxes paid, FICA and other applicable with-holdings. There would be no extra work for the IRS. They would actually be doing the same amount, or less, record-keeping than they do now.

Much spending is a built-in procedure as a result of congressionally passed laws and regulatory proliferations of the bureaucracy. In the case of our NIT system this is because Congress simply cannot get a handle on the system. *Congress is the only agency* which *can control* this situation and obviously this has been impossible under NIT.

There is a way Congress can control our tax mess. That is to go from NIT to a GIT system. Referance to our letter No. 19 will show how this could be done in an efficient and simple manner.

We hope some statesmen in our Senate and House of Representatives preceive these simple truths at an early date and get legislation passed which will give them the *control* they need.

Get with GIT and away from NIT

• OPEN LETTER NO. 42 •

One question which arises when the GIT (Gross Income Tax) system is examined is: How can the IWE (Individual Wage Earner) claim his exemptions for social incentives? An example of this would be the energy credit now available under our NIT (Net Income Tax) system. The answer is very simple. At the time the IWE receives his statement from the IRS as to how much taxes he has paid, the IWE could file a claim for such credits on a simple form. This form would be sent to the IRS who would then issue a check to cover these credits.

Close scrutiny will reveal how valuable, simple and exciting our change from NIT to GIT would be. It could change the entire attitude of our country from one of frustration and bewilderment to one of optimism and promise which our forefathers once knew.

LEE, TOOMEY & KENT,
Washington, D.C., June 22, 1979.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Washington, D.C.

DEAR MR. STERN: We request that the attached statement describing a proposed amendment to Section 851(a) of the Internal Revenue Code be made part of the record of the hearings being held today by the Subcommittee on Taxation and Debt Management.

Very truly yours,

GEORGE W. BEATTY.

Enclosure

JUNE 22, 1979.

PROPOSED AMENDMENT TO IRC SECTION 851(a)

The constructive ownership rules of present law can prevent a publicly-owned investment company from qualifying as a "regulated investment company" under §851 of the Code if, unknown to each other, some of the shareholders of the company happen to be limited partners in one or more unrelated limited partnerships. The statutory amendment described below is designed to correct this unintended and anomalous result.

FACTUAL CONTEXT—IN WHICH THE PROBLEM ARISES

An employee-owned investment counseling firm provides financial advice and investment management services to approximately 175 clients. The firm's income comes entirely from its clients and is based solely on the amount of assets which it manages for its clients. The firm has no participation or other financial interest in any of the investments it recommends to its clients or makes on their behalf, and the firm receives no fees, commissions or other compensation with respect to any such transactions.

In recent years, the firm has confined its investment recommendations to stocks, bonds, short-term debt instruments and selected real estate ventures which the firm believes are sound from an economic standpoint. As a result of the firm's recommendations, a number of its clients have purchased limited partnership interests in the same real estate ventures. However, because the firm agrees with each of its clients that their investment decisions will be treated as confidential information, a client who invests in a particular partnership is generally not aware of the extent, if any, to which other clients of the firm may have invested in the same partnership. In fact, in most cases, clients are not even aware of the identity of the firm's other clients.

As a service to its clients, the firm wants to organize a regulated investment company ("RIC") which will invest in a diversified portfolio of public-traded securities suitable for the needs of its clients. The firm anticipates that its clients will acquire substantially all the stock of the proposed RIC. In keeping with its previously stated policy, the firm will have no financial interest in the RIC, and will receive no compensation for organizing it or managing its portfolio.

DESCRIPTION OF THE TECHNICAL PROBLEM

Section 851(a) provides that an investment company can not qualify as a RIC if it is a personal holding company ("PHC"). Since all of the investment company's income will be from securities, the PHC income test of § 542(a)(1) will automatically be met. Thus, if the investment company also meets the PHC stock ownership test of § 542(a)(2), it will not be able to qualify as a RIG.

The PHC stock ownership test will be met if over 50 percent of the investment company's stock is actually or constructively owned by five or fewer shareholders. For these purposes, constructive ownership is determined by the rules in § 544. Under § 544(a)(2), a partner is deemed to own any stock owned by other members of the same partnership. This means that if any number of persons owning 51 percent of the investment company stock have limited partnership interests of any size in any of five totally unrelated limited partnerships, § 544(a)(2) will prevent the investment company from qualifying as a RIC. Countless other fortuitous combinations will produce the same result.

Based on an analysis of its clients' prior investments, the investment counseling firm described above has concluded that a literal application of § 544(a)(2) would prevent the firm from organizing a qualified RIC in which its clients could invest.

DISCUSSION

The personal holding company rules were enacted to prevent individuals in high tax brackets from sheltering passive income in a closely-held corporation where the income would be taxed at lower rates. In determining whether such a company was closely held. Congress decided that stock owned by partners should be aggregated "because of the close business relationship existing between members of a partnership". H. Rep. No. 1546, 75th Cong., 1st Sess. (1937), 1939-1 C.B. (Part 2) 704 at 709. In urging the adoption of such a rule, the Treasury stated that:

"It is believed the relationship of confidence which necessarily exists between partners affords a sound basis for including partners within the described group". Hearings before the Committee on Ways and Means on August 9 and 10, 1937, 75th Cong., 1st Sess., pp. 63-64.

Clearly, there is no "close business relationship" or "relationship of confidence" among passive investors who hold small fractional interests in publicly marketed limited partnerships. Generally, such investors do not even know each other.

In 1964, Congress amended the Code to eliminate the "sidewise" attribution of stock ownership from one partner to another for most corporate purposes. See H. Rep. No. 1844, 88th Cong., 2d Sess., 2-3 (1964). In keeping with this approach, § 102(a)(1)(A) of the Technical Corrections Bill of 1979 (H.R. 2797) provides that stock ownership will not be attributed from one partner to another in determining whether a corporation is closely held for purposes of the at-risk rules of § 465. See the Description of Technical Corrections Prepared by the Staff of the Joint Committee on Taxation, March 14, 1979, pp. 12-13; H. Rep. No. 96-250, 96th Cong., 1st Sess., Part III A5a.

The same approach should be taken for purposes of § 851. The partnership attribution rules used for PHC purposes are clearly not appropriate in the case of a publicly-held RIC, particularly when one remembers that the abuse which led to the PHC provisions can not exist in the case of a RIC. There is no possibility of avoiding individual tax on the shareholders of a RIC, because a RIC can not qualify as such under § 852(a)(1) unless at least 90 percent of its investment income is currently distributed.

