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# REVENUE PROVISIONS IN PRESIDENT'S FISCAL YEAR 1999 BUDGET

## HEARING

BEFORE THE

## COMMITTEE ON WAYS AND MEANS
## HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTH CONGRESS

SECOND SESSION

FEBRUARY 25, 1998

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# REVENUE PROVISIONS IN PRESIDENT'S FISCAL YEAR 1999 BUDGET

**WEDNESDAY, FEBRUARY 25, 1998**

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
*Washington, DC.*

The Committee met, pursuant to notice, at 1:03 p.m., in room 1100, Longworth House Office Building, Hon. Bill Archer (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

# *ADVISORY*

## FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE CONTACT: (202) 225–1721
February 18, 1998
No. FC–11

# Archer Announces Hearing on the Revenue Provisions in President's Fiscal Year 1999 Budget

Congressman Bill Archer (R–TX), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing on the revenue provisions in President Clinton's fiscal year 1999 budget proposals that are under the jurisdiction of the Committee. The hearing will take place on Wednesday, February 25, 1998, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 1:00 p.m.

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from Treasury Department witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

**BACKGROUND:**

On February 2nd, President Clinton submitted his fiscal year 1999 budget to the Congress. This budget submission contains numerous revenue provisions not included in the Administration's budget proposals in previous years. The hearing will give the Committee the opportunity to consider these revenue initiatives more carefully.

In announcing the hearings, Chairman Archer stated: "This hearing is an opportunity for the Administration to be an advocate for the revenue proposals in its budget. Given the public reaction to the numerous tax increase proposals in the budget, including proposals which have been rejected previously and new proposals increasing the tax burden on savings and investment, the Administration has a very heavy burden to carry."

**FOCUS OF THE HEARING:**

The Committee expects to receive testimony on the President's revenue proposals from the Secretary of the Treasury or his designee, who also will be asked to discuss general spending trends, and revenue and deficit projections, including economic trends forecasted by the Administration.

**DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:**

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) single-space legal-size copies of their statement, along with an IBM compatible 3.5-inch diskette in ASCII DOS Text or WordPerfect 5.1 format only, with their name, address, and hearing date noted on a label, by the close of business, Wednesday, March 11, 1998, to A.L. Singleton, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 300 additional copies for this purpose to the

Committee office, room 1102 Longworth House Office Building, at least one hour before the hearing begins.

**FORMATTING REQUIREMENTS:**

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments. At the same time written statements are submitted to the Committee, witnesses are now requested to submit their statements on an IBM compatible 3.5-inch diskette in ASCII DOS Text or WordPerfect 5.1 format. Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at 'HTTP://WWW.HOUSE.GOV/WAYS__MEANS/'.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

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Chairman ARCHER [presiding]. The Committee will come to order.

Our hearing this afternoon has been called to examine the revenue provisions in the President's budget.

I thank my colleagues in both parties for the comments, letters, and thoughts that you have shared with me concerning the administration's plan. And if I hear you right, the administration's tax hikes have met massive bipartisan opposition. And the reason is simple: The vast majority of these proposals are not what we would call loophole closures; instead they are proposing a series of tax hikes on women, widows, and middle-income Americans who save—savers—the very place where I believe we should not be attacking our system.

Taxes would be hiked on millions of airline passengers, small businesses that create jobs and manufactures that export, which

we desperately need more of. Rather than increasing the taxation on companies that export, we should be talking about how we reduce the taxation so that our corporations are not double taxed and can compete with foreign corporations that determine how successful they're going to be in creating jobs and in sales of American products.

I've closed abusive loopholes over the last 3 years—since becoming Chairman of this Committee—and I'll continue to close them again. But when it comes to protecting taxpayers, I have fought tax hikes before and it looks like it is time to fight them again. Taxes are at the highest level in our Nation's peacetime history as a percent of GDP, gross domestic product, and yet President Clinton's budget raises them even higher.

According to an analysis released yesterday by the Joint Committee on Taxation, the President's budget includes 43 separate tax hikes that raise a total of $38.9 billion over 5 years. The budget also calls for $65 billion from an undefined increase in tobacco revenues. The 10-year tax hike in this budget is $236.8 billion.

[The analysis is being held in the Committee files.]

Thirteen of these provisions are reruns that got bad bipartisan ratings the first time they were sent up. Given the administration's failure to win support for these proposals in the past, I question why the White House is trying them again. When I announced the Committee agenda, I said if the administration makes the same tax hiking mistakes it made in previous budgets, those hikes will be dead before arriving. To protect the taxpayers, let me be clear—and I could not say it more clearly—these tax hikes remain dead.

As for the rest of the tax hikes, Mr. Rangel and I have received a letter from virtually every Committee Member urging our opposition to the proposals that increase taxes on people who save and invest in life insurance and annuities. At a time when our Nation should increase incentives to save, I must question why the administration is raising these taxes.

The budget calls for a $6 billion increase in airline taxes. Last year's budget agreement provided a long-term, stable resolution to this thorny issue, yet the administration now wants to reopen it and to collect more money from the traveling public. This provision is an old-fashioned tax hike on millions of traveling Americans, and I oppose it.

On the other side of the ledger, the budget contains a mind-boggling series of provisions that add further complexity to the Code. If you think the tax forms are complicated now, just wait until the IRS gets deeper into your private life so you can qualify for many of these new proposals.

Targeted tax cuts are a code phrase for let's make the Tax Code more complex. Now, I have participated myself in putting provisions in the Code that added to the complexity of the Code in order to give taxpayers relief from too high a tax burden. But I would hope that this year we will concentrate on reducing complexities, on simplification, and make every effort not to further complicate the Code no matter how desirable some of these provisions may appear.

And the last thing we need to do is turn the IRS into another Department of Energy. Didn't we learn in the seventies when this

Committee passed innumerable tax credits on the basis of "oh, well we've got an energy crisis," only to find that we had to dismantle all of them in the succeeding years because we were attempting to micromanage the market system. And here we go again with the President's proposals in this budget: More complex effort to micromanage by energy credits of a variety of kinds.

One of the reasons that I want to change the holding period on capital gains from 18 months to 12 months is to simplify the Code. I've just recently looked at schedule D—the new schedule D—for 1997, and I defy the average citizen to work through that form. By reducing the 18-month holding period to 12 months so that it is uniform, will greatly simplify that form.

The President's new complicated loopholes, as they are called, are a step in the wrong direction and they will be hard to support. It appears to me that the administration's budget is beginning to unravel. Unless President Clinton can convince Congress to raise taxes on the American people, his budget will be out of balance. Having worked so hard to get the budget into balance, we must not return to the failed policies of the past. I intend to protect the taxpayer; and so I urge President Clinton to abandon his unacceptable tax hikes as well his $123 billion in new government spending. What we should be doing is working harder to reduce wasteful, inappropriate, and unnecessary Federal spending. Hard-working taxpayers should not be stuck with the bill for the return of big government.

[The opening statement follows:]

**Opening Statement of Hon. Bill Archer, a Representative in Congress from the State of Texas**

Good Afternoon.

Today's hearing has been called to examine the revenue provisions in the President's budget.

I want to thank my colleagues in both parties for the comments, letters, and thoughts you have shared with me concerning the Administration's plan. If I hear you right, the Administration's tax hikes have met massive bi-partisan opposition.

The reason is simple. The vast majority of these proposals aren't loophole closers. Instead, the President has proposed a series of tax hikes on women, widows and middle-income Americans who save; millions of airline passengers; small businesses that create jobs; and manufacturers that export.

I've closed abusive loopholes before and I'll close them again. But when it comes to protecting taxpayers, I've fought tax hikes before and it looks like it's time to fight them again. Taxes are at the highest level in our nation's peacetime history, yet President Clinton's budget raises them even higher.

According to an analysis released yesterday by the Joint Committee on Taxation, the President's budget includes 43 separate tax hikes that raise a total of $38.9 billion over five years. The budget also calls for $65 billion from an undefined increase in tobacco revenues. The ten year tax hike in this budget is $236.8 billion.

Thirteen of these provisions are reruns that got bad bipartisan ratings the first time. Given the Administration's failure to win support for these proposals in the past, I question why the White House is trying again. When I announced the Committee agenda, I said if the Administration makes the same tax hiking mistakes it made in previous budgets, those hikes will be dead before arrival. To protect the taxpayers, let me be clear. These tax hikes *remain* dead.

As for the rest of the tax hikes, Mr. Rangel and I have received a letter from virtually every Committee member urging our opposition to the proposals that increase taxes on people who save and invest in life insurance and annuities. At a time when our nation should increase incentives to save, I question why the Administration is raising these taxes.

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sion is an old-fashioned tax hike on millions of traveling Americans and I oppose it.

On the other side of the ledger, the budget contains a mind boggling series of provisions that add further complexity to the code. If you think the tax forms are complicated now, just wait until the IRS gets deeper into your private life so you can qualify for many of these new proposals. The last thing we should do is turn the IRS into another Department of Energy.

Last year's tax law made the code complicated enough. This year, our efforts should focus on simplifying the code. That's why I want to modify the new capital gains law that's driving sixteen million taxpayers crazy as they struggle to fill out their tax returns. But the President's new, complicated loopholes are a step in the wrong direction and they'll be hard to support.

It appears to me that the Administration's budget is beginning to unravel. Unless President Clinton can convince Congress to raise taxes on the American people, his budget will be out of balance.

Having worked so hard to get the budget into balance, we must not return to the failed policies of the past. I intend to protect the taxpayers and so I urge President Clinton to abandon his unacceptable tax hikes as well as his $123 billion in new government spending. Hard working taxpayers shouldn't be stuck with the bill for the return of big government.

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Chairman ARCHER. And now, I'm happy to recognize Mr. Rangel for any statement that he might like to make.

Mr. RANGEL. Mr. Chairman, let me join with you in congratulating the administration for the great job that they have done in the last several years in improving the economy. Federal Reserve Chairman Greenspan believes a large part of that improvement was due to the 1993 Budget Act. But I think we can get beyond that and recognize this is not a Democratic victory, but a victory for all of the people of our country. Indeed, the way things look it may be a victory for the whole world. We're going through a fantastic economic expansion. Interest rates, inflation, and unemployment are down and there's a general feeling of prosperity—or at least the hope that all Americans will be able to enjoy the benefits of this economic expansion.

The President now has come forward with some ideas that, I gather from the Chairman's remarks, about which you have some reservations. In view of the fact that the President has been so successful in reducing the deficit and providing us an opportunity to dedicate the surplus to the improvement of the Social Security system—and in my opinion, attempting to provide health care for those people who find themselves unable to afford it and to reduce class size. It would seem to me that, notwithstanding the reservations that people may have about some of these programs, we have to have some assurances that the President's proposals will have a hearing. I want to thank you for allowing this process to begin today.

I know your primary concern is sunsetting the Code and the IRS and pulling it up by the roots and replacing it with a postcard, simple, flat tax system. But it doesn't look like we'll be able to do that anytime soon—at least not before the election.

Between now and the time that we go back home to run for reelection, the leadership has not provided us with many working days. This means we will have limited time to review the program that the Republican leadership has—and that's an assumption on my part, that there is a program—but even a more limited time to

review the recommendations made by the President. So, I don't want to take time out today just lauding you for having this meeting, but I'm taking this time because, based on the scheduling process, I have no idea as to when we will be meeting again, whether this month or next.

In any event, I want to thank the administration for its patience, but do hope at some point in time that the President would insist that if his recommendations are not passed, that at least they be considered and debated. Knowing that fairness and the equity the Chair has demonstrated in the past, there's no question in my mind that, for those issues that come within the jurisdiction of this Committee, we should have a time for debate, to legislate, and to dispose of—one way or the other—the President's recommendations.

Thank you, Mr. Chairman.

Chairman ARCHER. We're pleased to have with us today representing the administration and standing in for Secretary Rubin his chief right-hand-man, the Deputy Secretary of the Treasury, Larry Summers.

We're happy to have you with us today to give your presentation of the President's revenue portions of the budget proposal. We will be delighted to receive your testimony, and you may proceed.

**STATEMENT OF HON. LAWRENCE H. SUMMERS, DEPUTY SECRETARY, U.S. DEPARTMENT OF THE TREASURY**

Mr. SUMMERS. Thank you very much, Mr. Chairman. And I am very glad to have the opportunity to appear before this Committee and speak about the President's budget.

I have a longer statement which I will submit, with your permission, for the record.

Chairman ARCHER. Without objection, your entire written statement will be inserted in the record.

Mr. SUMMERS. I want to make three primary points here this afternoon, Mr. Chairman. First, the American economy is in far better shape today than it was 5 years ago because of our progress in deficit reduction. We are enjoying an economy today with 4.7 percent unemployment; the creation of 14 million jobs; a higher share of equipment investment than at any time since the statistics began to be calculated; real wages starting to rise for the first time in 20 years; inflation at lower levels than we have seen in many, many years. That is something that I think most economists would agree reflects many factors. But probably no single factor is as important as the profound progress that we have made in deficit reduction since 1993 that brought the budget deficit down to $21 billion last year and puts us on the verge of substantial budget surpluses.