The purpose of a RIC is "to accord individuals of small means an opportunity to pool their investments . . . yet receive the same treatment as those of greater wealth can obtain by direct investment." See H. Rep. No. 2020, 86th Cong. 2d Sess., 4 (1960). The basic concept is that investment companies which "submit to public regulation and perform the function of permitting small investors to obtain the benefit of diversification of risks" should be exempt from tax at the corporate level. H. Rep. No. 1681, 74th Cong., 1st Sess., (1935), 1939-1 C.B. (Part 2) 642 at 644; H. Rep. No. 2020, supra at 3-4. That purpose should not be frustrated simply because some of the investors in the company, unknown to each other, are also passive investors in totally unrelated limited partnerships.

PROPOSED AMENDMENT

To resolve the foregoing problem, § 851(a) should be amended by adding the following new language at the end thereof:

"In applying section 544(a)(2) for purposes of this subsection, the term 'partner' shall not include a limited partner in a limited partnership. If, after giving effect to the preceding sentence, a corporation qualifies as a regulated investment company for the taxable year, it shall be deemed for all purposes of this subtitle not to be a personal holding company for such year."

FRIEDMAN & KOVEN,
Chicago, Ill., May 25, 1979.

Attention: Mr. Michael Stern, Staff Director.
Re Senate bill 1063—Section 1—Simplification of installment sales rules.

SENATE FINANCE COMMITTEE,
Washington, D.C.

GENTLEMEN: I am an attorney practicing in Chicago, Illinois, specializing in federal income tax matters. I am writing to you to suggest a modification to the disallowance of installment reporting treatment involving sales of real estate or personalty between related parties as provided for under Section 1 of Senate Bill 1063.

NATURE OF THE PROBLEM

Under the present income tax laws one form of tax planning technique which has been successful involves the sale of appreciated property on the installment basis by, for example, a father to an irrevocable trust created by the father or some other member of his family for the benefit of the father's children. Shortly after that sale the property purchased by the trustee of the trust is sold by the trustee at little or no taxable gain because the cost basis for the second sale would reflect the entire purchase price paid to the father by the trustee of the trust. Under such circumstances the father has the benefit of spreading out the gain over a period of time and thereby incurring tax at a lower effective tax rate since, notwithstanding the fact that the purchased property is promptly resold by the trustee, the father is only required to report his gain as he receives payments from the trustee. The Internal Revenue Service has attacked the right of the seller to report gain under the installment method under such circumstances but has not always been successful. See W. B. Rushing, 52 T.C. 888 (1969), aff'd, 441 F.2d 593 (C.A.-5 1971); Clair E. Roberts, 71 T.C. 311 (1978). Obviously in a number of situations the principal incentive for the original purchase by the related party such as the trustee of the family trust is to enable the original seller to defer the recognition of gain over a substantial period of time although the entire gain with respect to the sale of the property has been converted to cash by the family group. Under these circumstances it appears quite proper to disallow the benefits of installment reporting treatment.

However there are bases for making an installment sale to a related party other than the deferral of recognition of taxable gain. I cite the following two examples of where installment sales are not used to defer recognition of gain but rather are dictated by economic circumstances and the desire to sell property to members of a family to keep the property within the family group.

Assume a father owns a farm which has substantially appreciated in value. Assume further that the father is growing near retirement age and wishes to have his son own his farm. However, the father cannot afford to give the farm to his son because he needs income to live on. Assume further that the son wishes to own the farm and work it but is not in a financial position to pay the full purchase price for the farm on the date he purchases it from his father. If the father would be willing to make an installment sale of the farm to his son, the son could utilize the expected earnings from the farm in order to pay his father. Under the proposed bill, since installment reporting treatment would not be permitted on the sale by the father to his son, either the son would have to get outside financing to pay his father a sufficient amount to pay his tax on the sale as well as to provide income for him or the father would have to sell to a third party. If financing were not available or, if available, if the cost and repayment terms were so onerous that it would not be feasible to finance the purchase, the effect of the proposed bill would be to force the father to sell the farm to a third party such as foreign investors or large farming corporations.

Assume the same set of circumstances except, instead of a farm, the father owns all of the stock of a corporation and he wishes to sell his stock to his children. Assume further that, because of bank lending restrictions with respect to loans made to the corporation, the corporation would not be able to redeem (purchase) the stock owned by the father. If the father could make an installment sale of his stock to his children and report his gain under the installment method, the father would be able to have sufficient funds to live on and pay tax on the gain as payments are received. The children could utilize salary and possibly some dividends which a bank might allow to be paid to pay the father for the stock purchased. Obviously the installment sale would be no different than redemption transaction which is specifically exempted from the provisions of Senate Bill 1063 but, because the redemption technique is not available, installment reporting of gain is not allowed. Again the effect of Senate Bill 1063 would be to force the father to sell his corporation to a large corporation or wealthy investors rather than to his children.

It is submitted that Congress does not intend to force the sale of farms and family businesses to wealthy investors or large corporations rather than to members of a family provided the integrity of the revenue is protected.

SOLUTION TO THE PROBLEM

Since the real problem which is intended to be solved by Senate Bill 1063 is the prevention of deferral of income where all of the economic benefits from the ownership of the property have been realized by the family group, the solution to the problem is quite simple. Rather than providing for the complete disallowance of reporting gain on the installment method when there is a sale transaction between related parties as set forth in Senate Bill 1063, all that is necessary is to provide that, in the event the related party purchaser disposes of the property purchased, any portion of the gain not reported by the seller prior to the disposition of the property by the related party becomes reportable by the seller in the taxable year in which disposition by the related party occurs. Such a provision would eliminate deferral of gain where there is an installment sale of property to a related part followed shortly thereafter by a subsequent sale by the related party purchaser since the subsequent sale would require the immediate reporting of any gain not previously reported by the original seller. Thus, in the two examples described above, if the son were to sell the farm or if the children were to sell the stock purchased from the father, any gain not previously included in income by the father would be included in income and thus subject to tax in the year the farm or stock were resold.

SPECIFIC STATUTORY AMENDMENT

The heading to subsection 453(b)(3) would be revised to read as follows: DISPOSITION TO RELATED PERSONS.