As a consequence of the fiscal actions that the President entered into in 1993, of course with Congressional support, the budget deficit reductions will free up nearly $1 trillion that otherwise would have been invested in government bonds, in productive equipment, in productive new structures—homes, factories—for Americans. In our judgment, preserving this fiscal triumph is priority No. 1.

Second, the best way to preserve and build on the progress we have made is to put Social Security first, as the President has sug-

gested. It's the best way, in fiscal terms, because it helps best to prepare us for the challenge of an aging society. It is the best way in national economic terms because it provides for the increased national savings that we need if we are to meet the challenge of an aging society. And it is the best way in national social terms given the importance of the basic benefits that Social Security provides. Nearly half of Americans over the age of 65 would be in poverty without Social Security. Now, at a time of very strong economic performance, when we face a major economic challenge, that is a time to save. And the best way to save is to preserve the surpluses until we have resolved the challenges facing the Social Security system.

Third, a strategy of Social Security first does not preclude the important new initiatives to address important national goals. What is crucial, however, is that any such initiatives be fully paid for and paid for within the budget. That is the approach that is reflected in the President's budget. The President's budget provides moderate tax cuts that are fully paid for and new spending in areas that are crucial to increasing future productivity and to protecting America's key national interests.

Let me just highlight a few of the measures contained within the President's budget.

Increased funding for education—the one national economic strategy that both increases productivity and increases equality—including an additional $5 billion to support school construction and modernization projects, subsidies to recruit and train more teachers.

Far-reaching measures to make child care more affordable, including a $5 billion expansion of the child and dependent care credit that will grant 3 million taxpayers an average annual tax cut of $330. Helping parents with child care is not only good for families, it's good for the economy because it helps all to participate in the workplace to the full extent of their abilities and wishes.

Measures to promote growth in our inner cities and other economically distressed areas by increasing the low-income tax credit and increasing funding for community development banks. Democratizing the access to capital is a national issue. Our economy will never achieve its full potential until we equip the people of these areas to enter the economic mainstream.

Crucial new steps to protect the environment with $3.6 billion and nine tax incentives to promote energy efficiency and improve the environment. Tax incentives not directed at encouraging the purchase of goods that are ordinarily on the market, but encouraging leapfrog technologies such as the major innovations we've seen in fuel-efficient vehicles.

Mr. Chairman, a beneficial byproduct of our policy to reduce youth smoking through comprehensive tobacco legislation is that it will raise revenues for public needs. Our budget proposes to share these revenues among three uses. First, we'll return to the States roughly the amount of revenues that they would have received under the original settlement. A large part of this money will be unrestricted; States can use it for whatever purposes they choose. The rest of the money will go to States for State-administered programs to provide child care subsidies, reduce class size, and expand

coverage of children by public health insurance. Second, we are providing funding for a dramatic expansion of health-related research in America through our research fund. Finally, we divide the remaining dollars into other uses including cessation programs and farm support programs to deal with the adjustments associated with tobacco legislation.

The budget does contain, because of our commitment to maintaining fiscal discipline and paying in full for any new initiatives, $23 billion in revenue raising measures—$11.1 billion have been proposed in prior budgets. These items include: The repeal of the sales source rule; the repeal of the lower of cost or market inventory method; and repeal of the percentage depletion for nonfuel minerals mined on Federal lands; and the reinstatement of the oil spill excise tax.

The budget also provides $11.9 billion from new measures to eliminate unintended subsidies and other revenue raising provisions. These include: Several new insurance provisions which raise approximately $4.6 billion in revenues; three provisions restricting unintended consequences of the current REIT, real estate investment trust, rules, which raise approximately $135 million; and eliminating several unwarranted subsidies relating to estate and gift taxes, including a provision to stop nonbusiness valuation discounts, which raises approximately $1 billion.

Mr. Chairman, these revenue-raising proposals will no doubt be the subject of debate. But we look forward to working with the Congress in the process of identifying unwarranted subsidies where it is necessary to raise revenue in order to ensure that we maintain the fiscal discipline that has been so important. What is crucial is that any new expenditure or reduction in tax burdens be fully paid for. We have finally put our Nation's fiscal house in order. It is an enormous achievement we must protect, and it is an enormous opportunity to seize. As the old saying goes: You fix your roof while the sun is shining. And that is the approach that the President's budget takes.

Thank you very much.

[The prepared statement follows:]

**Statement of Hon. Lawrence H. Summers, Deputy Secretary, U.S. Department of the Treasury**

Mr. Chairman and members of this committee, it is a pleasure to speak with you today about the President's FY 1999 budget. This is an historic moment: The President is proposing a balanced budget for the upcoming fiscal year, the first since 1969. The budget is rooted in fiscal discipline, yet invests in areas critical to future productivity and the American people. Perhaps most importantly, this budget provides a clear answer to the question of how to use the projected budget surpluses. The President proposes that surpluses be reserved pending reform of the Social Security system.

This budget carries forward the President's successful economic strategy. As the President said last month during the State of the Union, from the beginning of this Administration we have "pursued a new strategy for prosperity: fiscal discipline to cut interest rates and spur growth; investments in education and skills, in science and technology and transportation to prepare our people for the new economy; new markets for American products and workers."

Before I discuss the specifics of this budget, I think it is important to review the progress we have made in getting our fiscal house in order.

When President Clinton entered office in 1993, the federal debt had quadrupled from 1980 to 1992 and the 1992 deficit was $290 billion, an all time high. These huge deficits kept interest rates high, diminished confidence, lowered investment and stifled growth. Budgets were based on economic assumptions that were far too

optimistic. When these assumptions failed to materialize, the result was higher deficits than forecast, and cynicism about the budget process.

In 1993, President Clinton fought for, and Congress approved, a powerful deficit reduction plan that was based on conservative economic assumptions and which brought the deficit down by $500 billion over five years. The deficit reduction increased confidence, helped bring interest rates down, and that, in turn, helped generate and sustain the economic recovery, which, in turn, reduced the deficit further. The result was a healthy, mutually reinforcing interaction of deficit reduction policy and consequent economic growth, that brought the deficit down to $22.3 billion in 1997, and sets the stage for going to balance.

Today, unemployment is 4.7 percent; it has been under 6 percent for the last three years. Over the last five years, the economy has generated over 14 million new jobs, inflation and interest rates are low and real wages are rising, although too many Americans are still not participating fully in the economic well-being that most are sharing. Last year's bipartisan deficit reduction package has further improved our fiscal picture, even while increasing investments and cutting taxes for the middle class.

Moreover, for a median income family of four, the federal income and payroll tax burden will be lower in 1998 than at any time in the last 20 years. And for a family of four earning half the median income, in part because of the expansion of the Earned Income Tax Credit for 15 million families, the federal income and payroll tax burden is lower than at any time in the last 30 years. Families' tax burden will fall further next year when the child credit enacted last year is fully phased in.

Mr. Chairman, the efforts over the past five years have paid off: the current projection anticipates surpluses well into the next century, although long-term budget forecasts inherently involve a great deal of uncertainty. How we use these surpluses is a critically important issue in the years ahead, and a key focus of the President's budget.

The overarching point of the President's economic strategy going forward and his 1999 budget is clear: under no circumstances can we take any steps that will undo the fiscal discipline we have worked so hard to achieve. The last few years clearly demonstrate the economic benefits of a strong fiscal position and the global financial markets that have emerged in recent years greatly heighten its importance. The global capital markets impose swift and strict penalties on countries with unsound policies as we have seen in recent months in Asia and confer great benefits on countries with sound policies.

The surpluses present an enormous opportunity, one that so many have worked hard to achieve, and one that we must not squander. Because this nation has a major challenge ahead: the challenge of moving from a younger society to an older one.

A time of surplus, a time when a major change is coming, is not a time to spend. It is a time to save. And the best way to save for our future is to save Social Security. That is why we believe the surpluses should be reserved until Social Security is placed on a sound financial footing for the 21st century.

This is the right policy for our nation. It is the right policy from the standpoint of the economy, which needs to save more in order to invest and grow fast enough to shoulder the burdens of the next century. It is the right policy from the standpoint of our long-term fiscal health, which will otherwise be placed under growing strain by the costs associated with aging. And it is the right policy from the standpoint of individuals, who need to make plans to ensure their long-term security in retirement, and a substantial proportion of whom will inevitably rely on Social Security. That is why the President believes very firmly that nothing should be done with the surpluses until Social Security reform is addressed.

Of course, as we go forward there will be a need for new measures to equip our nation for the challenges ahead and to compete successfully in this new global economy. The President's commitment to preserving the surpluses does not preclude undertaking these kinds of initiatives—including cutting taxes and increasing spending. But what is critical is that all those initiatives are paid for in full.

We propose moderate targeted tax cuts that are fully paid for and propose new spending in areas that are critical to increasing future productivity and to protecting and promoting America's global economic and national security interests. Today I would like to focus on just a few significant measures that reflect those priorities.

First, to enhance productivity and maintain our country's competitive position in the years ahead, the Administration proposes:

• increased funding for education, including an additional $5 billion to support school construction and modernization projects, subsidies to recruit and train more teachers.

• far-reaching measures to make child care more affordable including a $5.1 billion expansion of the child and dependent care tax credit that will grant 3 million taxpayers an average annual tax cut of $330; a new employer credit to promote employee child care and expand its availability; and new spending for child-care subsidies for children from poor families. Helping parents with child care is not only good for families, it is also good for the economy, because it helps all to participate in the workforce to the full extent of their abilities and wishes,

• measures to promote growth in our inner cities and other economically distressed areas, by increasing the low-income housing tax credit and increasing funding for community development banks. This is a national economic issue: Our economy will never achieve its full potential until we equip the people of these areas to enter the economic mainstream.

Second, our budget proposes major new steps to protect the environment, with $3.6 billion in nine tax incentives to promote energy efficiency and improve the environment. These include: tax credits of up to $4,000 for purchasers of highly fuel-efficient vehicles and up to $2,000 for buying rooftop solar equipment; new credits for buying energy-efficient homes and certain energy-efficient building equipment; and a range of new incentives to clean up environmentally contaminated sites.

Mr Chairman, a beneficial byproduct of our policy to reduce youth smoking by increasing the prices of tobacco products is that we will raise revenues for the government. Our budget proposes to share these revenues among three sources. First, we will return to the states roughly the amount of revenues that they would have received under the original tobacco settlement. A large part of this money will be unrestricted; states can use it for whatever purposes they choose. The rest of the money will go to states for state-administered programs to provide child care subsidies, reduce class size, and expand coverage of children by public health insurance. Second, we are providing funding for a dramatic expansion of health-related research in America through our Research Fund. Finally, we divide the remaining dollars into other uses including cessation programs, farm support programs, etc.

Of the $23 billion in revenue-raising measures we propose, $11.1 billion have been proposed in prior budgets. These items include the repeal of the sales source rule ($6.6 billion); the repeal of the lower-of-cost-or market inventory method ($1.6 billion); repeal of the percentage depletion for non-fuel minerals mined on Federal lands ($500 million); and the reinstatement of the oil spill excise tax ($1.2 billion). The budget also raises approximately $11.9 billion from new measures to eliminate unintended subsidies and other revenue-raising provisions. These include several new insurance provisions, which raise approximately $4.6 billion in revenue; three provisions restricting unintended consequences of the current real estate investment trust (REIT) rules, which raise approximately $135 million; and eliminating several unwarranted subsidies relating to estate and gift taxes, including a proposal to stop non-business valuation discounts, which raises approximately $1 billion.

Mr. Chairman, these revenue-raising proposals will no doubt be the subject of debate. What is crucial is that any new expenditure or reductions in tax burdens be paid for. Let me repeat: all of the initiatives in the President's budget are fully paid for. This budget is in full accordance with the Budget Enforcement Act. It does not exceed the discretionary caps.

We have finally put our nation's fiscal house in order. That is an enormous achievement we must protect. And it is an enormous opportunity we must seize. We face significant challenges in fostering a strong economy and maintaining fiscal responsibility in the years and decades ahead, particularly with the coming retirement of the baby boom. So, as the old saying goes, you fix your roof when the sun is shining.

Mr. Chairman, the President's budget carries forward the President's economic strategy that has been so central to the strong economic conditions of the past five years. This budget preserves the surpluses until we strengthen Social Security, invests in areas that are critical to the future of this country, provides for programs that protect and promote our critical economic and national security interests in the global economy, and, of absolutely critical importance, it keeps us on the path of fiscal discipline that is so crucial to our economic well-being. I look forward to working with all of you in the days and weeks ahead to approve this budget. Thank you very much.

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Chairman ARCHER. Thank you, Secretary Summers. I'll try to keep my inquiry brief and permit adequate time for all the Members. Do you have a time constraint today? How long?

Mr. SUMMERS. I've got plenty of time, Mr. Chairman.

Chairman ARCHER. OK, great. You mentioned——

Mr. SUMMERS. I may develop one depending on how the questioning goes here, but at this point I have plenty of time.

Chairman ARCHER [continuing]. You mentioned the reduction in borrowing at the Federal level, which I applaud. Of course, we're continuing to increase borrowing, but we're reducing the rate that otherwise would have occurred had we not taken action against the deficit. Is that fair?