Subsection (A) would then be revised to read as follows:

(A) IN GENERAL.—In the event there is a disposition directly or indirectly to a related person and following such disposition such related person makes a disposition of the property purchased, the entire unpaid balance of the purchase price of such property shall be deemed to have been received from the related person by the seller in the taxable year in which the disposition by such related person occurs.

I would be happy to testify concerning the modification recommended.

Very truly yours,

ROBERT J. PALEY.

TOUCHE ROSS & CO.,
Washington, D.C., June 21, 1979.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Committee on Finance, Washington, D.C.

DEAR SENATOR BYRD: On behalf of Touche Ross & Co., a major international public accounting firm, I would like to submit our comments for your subcommittee's consideration at its June 22 hearings on S. 1063, a bill to simplify the taxation of installment sales. We are most pleased that Senators Long and Dole have introduced this bill on the Senate side, since the artificiality of some of the installment sale rules has, indeed, proven to be a trap for the unwary (as Senator Long pointed out in his remarks on introducing the bill). We support the present provisions of S. 1063.

We would, however, urge the inclusion of one additional change in the installment sale rules applicable to dealers, as the subcommittee considers the Long-Dole proposals. Our suggested change goes most strongly to the issue of simplification of installment reporting, and would remove what is today either another trap for the unwary or a requirement for rather sophisticated and costly avoidance of a rather 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 not to be taxed twice on the same income. The tax attributable to an amount included 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 supplied)

However, the relief granted in section 453(c) will almost always be incomplete. Based upon the Senate Finance Committee language above, we believe the lack of complete relief is due more to legislative drafting problems than to a deliberate policy decision by Congress. In effect, section 453(c), and the regulations thereunder, provides that the relief granted by the subsection is the lesser of the tax attributable to the gross profit on the installment 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, that taxpayer has been selling on installments, but does not elect the installment method until 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-percent 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=$9.25

The 1980 tax relief is limited, therefore, to $5.75, whereas the actual double tax is $23.

We would urge the inclusion, in S. 1063, 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, 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 obtain complete relief today, taxpayers wishing to change from accrual to installment accounting for their installment sales may 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, only sales made in those subsequent years will be subject to the installment method election, and no double taxation will occur.

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 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 equity 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 property 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 S. 1063 is aimed at simplifying the installment sale tax rules, it would be most appropriate to add language which will permit complete rather than partial relief from double taxation for those wishing to change from the accrual to the installment method. One 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, albeit the relief would be granted at taxpayers' highest brackets. An alternative approach, which would cut across tax brackets, would be to reduce actual tax by the fraction represented by gross profit over taxable income. Either approach would be preferable to the present rule.

We appreciate the opportunity to prevent these comments to you, and hope they will receive your favorable consideration.

Sincerely,

GERALD W. PADWE,
Associate National Director—Tax Services.

WINDELS, MARX, DAVIES & IVES,
New York, N.Y., June 19, 1979.

Hon. HARRY F. BYRD, Jr.,
Chairman, Subcommittee on Taxation and Debt Management, Senate Finance Committee, Washington, D.C.

DEAR SENATOR BYRD: I am writing in connection with your announcement of hearings on June 22 to deal with proposal of the American Bar Association to consolidate and simplify the present Code Provisions concerning the attribution of stock ownership. I regret that because of a long-planned business trip I cannot testify before your committee, but I submit this letter for inclusion in the record.

I am the chairman of a subcommittee dealing with uniform attribution rules of the New York State Bar Association Committee on Reorganizations. While I draw upon my committee experience in these comments, I want to emphasize that the views expressed are strictly my own and not those of the subcommittee or of the New York State Bar Association.

Uniform attribution rules are an important part of our Internal Revenue Code and have an impact on may kinds of transactions. Yet at the same time they are highly technical and have never received the attention which they deserve from our Congress, presumably because there were other matters which were regarded as a higher priority. In the past, there have been two extensive projects dealing with the attribution rules, one instituted by the American Law Institute, and the other by the American Bar Association. In addition, there have been a significant number of articles in professional journals over the years discussing the attribution rules and recommending changes.

When the Treasury Department suggested to the New York State Bar Association that it provide assistance with respect to developing uniform attribution rules, both the state bar and I responded with enthusiasm. However, when I discovered that there were two prior projects devoted to this subject, I felt it appropriate that our subcommittee suspend its efforts until we received some generally policy guidance from the Treasury Department and an indication of the areas of agreement of disagreement with the prior suggested revisions. That guidance was requested more than a year ago and our subcommittee is still awaiting a response. Our subcommittee will be delighted to work with your staff, the Treasury Department or with both in an effort to produce a set of uniform attribution rules. But before work begins, some policy guidance should be given by your committee and by Treasury Department.

In considering what the general policy should be in this area, there are three general propositions which I believe should be adopted as guidelines:

(1) It is my view that what the attribution rules say is less important than having rules which are uniform and relatively easily understood.

The Internal Revenue Code is a difficult body of law which to work. Nonetheless, any specific, narrow attribution question can be answered by consulting the statute. However, when clients are seeking general advice of preliminary guidance with respect to various ways in which a particular problem can be approached, the present difference in attribution rules makes giving that kind of advice extremely difficult. It can be said that attribution rules will never be so simple that one can keep them all in one's mind, yet if they were uniform one would at least have some faint of achieving that objective. In short, attribution rules should be uniform in all sections where attribution rules are required and this principle should not be varied unless there is an extremely strong showing in the case of a particular section that an alteration is essential.

(2) Attribution rules should be relatively simple.

Obviously the rules should not be so simple that a good deal of improper tax avoidance is possible. Yet on the other hand they should not be extremely complex in an effort to prevent consummation of some unique transaction.

(3) All attribution rules should have de minimis standards.

The present rules cause a great deal of difficulty in practice in cases where there is no substantial reason why they should be applied. For example, I am presently concerned with a case where a family dispute was to be settled by a redemption of stock. This redemption cannot take place because of a remote contingent interest of an infant in a trust owning stock in the corporation. The infant is technically a beneficiary, although her chances of ever receiving a benefit from the trust are one in ten million because of the existence of prior takers and powers to appoint, yet she is deemed to own stock in the company which is attributed from her to her parents and grandparents. Similar remote contingent interests can be disclaimed by adult members to make a redemption possible, but an infant is unable to waive. Because of the attribution rules a perfectly legitimate transaction is stymied.