Mr. SUMMERS. Well, starting this year, if as expected the surplus materializes, we would actually be in a situation where the Federal Government as a whole would not be involved in net borrowing from the public and the stock of outstanding debt held by the public would start to decline.

Chairman ARCHER. You specifically refer to debt held by the public. As we see, the Social Security Trust Fund continues to lend money to the Treasury, money that is not coming from the public—unless you consider that the payroll taxes paid by the public into the trust fund is drawn out of the public sector. But the debt service charges are continuing to increase because the overall debt is continuing to increase. And the debt ceiling is going to have to be raised again as proof of that. I don't want to get into an economic debate with you about whether the public holds it or the trust funds hold it, because I understand the differences there. But the point that I want to make, without belaboring that, is that whereas we have reached the point—and it's been a cooperative effort, as you mentioned, between the Congress and the President to get to this point—to where we've got a balanced budget, that as the Federal Government's rate of increase of borrowing has gone down, thereby leaving more money in the private sector, we've also witnessed a major decline in personal savings in this country that has offset that. And I wonder if that disturbs you? I think we're at a virtual historic low in personal savings, and certainly, of all the industrial countries in the world, I believe we're right at the bottom.

Mr. SUMMERS. Mr. Chairman, as you know, going back a long time to the time that I was involved in academic work, I've been very concerned about the problem of savings in the United States. I think we can all take some satisfaction from the fact that the net national savings rate of our country—adding together personal savings, corporate savings, and government savings—which was approximately 3.1 percent in 1992, has increased to 6.5 percent—more than doubled—by 1997, largely, as a consequence of the reduction in government budget deficits. Unfortunately, that savings rate is still substantially lower than our country enjoyed during the high-growth fifties and sixties, and is still low by international standards. But I think in the last few years, after a period of 12 years when we saw declining national savings rates, we have at last started to see the total savings in our country increase. And I think that's a very important thing on which we can build.

Chairman ARCHER. But, I think you share my concern that the personal savings rate needs to come up.

Mr. SUMMERS. I do.

Chairman ARCHER. Instead of going down. And that leads me to the question of why do you want to attack one of the best sources

of individual savings in this country which is the inside buildup in insurance policies where millions of Americans buy insurance and depend on ultimately being able to get a payback from that and the annuities. And yet, the proposals that you have made directly attack these areas which, once again, will erode personal savings in this country.

Mr. SUMMERS. Mr. Chairman, it is not our intent, and I believe it is not the content of our proposals, to attack inside buildup. There are a number of insurance proposals and they are somewhat technical in their nature. One of the proposals, without attacking the basic rule that defers tax on inside buildup, does provide for parallel treatment in the case of deferred annuities where investments in contracts or funds within contracts are realized and switched, parallel with other financial instruments. These are provisions that do not change the basic rule that defers tax on inside buildup, and affect financial instruments that are held by only a very, very small fraction of Americans.

There are also proposals which address not the taxes on beneficiaries, because inside buildup is indeed very important for savings, but affects certain taxes on insurance companies that are associated with reserving practices that go beyond what is associated, according to generally accepted accounting principles, with the measurement of economic income. And there are provisions which affect the corporate-owned life insurance case which is primarily a financial devise that is used by corporations.

But, I would be—I am very much committed to the objective of increasing savings. And we were very pleased to work with you last year on the expansion of IRA provisions and other forms of tax-deferred saving. And I would be very troubled about anything that interfered in a substantial way with savings. But I don't believe that these provisions run that risk. The vast majority of the revenue in the insurance area comes from things that do not affect taxes on beneficiaries at all. And the one provision that does is a provision which does not change the basic rule that defers tax on inside buildup.

Chairman ARCHER. Well, the net effect of all of these provisions that raise taxes out of the insurance industry are going to directly attack savings, no matter how you describe it.

Now, let me get into another area very quickly, and then move on to other Members of the Committee. The Joint Tax Committee has now done an analysis of the recommendations of the administration, and they have concluded that there is a net tax increase of $80 billion over 5 years, and $174 billion over 10 years. Now, that is over and above whatever tax benefits that you have recommended in your proposal. And in your own budget documents, you cite that in 1997 Federal tax receipts were 19.9 percent of GDP, and if your administration proposal is enacted, they would go to 20.1 percent. Now, 19.9 percent is already a historic, peacetime high for this country. And 20.1 percent increases that to where there will only be 2 years in the history of this country where the Federal Government's take of GDP has been higher, and those were both in World War II.

Now, I want to ask you a couple of things after also referring you back to the President's comment that he made in my own home

city of Houston, Texas, where he agreed that he had raised taxes too much in the 1993 bill. Well now, considering all of that, do you now think that the Tax Relief Act of 1997 gave back too much in the way of taxes? And is that the reason why you are recommending an additional $174 billion net tax increase over the next 10 years? Do you believe that 19.9 percent is an appropriate percent of GDP for the Federal Government to take? Do you think that burden is too high on the American people? And if so, do you have any plans to bring the net tax burden down?

Mr. SUMMERS. Mr. Chairman, you've asked a number——

Chairman ARCHER. A lot of questions.

Mr. SUMMERS [continuing]. You've asked a number of questions. Let me, if I could, just make a few points in response. First, I very much support the 1997 tax bill, as the other tax bills that have passed in the last few years, as a result of which, I think, we can all take a great deal of satisfaction in the fact that the tax burden, adding in both income and payroll taxes on median-income Americans, is now lower than it has been in 20 years. And income tax burden on median-income Americans is now lower than it has been in 30 years. I think that's an important accomplishment in which we can all take pride.

Second, on the figures that you referred to, I think I have a slightly different perspective. There's a technical issue which is that the 19.9 percent figure is not actually a figure for tax collections, but includes all receipts, such as fines, and the profits from the Federal Reserve, and so forth. And if you look at the share of receipts that go to the Federal Government, the administration does indeed want to see it go down, and its budget provides for a measure that you used, which isn't quite the taxes, for it to go from 19.9 percent this year to 19.6 percent in 2003. Of course, there are fluctuations from year to year reflecting changes in profit shares and things of that kind, but our budget does provide for that to go down.

Third, on the question of tax increases, the issue, Mr. Chairman, is largely or entirely due to the treatment of possible tobacco revenues, which as you know, the administration regards as being part of the context of a settlement, and doesn't think should be viewed as a tax increase. And indeed, it has not been viewed as a tax increase so far in the context of those settlement discussions. And so if you take the tobacco out of it, ours is a budget that does not raise taxes. Ours is a projection that reduces the Federal share of GNP, gross national product, and ours is a budget that reduces tax burdens on middle-income families from their current level, which is lower relative to income than they have been in 20 years.

Chairman ARCHER. Well, let me if I may, and I didn't intend to do this, but since you brought up the cigarette tax, let me pursue that for just a moment. I'm fortunately one who has never smoked in my life. I despise cigarette smoke. I wish everybody in this country would stop smoking—we'd be a much better Nation. But, a tax on cigarettes is a tax. It's called a tax, and it is a tax. And for those people who do continue to smoke, though unwise to their own personal health, they will be paying that as a tax into the Federal Government, which means that they will have less money to spend on other items in the marketplace. So it is clearly a tax. And to

call it anything else, although you may be able to find that it's more popular than other taxes, is to ignore an economic basic reality that it is a tax. And it impacts on the economy in the same way other taxes would, except that it hits lower income people the hardest. It is one of the most regressive taxes that there is. And all of the data, whether done by the Treasury, or the Joint Committee on Taxation, shows that to be true. So it is a tax. And to say: Well, we can ignore that in determining what the net tax impact of this bill is, is just not accurate.

But I do appreciate your comments, and I yield to Mr. Rangel. In fact, I recognize Mr. Rangel.

Mr. RANGEL. And I recognize you too, Mr. Chairman. [Laughter.]

That compassionate display for the poor as it relates to cigarette tax, is really something that I was moved by. I just wanted to indicate that.

I know you have a lot of time, but, I hate to raise this, this election is kind of closing in on me, and I don't know how much time the President has. I have to agree with the Chairman that there are some rather provocative tax increases that you presented. They have brought a degree of bipartisanship, of opposition. But there are some pretty exciting social programs: Social Security, education, health care, child care, and the economic development of inner cities.

Now this is the President's program, and I just got a copy of the Majority Whip's program, which I share with the Chair, of course. As I look at this, Mr. Chairman, all the red dates are days we're not here. So, that's half of February we're not here. The President will be in Africa in March. We'll be here for about 5 or 6 days in April; half of May; most of June; half of July; a little bit in August; half of September; and then, Tom DeLay, the Majority Whip says that the target adjournment date is October 9. Now, I haven't added the days that we actually are going to be working, but has the President or his representative worked out some type of an agreement with the Majority so that the President's proposals, as well as the Majority's—for lack of a better word—legislative program, would be discussed? I mean is there any timeframe that you know of that you could share with us?

Mr. SUMMERS. Congressman Rangel, I'm not aware of agreed legislative timetable. I think we in the administration believe that the President's budget contains a variety of very important proposals that are very much in the national interests. Others, of course, will have a different view. And our hope is that the proposals will receive full and careful consideration by the Congress this year. But I don't have a particular set of timetables to share with this——

Mr. RANGEL. Well, let me say this: I'm certain that the Majority and the Chairman make certain that they're fair in reviewing the President's proposal. But suppose, just for the purpose of our discussion, they decided to do nothing with any of the President's proposals and just decided not to work this year at all. What happens then? I have no idea how this thing works, but since we don't see each other that often, what would the President say or do?

Mr. SUMMERS. I would think that all of us have an obligation to pass a budget so that the government——

Mr. RANGEL. Well let's talk about that——

Mr. SUMMERS [continuing]. So that the government can continue to function into the next year. I think that if we passed a status quo budget rather than advanced initiatives of the kind that are contained in the President's budget, we would be passing up important opportunities to invest in education, to invest in child care, to invest in basic medical research, and we would leave what I feel is a very serious problem: The million young people who begin smoking each year—nearly 300,000 of whom will die as a result of that smoking—we would leave that problem unaddressed.

Mr. RANGEL. OK, well, just on the question of the budget, I'm not certain, but don't we have a legal responsibility to have a budget passed by the 15th of April? Now, if that's so, and we are only scheduled to work in March, and we're out of here for April, I don't think we'll be able to do that. So I hope the President might share with us, Republican and Democrats, some timetable that you might just recommend so that when I work with my Republican friends we might be able to fold in some of the President's proposals in the few days that we intend to be in session this year.

Thank you, Mr. Chairman.

Chairman ARCHER. Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman. On the positive side, the budget did include a provision I've supported and that's funding for the Conservation Trust Fund for Puerto Rico. And I want to commend you for that and ask unanimous consent, Mr. Chairman, that a printed statement I have might be inserted in the record at this point.

Chairman ARCHER. Without objection. So ordered.

Mr. CRANE. I yield back the balance of my time. Thank you.

[The prepared statement follows:]

**Statement of Hon. Philip M. Crane, a Representative in Congress from the State of Illinois**

Mr. Chairman, The Conservation Trust Fund of Puerto Rico is an organization dedicated to the preservation of the natural resources of that magnificent island. For the past two years I have been seeking a solution to an impending financial crisis that would render the Trust Fund unable to perform its valuable mission. The termination of the so-called "Section 936" provision within the tax code ended the source of the Trust's funding. This year's FY99 Federal Budget adopts a proposal that I first put forward last year and incorporates it in the recovery of excise taxes back to the Commonwealth of Puerto Rico. By designating 50 cents to the Trust Fund out of the $13.50 excise tax collected on each gallon of distilled spirits exported from Puerto Rico, for a period of 5 years, the recommendation allows the Trust to complete its endowment fund and perform its work in perpetuity.

The Trust Fund was established in 1968 by a Memorandum of Understanding between the Secretary of the Interior, Steward L. Udall and the Governor of the Commonwealth of Puerto Rico, Roberto Sanchez Velella, and the Administrator of the Economic Development Administration of Puerto Rico, Sergio Camero, to protect the natural resources of the island. During the past 29 years the only significant efforts to preserve critical land resources have been conducted by the Conservation Trust Fund. Even with this active role, only 5% of the Island of Puerto Rico is under some protection either by federal or local conservation agencies or the Trust. This number is half of the percentage in the United States and less than 25% of Costa Rica. In the aftermath of Hurricane Hugo, when the island was devastated, it was the Conservation Trust Fund that led the reforestation effort of the rain forest. It was the Conservation Trust Fund that used this opportunity to prepare critical environmental areas for restoration and at the same time utilize them as an educational tool for the children and people of the island.

Mr. Chairman, funding for the Trust was initially provided through contributions imposed by the Department of Interior in the Oil Import Allocations of petroleum and petrochemical companies operating in the island. This lasted for a period of ten

years. Later the Trust became a participant in the QPSII program within Section 936 of the Internal Revenue Co realized that the changes being made in Section 936 would call for the gradual phase out of the program. The Trust embarked on an aggressive saving campaign. They cut back all capital expenditures, including land procurement and major improvements to existing properties. During that time the Trust has been able to accumulate approximately $30 million in the endowment fund. The goal was to reach somewhere near $80 million and this would have been accomplished had Section 936 phased out in the projected time period.