The ABA proposed attribution rules seem generally satisfactory upon the application of the three tests set forth above.

There is also a question of how best to deal with the possibility that a close study of the proposed ABA rules could suggest to your committee, the Treasury or the public that changes in these proposals are desirable. Of course, your committee can resolve these questions. However, if your committee feels that is is unable to devote the necessary resources to deciding whether to adopt the American Bar Association recommendations in toto, or what changes are to be needed, there is another approach, used elsewhere in the Code, which seems promising. This approach would be to adopt guidelines and authorize the Treasury Department, by regulation, to develop uniform attribution rules. This would provide a mechanism whereby the Treasury could develop rules subject to public comment through the regulations process. These regulations by statute could be required to be consistent with the general pattern previously established by Congress, but many of the peripheral questions which necessarily are presented by these rules could be resolved outside the normally hectic atmosphere of the legislative forum. Since attribution rules are extremely technical matters, concern in detail only to technicians, the establishment of general policies and the delegation of the details to the technicians might well be the way to achieve reform, which I believe is desirable in this area.

I hope that the Committee will take some action with respect to this matter so that its hearings do not merely become one more abandoned monument to the efforts of many to improve and simplify this particular part of the Internal Revenue Code.

Very truly yours,

JOHN Y. TAGGART.

Prepared Statement of Allen Greenberg

I applaud the introduction of S. 1063 as the first step in an effort to clarify and simplify the tax law.

Simplification of the substantive rules for installment reporting of gain should be accompanied by simplification of wording. Attached is an example of what can be done to express the same substantive rules set forth in Sec. 1 of S. 1063 in simpler style and language.

S. 1063: Section 1. Simplification of Installment Sales Rules

Sec. 453:

(b) Disposition of Realty and Casual Disposition of Personal Property.—

(1) General Rule.—Income from—

(A) a disposition of real property, or

(B) a casual disposition of personal property for a price exceeding $3,000, may (under regulations prescribed by the Secretary) be returned on the installment method.

(2) Special rules for application of subsection.—This subsection shall not apply

(i) to property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or

(ii) to a disposition directly or indirectly to a related person, other than any redemption to which section 302(a) (relating to distributions in redemption of stock) or 303(a) (relating to distributions in redemption of stock to pay death taxes) applies.

(3) Definitions.—For purposes of this subsection—

(A) Installment Method Defined.—The term "installment method" means a method in which the income for any taxable year from a disposition is that proportion of the payments actually received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

(B) Related Person Defined.—The term "related person" means a person bearing a relationship to the person disposing of the property which is set forth in section 267(b) or 707(b)(1).

(C) Purchaser Evidences of Indebtedness Payable on Demand or Readily Tradable.—The term "receipt of payment" shall include receipt of a bond or other evidence of indebtedness which—

(i) is payable on demand, or

(ii) is issued by a corporation or a government or political subdivision thereof and is readily tradable.

(D) Readily Tradable Defined.—The term "readily tradable" means a bond or other evidence of indebtedness which is issued—

(i) with interest coupons attached or in registered form (other than one in registered form which the taxpayer establishes will not be readily tradable in an established securities market), or

(ii) in any other form designed to render such bond or other evidence of indebtedness readily tradable in an established securities market.

Chicago, Ill., *June 14, 1979.*

Re Senate Bill 1063.

Mr. Michael Stern,
Staff Director, Committee on Finance,
Washington, D.C.

Dear Mr. Stern: As a tax practitioner, I would eagerly encourage simplification of the Internal Revenue Code and avoidance of tax traps for the unsophisticated taxpayer. It would appear that the purpose for denying installment method of reporting under Section 453 to sales between related persons was not simplification, but rather to remove a tax technique which is considered an abuse. The tax technique, of course, is a sale of an appreciated asset on an installment basis to a friendly trust which in turn sells the asset purchased at no gain. It is not necessary to deny installment method of reporting to all sales between related taxpayers in order to remove this abusive tax technique. The tax technique could be eliminated by requiring either a new good economic reason and/or an absence of tax avoidance test or recognizing a disposition of the installment obligation if the installment vendee sells the asset purchased within a prescribed time.

It is a hardship to pay tax on a sale when the taxpayer has not received the proceeds of sale in a form to pay the taxes. There are many installment sales between related taxpayers that have a legitimate purpose such as sales of personal residence, a family farm, or a family business between members of a family when outside financing is not feasible. I wonder if you can imagine how many existing shareholder buy-sell agreements the proposed Bill would affect which serve a good purpose and should not be considered abusive. Unadvised family installment sales could conceivably become a tax trap of a type which Senate Bills 1062 and 1063 attempt to avoid.

Very truly yours,

JOHN W. BOWDEN.

WRITTEN TESTIMONY OF ELMER DEAN MARTIN III REGARDING PENDING TAX LEGISLATION

Description of legislation: S. 1063 introduced May 2, 1979 which includes provisions to amend and simplify Internal Revenue Code § 453(b) regarding the installment reporting of income from sales of realty and casual sales of personalty. The House counterpart is H.R. 3899.

STATEMENT

In response to Chairman Harry Byrd's indication that the Subcommittee will not limit testimony to the specific provisions of S. 1063 but will also hear testimony as to the broader questions of treatment of deferred payment sales, contingent payments and the distinction between open and closed transactions, I wish to submit for the Subcommittee's consideration the advisability of an amendment to Internal Revenue Code § 453 to allow installment sale treatment for contingent payments received by the seller of personal property in casual sales or real property.

It is not unusual for the buyer of a business to offer to pay the seller an additional sales price or "earn-out" incentive contingent on achievement of specified earnings or sales amounts after the sale and payable after the specified performance level is attained. The contingency of such "earn-out" in payments renders the total sales price unascertainable at the time of the sale. The United States Court of Appeals for the Ninth Judicial Circuit has construed § 453 to require a sales price ascertainable at the time of sale. Accordingly, § 453 as construed does not allow a seller of a business to report on the installment sales basis either the "earn-out" incentive or any other payments received in payment of the purchase price of a business he sells, even though the purchase payments not contingent on future performance are ascertainable at the time of sale. The failure of § 453 to allow installment sale reporting in such transactions artificially restricts business growth, disallows use of incentive performance standards in sales of businesses and prevents the attainment of a legitimate business objective which would necessarily be accompanied by desirable formation of capital and creation of employment in our country.