Two years ago this committee abruptly changed those plans. With the passage of the Small Business Job Protection Act we ended Section 936. The Conservation Trust Fund was the unintended victim of this action. Left without a source for 80 percent of its funds, the Trust has endeavored to work with my office to find a solution. My staff has discussed this problem with the committee staff on numerous occasions. The proposal in the FY99 Budget is a natural outgrowth of a proposal that I made last year. The support of the Secretary of the Interior has been critical in shepherding this through the budget maze. The Governor of Puerto Rico is in support of this proposal and I urge my colleagues on the Committee to support this effort to save the endeavors of the Conservation Trust Fund.

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Chairman ARCHER. Mr. Bunning.

Mr. BUNNING. Thank you, Mr. Chairman.

Mr. Summers, would you explain the administration's proposal for the treatment of the budget surplus in reform of the Social Security system.

Mr. SUMMERS. The President has simply said that in light of the very great importance of the Social Security issue to the future well-being of all Americans, that we should not violate current budget rules and spend the surplus on either new expenditure programs or tax cuts that are not fully paid for within the budget until we have reached a resolution with respect to the long-term future of the Social Security system. And he——

Mr. BUNNING. Does that mean—excuse me.

Mr. SUMMERS. And he has called for a process of national dialog, including a number of conferences and a number of other steps during 1998, to set the stage for the process of coming together on legislation that would begin in January 1999.

Mr. BUNNING. Does that mean the President is not proposing to take the OASDI reserves out of the budget? In other words, are we going to be able to recycle? As you well know, what happens now—I don't have to explain this to you, but some people out here might not understand—is when we bring in the FICA funds into the Treasury, we bring them into the Social Security Trust Funds, there are nonnegotiable bonds issued, and then we recycle the money out and spend it for other reasons, other purposes of the Federal Government. Would you think that we would not do that with the surplus, or that we would reissue bonds, and we would recycle the surplus and spend it for other purposes?

Mr. SUMMERS. There are a number of possibilities that can be described in a number of ways. At this point, what the President has said is that the unified surplus is not something we should eat into until and unless we have put the Social Security system on a long-run viable path.

Mr. BUNNING. Let me ask you then: Yesterday before the Senate Budget Committee, you suggested that the surpluses, up to $100 billion or more, be transferred to the OASDI fund and invested in Treasury bonds. That means that they could be recycled and spent

for other purposes then. In other words, under the budget, as it presently is constructed.

Mr. SUMMERS. Congressman Bunning, I didn't make any policy suggestion——

Mr. BUNNING. Am I misquoting you?

Mr. SUMMERS. A little bit, I think.

Mr. BUNNING. Oh, really?

Mr. SUMMERS. What I said yesterday was that there were a variety of possibilities and I had no recommendation. Then I observed, referring to one of those possibilities, that if $100 billion of money was credited to the Social Security Trust Fund and allowed to accumulate in the Social Security Trust Fund, that the result would be to push the expiration date of the Social Security Trust Fund out by 1 year only, only if we didn't recycle the money.

Mr. BUNNING. Because obviously, if we recycled the money, we'd be spending it and putting more liability into the trust fund. Was that what your suggestion was?

Mr. SUMMERS. There was no suggestion. The assumption was, and I think for the reasons you suggest it's completely right, that clearly if the trust fund took on an asset of $100 billion and took on an extra liability of $100 billion, nothing would be accomplished.

Mr. BUNNING. That's correct.

Mr. SUMMERS. And so, that line of thought—which again is one possibility, it is not a recommendation—would call for adding $100 billion to the surplus, in effect, transferring the money from the unified budget to the Social Security Trust Fund which would strengthen the Social Security Trust Fund and would, as a byproduct—because the money would then be allocated there—assure that the unified surplus would be maintained.

Mr. BUNNING. Only if we walled off the surplus and said: No further use of this money could be used for any other purpose than the Social Security Trust Fund and you couldn't issue new debt against that money.

Mr. SUMMERS. In a sense, Congressman, those who think about that proposal are regarding the transfer of the revenues to the Social Security Trust Fund as a way of accomplishing exactly the kind of walling off that you're speaking of.

Mr. BUNNING. One more question. What would the budget deficit be if the Social Security Trust Funds were not used to offset the budget deficit from now until the year 2008?

Mr. SUMMERS. It would be—the budget would be—certainly for the next half dozen years and probably a little bit beyond that, the budget would be in quite significant deficit but for the unified budget which reflects a unification of the trust funds. The trust funds are in surplus, the other parts of the budget are in deficit; together we will emerge with a surplus—that's the unified surplus—but the non-trust fund budget is, as your question suggests, in deficit.

Mr. BUNNING. Thank you very much.

Mr. CRANE [presiding]. Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman.

There's a lot of talk about simplification and not wanting to clutter up the Code, particularly by Chairman Archer. Will you help me with this because I don't understand it: To go on the capital

gains holding period from 18 months down to 12 months, which is what, I think, a number of Republicans want to do, does that do anything to decrease the rate from 28 percent? Does that change the number of lines on the tax form?

Mr. SUMMERS. I think at this point, Congressman Matsui, any change in the capital gains rules would be, on net, complicating of the Tax Code for two reasons. First, the IRS, which I think the Committee is aware, faces a number of very serious challenges, including the year 2000 problem, including a reorientation toward customer service, and would, I think, have a difficult time handling and managing the amendment to provisions that are only now being phased in. And so a transitional adjustment would be very complicating in that way.

Second, I think that the, to use the euphemism, I think the tax bill that we enacted last year reflected a carefully crafted and balanced set of compromises. And an effort to undo those compromises in one area will inevitably raise questions about many other areas.

Mr. MATSUI. Let me get to my main point. Obviously you support the change on the IRS and the restructuring effort. Is that correct?

Mr. SUMMERS. We very much support it.

Mr. MATSUI. You support it. And so, you're no longer concerned about the fact that we have an independent commission overseeing the IRS and the whole issue of confidentiality, and many of the issues that were raised a little earlier.

Mr. SUMMERS. I think we found——

Mr. MATSUI. But let me get to my main point, because I think what I want to do is address the issue of complexity. Last year we had an additional 824 amendments that were added to the Internal Revenue Code as a result of the tax bill, and we had 285 new sections. I've just counted the administration's proposal here; we have 75 new tax cuts—I don't know whether these are new sections or new amendments—and we also have 42 new tax increases, and 7 other provisions. So that's about 120 or so new provisions in the Code, coupled with the 285 and the 824. I know that Mr. Rossotti is trying to do a good job, and I do understand that you are trying to clean up the whole Internal Revenue Service. I commend you, Mr. Rubin, and obviously, Mr. Rossotti, and many of those who have preceded you.