Recently I was involved in the negotiations between a corporation which desired to buy outstanding shares of capital stock of another corporation. After protracted negotiations, the sale was called off because the sellers could not defer the reporting of their gain as they received it in cash under the provisions of § 453. I represented the selling shareholders. The buyer offered to pay a minimum payment of $8,500,000 in installments of principal and interest over a period of six years. The buyer was willing to make an additional payment of $2,830,000 if the average net income of the business for the five-year period after the sale increased from $857,000 to $1,590,000.

The contingent payment of $2,830,000 represented an estimate of the value of the business to the buyer in excess of the minimum payment of $8,500,000. The buyer believed it could stimulate and expand the sellers' business to the extent of almost doubling the business' net earnings in five years. However, business practicality required that actual events confirm the buyer's belief in value before it paid the price in excess of the minimum payments totaling $8,500,000. Consequently the buyer insisted that the $2,830,000 additional payment be contingent on the attainment of the postsale average earnings to which I have referred.

The sellers had a low cost basis for the shares of stock which were the subject of the sales negotiations so that the reportable profit for practical purposes was whatever they would receive for the stock. I had to advise the sellers that they could not report the payments as income as they received them, but rather must report the value of their sale contract on the date of the sale as capital gain and the excess of the minimum payment of $8,500,000 over such value as ordinary income in the year of the sale. I informed them that the manner in which the contingent "earn-out" must be reported would depend on whether on the date of sale the sale would be deemed to be open or closed and that there was precedent for considering the contingent payment to be capital gain when received, but that the propriety of characterization of the contingent payment as capital gain was not certain. Consequently, the negotiations for sale were abandoned, solely because of the uncertainty of the tax consequences of the sale to the sellers.

My advice to the sellers was based primarily on two decisions of the United States Court of Appeals for the Ninth Judicial Circuit, *Steen* v. *United States*, 509 F.2d 1398 (1975) and *Warren Jones Company* v. *Commissioner*, 523 F.2d 788 (1975), on remand, 68 T.C. 837 (1977). These cases read together hold that a contingency of part of the sales price prevents the seller from reporting any part of the sales price on the installment basis under § 453 and also prevents the seller from first recovering his cost basis out of the payments and then reporting payments as capital gain when received in circumstances such as I have described. The court's decision in *Tombari* v. *Commissioner*, 299 F.2d 889 (9th Cir. 1962) and Revenue Ruling 76-109, 1976-1 C.B. 125, also contribute to this conclusion. *Gralapp* v. *United States*, 458 F.2d 1158 (10th Cir. 1972) also held that an unascertainable sales price would disallow use of § 453, but the sellers in that decision were allowed to recover their cost before reporting any gain and deferral of recognition until receipt was accordingly allowed.

I submit that § 453 should be amended to allow sellers of realty and casual sellers of personalty to defer the reporting of gain in sales in which the purchase price is paid in the form of a minimum payable in installment payments together with a future payment contingent on future events. The definition of "payment" in § 453(b)(2) and (3) should continue to be limited as presently interpreted to disallow deferral to the extent a seller receives cash or equivalent other than "evidences of indebtedness of the purchaser" as interpreted under present law. Such amendment would conform the tax laws to the practical requirements of business operations and tend to stimulate the economy and increase government tax revenues indirectly. It would also achieve the equity intended by the rationale underlying § 453 which is that the reporting of income should be deferred until the ability to pay the tax on the income is realized from the sale by the taxpayer because a mere change in form of investment should not cause recognition of income and also eliminate a very real trap for the unwary similar to the 30 percent downpayment trap which S. 1063 specifically is intended to rectify.

The form of amendment could be to allow open transaction treatment for the sale I have described and allow the sellers to recover their cost basis, thereafter reporting all payments as gain. Whether this form is adopted will depend on what other aspects of problems involving open transactions the Subcommittee wishes to consider. This could require the amendment of Internal Revenue Code sections other than § 453.

The amendment could also be to allow a seller to use the sales price to the extent it can be ascertained at the time of sale in the computation of the contract price and the gross profit percentage applicable to each payment received and to report any contingent payment when received as entirely gain. This would require a new definition of "contract price" and "gross profit" in § 453 and the amendment could be isolated to § 453(b) involving sales of realty and casual sales of personal property. This would prevent the double disability of taxation before receipt and transmutation of capital gain into ordinary income which can occur under § 453 as presently constituted while leaving undisturbed present law under § 453(a) applicable to dealers in personal property.

Conceivably a seller's basis could exceed a minimum price payable in installments so that § 453 with the suggested amendment would not apply. In such circumstances the transaction would probably be construed to be a closed transaction under the suggested amendments, an immediate loss could be claimed and a gain would be recognized when the contingent payment was received. The committee may wish to amend I.R.C. § 1001 to provide for the deferral of loss in such circumstances to prevent abusive practices and disputes over the propriety of an allocation of value between a minimum sales price and the contingent payout.

I appreciate the Subcommitte's consideration of the very practical problem I have described, and I will be pleased to comment with particularity on specific statutory language if the Subcommittee wishes to address the problem.

WEIBEL & HENDRICK, INC.,
Fort Collins, Colo., June 4, 1979.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance,
Washinton, D.C.

DEAR COMMITTEE MEMBERS: I understand that there has been legislation proposed in your committee to eliminate the availability of installment sale reporting among related parties. This legislation if passed seems to me to be an unwarranted burden on the general taxpayer. Related taxpayers frequently transact sales between themselves in the normal course of their trade or business, but these transactions are nearly always arms-length dealings. To flatly eliminate the availability of those positions to related parties is unduly strict.

I would prefer to see the retention of the bargain sales rules to protect the Treasury from improper sales reporting. Please submit these remarks as written testimony in your hearings on changes for installment reporting rules.

Sincerely,

RICHARD L. EVERSOLE.

MAYER, BROWN & PLATT,
Chicago, Ill., July 20, 1979.

Mr. MICHAEL STERN,
Staff Director,
Committee on Finance, Washington, D.C.

DEAR MR. STERN: I would like to comment on the proposals contained in the Treasury Department's Statement of June 21, 1979 before the Senate Committee on Finance Subcommittee on Taxation and Debt Management with respect to sales for deferred payment.

The Treasury Department should be commended for its proposals which would greatly simplify the law. The enactment of the proposals should sharply reduce controversies between taxpayers and the Internal Revenue Service and also should reduce the inordinate waste of judicial time and talent expended on resolving the tax consequences of common-place sales for deferred payment.

The elimination of the 30 percent test for payments in the year of sale, and the extension of installment reporting to contingent payments, would be major improvements in the law. The extension of installment reporting to certain obligations received in section 337 liquidations should relieve some of the pressure which impelled shareholders to make pre-distribution installment sales to related parties of stock in a liquidating corporation.

The elimination of the requirement for two or more installment payments, and the proposed uniform treatment of collection gains, will dispense with irrational distinctions.

The Treasury's proposal with respect to installment sales to related parties is more narrowly structured than other proposals advanced to meet the perceived abuse. Closer examination may reveal the need for more fine-tuning. For example, the Treasury Statement (at page 12) indicates that a subsequent sale by the related buyer "within two years of the original sale will result in the acceleration of gain recognition on the installment obligations held by the seller equal in amount to the consideration received in the second sale *(or amount of charitable contribution deduction taken if the subsequent disposition is a contribution to a charitable organization).*" (italic supplied) A subsequent charitable contribution does not seem to be an abuse, but rather a non-tax oriented transfer indicating lack of tax planning by the related parties. With proper timing, the original seller could have obtained the charitable contribution deduction without ever recognizing gain on the appreciation in value. Once the original seller has sold the property on the installment method, the gain ultimately must be recognized. The related buyer obtains no tax benefit from the stepped-up basis of the property which he contributes to charity, and no cash equivalents are received by the related group from outsiders to fund the promise to pay the original seller. All in all, it seems to be a case of poor tax planning in which the Treasury obtains a windfall.

The Treasury understandably objects to the use of the "cost recovery" method for sales which are treated as "open" transactions (i.e. where the obligation of the buyer to make deferred payments is viewed as not having a "fair market value" for purposes of section 1001(b) of the Internal Revenue Code) and the seller elects out of installment reporting. Frequently this inability to ascertain "fair market value" is due to the contingent nature of the payments. Since the Treasury proposal would make such transactions eligible for installment reporting (and a consequent ratable recovery of basis) it seems fair to require ratable recovery of basis for all sales which are "open" transactions due to the inability to ascertain a fair market value for the buyer's obligations. The alternative of allowing the taxpayer who "elects out" of installment treatment to recover his entire basis at the front-end may be too one-sided. Of course, the details of the particular rules for ratably recovery of basis are subject to a range of reasonable difference in judgment as to what is fair to both the taxpayer and the Treasury.

One aspect of the proposed ratable recovery of basis rules seems clearly deficient. It seems complicated and confusing to apply a new form of ratable recovery of basis to a "closed" transaction (i.e. where the obligation of the buyer to make deferred payments has an ascertainable "fair market value" for purposes of section 1001(b)) when the taxpayer elects not to report on the installment method. Since the sale is "closed", there seems to be no reason to require the taxpayer to disregard any portion of his cost basis in computing gain or loss in the year of sale. Such a requirement would artificially inflate gains, and reduce losses, in the year of sale as compared with the amount which has been traditionally recognized as the correct amount of gain (or loss) since the inception of the modern income tax law.

The problem may be illustrated by the example on pages 6 and 7 of the Treasury Statement. A sells real property with a basis of $5,000 to B for $10,000, of which $1,000 is a cash down payment and $9,000 is the principal amount of interest-bearing notes due in equal installments of $3,000 during the following three years. The notes have a fair market value of $6,000 at the time of sale. A affirmatively elects not to report on the installment method.

Under existing law, A would recognize a gain in the year of sale of $2,000 ($7,000 "amount realized" consisting of $1,000 cash and the $6,000 value of the notes minus $5,000 cost basis).

Under the Treasury proposal, A would recognize a gain of $3,500 in the year of sale because A could use only $3,500 of his $5,000 cost basis in the year of sale. A would be required to disregard $1,500 of his cost basis because the "amount realized" in the year of sale ($7,000) represents only 70 percent of the total selling price of $10,000, and 70 percent of the cost basis of $5,000 is $3,500. The unallocated cost basis of $1,500 would be added to the $6,000 cost basis of the notes and would be recovered in the following three years.

The reason for the above artificial gain of $1,500 in the year of sale seems difficult to comprehend. The Treasury Statement does not set forth the rationale for this computation.

It is not clear whether the proposed ratable recovery rule is intended to apply in the case of a sale at a loss where the seller elects not to use installment reporting. Assume for example that A sells property, having a cost basis of $5,000, in exchange for interest bearing deferred payment notes in the principal amount of $6,000 which have a demonstrable fair market value of $4,000 at the time of sale. Under traditional concepts, A would recognize a loss of $1,000 in the year of sale (unless he elected installment reporting[1]). If the proposed ratable recovery of basis rule is applied, A can use only 66⅔ percent (or $3,333) of his $5,000 cost basis in the year of sale, and A has a gain of $667 at that time.

It should be noted that in both the gain and loss case, the amount of the sellers "true" gain and "true" loss (computed under traditional concepts) would in fact be determined before one could apply the ratable recovery of basis rules to inflate the gain or deflate the loss. In both the gain and loss example set forth above, the fair market value of the buyer's obligation has to be determined, and then compared with the total selling price to determine the percentage of cost basis which could be applied against the "amount realized" in the year of sale. The whole process simply adds a strange new second step to a "closed" sale transaction and produces an artificially inflated gain, or deflated loss, as compared with traditional concepts.

The proposed form of ratable recovery of basis for closed transactions (not reported on the installment method) would not reduce controversies over valuation because, by hypothesis, we are discussing closed transactions where the buyer's obligation can be valued and must be valued.

The fact that it is very difficult to ascertain, under existing judicial standards, when a transaction may be viewed as "open" or "closed" does not support "ratable" recovery of basis in a closed transaction.[2] Regardless of the difficulties in determining when a sale may be viewed as "open", if a taxpayer elects not to use installment sale reporting he could not gain an advantage by demonstrating that the buyer's obligations did not have a fair market value or was not a cash equivalent. In such event, he would not have any gain until payments were received, but in computing gain the ratable recovery of basis rules would apply.

If the seller can demonstrate that the obligations do have a fair market value, it seems unnecessary to compute gain or loss under a new second-step process which produces a result that is foreign to most individuals' conception of gain and loss.

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[1] Installment reporting would be available, even though the amount realized is less than cost basis, because the "income" which may be reported on the installment basis is computed by reference to "selling price." Reg. § 1.453-1(b)(1)

[2] Whether a transaction is "open" or "closed" may be based not only on a standard of an ascertainable "fair market value" but on additional standards relating to "cash equivalency" for a cash basis taxpayer. Although the Ninth Circuit indicated that the "cash equivalency" test is not applicable under the existing statutory standard, *Warren Jones Company* v. *Commissioner*, 542 F.2d 788 (9th Cir. 1975), this issue is still unsettled. See John McShain, 71 T.C. No. 89 (1979)

The Joint Report On Simplication Of Installment Reporting (submitted by committees of the American Bar Association, Association of the Bar of the City of New York and the New York State Bar Association) supports the new type of ratable reporting for "closed transactions." The Joint Report, at page 45 and 46, gives an example of a closed transaction involving a sale of stock with a basis of $100,000 in exchange for a secured, negotiable note in the face amount of $1 million which is valued at $800,000. The seller has a large capital loss carryforward that is about to expire, and elects out of installment reporting. Under existing law, the seller's gain in the year of sale is $700,000 ($800,000 amount realized less $100,000 basis). The Joint Report states:

"In the new ratable recovery of basis world, S will allocate $80,000 (80 percent) of its total $100,000 stock basis to the $800,000 year of sale receipt. S' year of sale capital gain thus will be $720,000 against which S will offset its expiring loss carryforward."

Unfortunately, the Joint Report does not set forth any rationale for this curious result. Since the cost basis of $100,000 is known, the "amount realized" of $800,000 is ascertained, and the "true" gain of $700,000 is determined, what is the reason for adding a complicating second step to the computation which enables the taxpayer to compute an additional "gain" of $20,000 to offset expiring losses?

It is submitted that, absent some persuasive reason for applying ratable recovery to transactions which are entirely closed (and which are not reported on the installment method) ratable recovery should be limited to "open" transactions or to transactions which are partly closed and partly open.

A partly open sale is exemplified by the facts of In re *Steen* v. *United States*, 509 F.2d 1398 (9th Cir. 1975) where 94 percent of the total maximum payments was represented by cash and deferred payments which could be readily valued, and 6 percent by a highly contingent deferred payment. The contingent payment rendered the seller's election of installment reporting invalid, and he was required to recognize gain in the year of sale on the value of the definite deferred payments. The seller ultimately did receive about one-half of the maximum contingent payment.

Ratable recovery seems appropriate for a sale which is partly closed and partly open, at least where the maximum amount of the contingent payment is substantial compared with the principal amount of the payments which have an ascertainable fair market value.

Perhaps one theory underlying the proposed application of a ratable recovery rule to a completely closed transaction is that taxpayers who wish to accelerate an artificial gain into the year of sale might do so by contracting for tail-end contingency payments which have little probability of occuring. It would seem preferable to meet this problem by a de minimis rule which would treat the transaction as fully closed (with application of full cost basis) where that portion of the obligation of the buyer which does not have an ascertainable value is reasonably expected to produce receipts of less than a specified percentage (e.g. 20 percent) of the definite payments which can be valued. The rule for prorating certain capitalized costs under section 280 is based upon "the income the taxpayer may reasonably be expected to receive" from a property. This concept of "excepted receipts" would seem to be easier for administrative application than a "fair market value" standard.

Since the general thrust of the ratable recovery of cost method is to defer the utilization of cost basis, this will consequently increase the probability of losses (particularly capital losses) in later years if the anticipated receipts do not materialize. In view of the restrictions on the use of capital losses under section 1211, consideration should be given to the devleopment of a rule which would treat such tail-end losses (resulting from failure to offset cost basis against earlier receipts under the contract) in a manner similar to deductions under section 1341 with respect to a restoration of a substantial amount held under claim of right. This would reduce the tax for the later year by the amount of decrease in tax for the immediately preceding prior years which would result from the utilization of the unrecovered cost basis in such prior years against receipts under the contract. The statutory mechanics for such a rule would appear to be relatively simple in view of the precedent of section 1341. Such a rule would be a natural complement to a repeal of the cost recovery method for open transactions, and should substantially allay objections based upon unuseable tail-end losses.

Very truly yours,

FRANCIS A. LAVELLE.

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COLUMBIA, S.C., *July 17, 1979.*

Hon. STROM THURMOND,
U.S. Senate,
Washington, D.C.

DEAR SENATOR THURMOND: I first want to thank you for sending me the copy of the general explanation of the Revenue Act of 1978, as well as a copy of S 1062 and S 1063. Your office has always been very prompt in sending me the informations which I requested and I sincerly appreciate your help in this regard.

I just want to be on record as heartily endorsing the changes to the installment sales rules which are contained in S 1063. Elimination of the less than thirty (30) percent of the selling price requirement under Section 453 will be a well received change in our tax laws. It would benefit anyone who intends to sell property on the installment basis.

I also heartily recommend each of the changes contained in S 1062. Those with which I am familiar appear to be very timely changes which will greatly simplify report and disclosure for tax purposes. The change of time for filing the fourth quarter gift tax return would be a welcome change in and of itself.

I encourage you to do all that is within your power to see that these bills are passed.

Yours sincerely,

ALBERT C. TODD III.

NATIONAL CATTLEMEN'S ASSOCIATION
P.O. Box 569 • 1001 Lincoln Street • Denver, Colorado 80201 • 303-861-1904

August 3, 1979

Honorable Russell B. Long, Chairman
Committee on Finance
United States Senate
Washington, D. C. 20510

Dear Senator Long:

Enclosed for your information is a copy of the testimony on H.R. 3899 presented by the National Cattlemen's Association to the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means.

As you know, the purpose of H.R. 3899 is to simplify the installment sale rules; but, in so doing, the bill would deny installment sale treatment with respect to all sales between spouses, brothers and sisters, parents and children or grandchildren, and other related parties as defined.

Such a denial would work a particular hardship on farmers and ranchers. The installment sale (land contracts, etc.) is commonly used in the orderly transfer of family farm and ranch property from father to son, and to other family members, especially when said property is heavily mortgaged. In the latter case, which is a common circumstance for farm and ranch property, the installment sale is the only feasible transfer vehicle since it is virtually impossible to borrow money from a lending institution using heavily mortgaged land and other assets as collateral.

Please note that the NCA does support certain other provisions of the pending legislation under consideration.

You are aware that H.R. 3899 is identical to S. 1063, the bill you introduced in the Senate, which has been referred to the Committee on Finance.

Sincerely,

B. H. (Bill) Jones
Vice President
Policy Development

Enclosure

cc: Members of the Committee on Finance

Michael Stern, Staff Director

Bernard M. Shapiro, Chief of Staff
Joint Committee on Taxation

Serving The Nation's Beef Cattle Industry

BEST COPY AVAILABLE

STATEMENT

of the

NATIONAL CATTLEMEN'S ASSOCIATION

Presented by

Thomas A. Davis, Attorney
Davis & McLeod
Washington, DC

SUMMARY

The National Cattlemen's Association is opposed to the provision in H.R. 3899 which denies installment sale treatment for sales between related parties, including spouses, brothers and sisters, parents and children or grandchildren, and other parties as defined in the bill.

If a legislative solution is needed to deal with unintended benefits where property acquired in an installment sale from a related party is resold outright to a third party, it should address the resale, not the original sale, by accelerating the taxable gain to the original seller unless the resale is due to an involuntary conversion. However, the Subcommittee should take into consideration that any equitable legislative solution to the abuse situation will necessarily add complexity to the Code.

NCA endorses the provisions in H.R. 3899 which amend the installment sale provision by (1) eliminating the requirement that no more than 30% of the selling price can be received in the year of sale, and (2) eliminating the requirement that there be payments in at least two different tax years.

NCA commends the members of the Subcommittee and the full Committee for their efforts to simplify the Tax Code.

STATEMENT OF THE NATIONAL CATTLEMEN'S ASSOCIATION

TO THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
REGARDING
SIMPLIFICATION OF THE INSTALLMENT SALE RULES
H.R. 3899
July 27, 1979

Mr. Chairman, my name is Thomas A. Davis and I am appearing before you today as Washington tax counsel for the National Cattlemen's Association. 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. The NCA represents approximately 280,000 professional cattlemen throughout the country. Membership includes individual members as well as 51 affiliated state cattle associations and 13 affiliated national breed organizations.

The National Cattlemen's Association is strongly opposed to the provision in H.R. 3899 which denies installment sale treatment with respect to all sales between spouses, brothers and sisters, parents and children or grandchildren, and other related parties as defined in the bill.

Our reason for opposing the limitation on installment sale treatment for sales between related parties is quite simple. Installment sales and the tax treatment accorded such sales under Section 453 of the Code are commonly used by ranchers and other farmers as the only practical and feasible means of transferring all or part of a ranch or farm to children or other members of the family so that the family member or members can then operate that business. To deny ranchers and other farmers the benefit of reporting the taxable gain on the sale of a ranch or farm to a son, daughter or other member of the family over the period the payments are received would make it impossible in many situations for the parents to sell all or part of their cattle business to one or more of their children or for families to divide up a cattle business between various members of the family. Quite often, particularly in today's economic setting, a ranch must be heavily mortgaged in order to obtain the necessary operating capital. When this is the case, it is almost impossible for a son or other member of the family to borrow money from a lending institution by using the land and other business assets as collateral. Consequently, the only feasible way to sell a cattle ranch to a son or other family member is to do it through an installment sale which allows the purchaser to pay for the business out of the future profits.

In short, the denial of installment sale treatment for sales between family members and other related parties would further exacerbate the already difficult problem of preserving the family farm.

We do share the concern of Mr. Ullman, Mr. Conable and other members of the House Ways and Means Committee about abuse situations in which there is a sale between related parties followed soon thereafter by a prearranged or other sale to a third party. This obviously can result in substantial tax benefits since the related parties may have the effective use of the entire sale proceeds and yet pay the tax liability over many years, However, if a change in the law is necessary to deal with the abuse situation, the change should address the resale rather than the initial sale between the related parties. The Treasury Department, the Tax Section of the American Bar Association, and other organizations have testified or will testify that a broad denial of installment sale treatment for sales between related parties is not the solution to the problem. Instead, they recommend certain restrictions on the resale of the property.

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One suggested approach is to accelerate the taxable gain for the original seller to the extent the related party who purchased the property resells it within two years from the date of the original sale. This is an acceptable approach, provided there is some safeguard against acceleration of the taxable gain to the original seller if the property is resold because of an involuntary conversion such as death, fire, condemnation, drought, bankruptcy or some other similar event. If the Subcommittee decides to deal with the resale of property sold under an installment sale to a related party, NCA would be pleased to work with the Subcommittee and the Subcommittee staff to develop an acceptable provision which would eliminate the abuse situation available under existing law but, at the same time, which would preserve installment sale treatment for sales between family members. However, it should be emphasized that any legislative solution to the resale problem will necessarily add complexity to the installment sale provision -- the opposite result of your simplification objective.

Briefly, I would also like to make several comments about other aspects of the installment sale provision:

1. NCA endorses the provision in H.R. 3899 which eliminates the requirement in the present law that the amount of payments in the year of sale cannot exceed 30% of the selling price. There appears to be little or no reason for imposing this arbitrary limitation on the amount of the payments in the year of sale. This limitation tends to make the tax consequences, rather than the economics, dictate the structure of the transaction. In fact, eliminating the 30% rule may accelerate revenues to the government since it will allow sellers to take larger down payments without losing the benefits of the installment sale provision.

2. NCA endorses the provision in H.R. 3899 which eliminates the requirement that a sale must involve two or more payments to qualify

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for installment sale reporting. This will allow the income from the sale of property which is sold on the basis of a lump sum in a year subsequent to the year of sale to be reported when the payment is received.

In closing, Mr. Chairman, the National Cattlemen's Association would also like to commend you and this Subcommittee for your interest in and your efforts toward simplification of the tax laws. We realize that many problems are involved in trying to make the Tax Code understandable to the average American citizen, and less complex for the small businessman, yet at the same time not denying a long-standing tax benefit to a segment or even to all of the taxpayers. Nonetheless, we urge you to pursue your simplification goals. In this regard, the National Cattlemen's Association will do everything possible to assist you in your efforts and will restrain from objecting to simplification changes unless significantly detrimental to our industry.

Thank you very much for allowing me this opportunity to present the National Cattlemen's Association's views.

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