But I guess what I'm troubled by is some of the hypocrisy here. We're trying to clean up the Code and I keep seeing amendments being offered. I had somebody do a little research—one of those LEXIS–NEXIS searches—and Members of this Committee, Members of the House, who were talking about simplifying the Code are offering all kinds of credits and deductions and preferences. And your proposal is just packed with more of these. You know, I think we have to come to terms, because we can't go out there and talk about tax reform and simplifying the Code, and at the same time, quietly, behind everyone's back, offer literally hundreds of changes in the Tax Code. I think we're being a little unfair to Mr. Rossotti. I think we're being unfair to the employees of the Internal Revenue Service, and certainly I think we're misleading people.

And so, you may want to have a comment on it; you may not want to have a comment on it. It's not totally your responsibility. I mean, I think a lot of Members of Congress last year played a

significant role in this particular effort. It was interesting, at least the 1981 bill had a philosophy: It wanted to promote economic growth. The 1986 bill had a philosophy of simplifying the Code. Last year's bill had no philosophy at all. It was just: Let's just put everybody's tax cuts together and make that a tax bill, and make everybody happy. But there was no growth, economic philosophy, or simplification philosophy to it. And I'm afraid that's what's going to happen again if you embark upon another tax bill and at the same time blame it on the IRS.

Mr. SUMMERS. Congressman Matsui, I think you raise a very, very important issue. We've tried to be very conscious of that as we tried to balance the various objectives here, and I think a substantial fraction—more than 40—of the initiatives and amendments that are contained in the President's budget that you referred to are Taxpayer Bill of Rights for simplification items that would have the net effect of reducing burdens on taxpayers and reducing compliance and striking out other forms of complexity.

But I do think in looking at the various kinds of incentives we provide through the Tax Code that we do need, if you like, to put a higher price on measures which complicate the Code and try to recognize that each thing we add adds to the weight of the whole system and that at a certain point the system might fall of its own weight. And I think that is an important concern.

Mr. CRANE. Mr. Summers, if you'll hang in there, I want to recess the Committee subject to the call of the Chair, because we're down to 5 minutes on this vote.

[Recess.]

Mr. SHAW [presiding]. There's going to be another vote shortly, so we're going to be disrupted again, but I was asked to start the hearing, so we won't unnecessarily delay the witnesses.

So Mr. English is recognized

Mr. ENGLISH. Thank you, Mr. Chairman.

Secretary Summers, I noted that the administration's proposal includes an exemption for severance pay from the income tax of up to $2,000 with a variety of restrictions—after 6 months, applying the severance packages below under $125,000. I have a couple of questions. One is you would apply this severance pay exemption specifically for separations from service that are connected with a reduction in employer's work force. How would you define that?

Mr. SUMMERS. It's a technical question, and I'm not a tax lawyer, but I would assume that the employers would qualify instances of severance based on a comparison of the total size of the work force in the tax year with the total size of their work force in the preceding year.

Mr. ENGLISH. Do you think this provision substantially adds to the complexity of the Tax Code? Do you think it's a provision that you would anticipate the administration would seek to expand down the road?

Mr. SUMMERS. I don't particularly see any plan for subsequent expansion, and I don't think it adds substantially to the complexity of the Code. I think it serves an important, very important function at a time of greater globalization in the economy, and at a time of greater change in helping people to adjust to change. I think in that way it allows market forces to operate more effectively.

Mr. ENGLISH. Mr. Secretary, I think I understand that part of the intent, and, again, I presume you're familiar with the provision. What I wanted to get a feel for—$2,000 seems to be a fairly arbitrary number and a very small part of any severance package. I guess, recognizing that there might be some benefits for this kind of a tax exclusion, I was wondering if the administration saw this as part of a long-term strategy. I am judging from your comments probably not. Do you have anything to add?

Mr. SUMMERS. This is not part of any long-run strategy of which I am aware to—it is, I think, you know, $2,000, not some of the severance packages you read about for executives in the newspaper, but I think for a lot of people who are laid off I think $2,000 and the tax deductibility on $2,000 makes a real difference.

Mr. ENGLISH. Thank you. Let me move on. Under the energy and environmental tax credits, have you done any studies in-house on the distributional effects of these proposals?

Mr. SUMMERS. We do not have distributional analyses of them, and to do the distributional analysis would be very complex. You think, for example, about, say, the incentive for purchasing very highly fuel-efficient cars. Part of the incidence might be on the buyers of those cars, but part of the incidence would be on the producers and the workers who are involved in making those cars. So I think to look at an incentive of that size and do a distributional analysis would be, our analysts report, very, very difficult.

Mr. ENGLISH. OK. I notice in your energy and environmental tax credit proposals you do not include an extension of the ethanol credit. What is the significance of that?

Mr. SUMMERS. I think the incentives in our energy and environmental credit are really all measures that are directed at market-based approaches to——

Mr. ENGLISH. And ethanol——

Mr. SUMMERS [continuing]. Supporting reductions in carbon usage, and the fuel from carbon. And so I think a subsidy——

Mr. ENGLISH. So you don't regard——

Mr. SUMMERS [continuing]. A subsidy to a fossil fuel, I mean, I think——

Mr. ENGLISH. You don't regard auto emissions as greenhouse gas then or——

Mr. SUMMERS [continuing]. Well, I think—certainly carbon dioxide, which comes from any fossil fuel, is a greenhouse gas, but the focus of our incentives is on greenhouse gas reductions.

Mr. ENGLISH. OK. And I guess a final question: One of the perennial provisions that comes out of the administration has to do with changing the deposit requirements for FUTA taxes from quarterly to monthly. This has been proposed before, and it's been fairly consistently shot down. Is there any policy reason why you would be continually proposing this, because it appears primarily to harass businesses, particularly small businesses, and does not appear, at least from my perspective, to generate any real positive effects from the standpoint of tax enforcement.

Mr. SUMMERS. Let me say, Congressman English, that the proposal is crafted to include an exclusion for small businesses in order to respond to the small business concern, and that the rationale is that it will improve compliance, and in that way make pos-

sible reductions in other taxes, and that it will more closely match the inflows of money into State funds with the outflows from State unemployment insurance funds.

If I might just return to your previous question, I'm told that the extension of the ethanol provisions is contained in the administration's ISTEA proposal, the highways proposal, but that the ethanol provisions do not expire this year. And so we are providing for that.

Mr. ENGLISH. OK.

Mr. SUMMERS. It's just not a global greenhouse gas.

Mr. ENGLISH. I understand the distinction, and I appreciate that. Thank you very much.

Mr. SUMMERS. Thank you.

Mr. ENGLISH. Thank you, Mr. Chairman.

Mr. SHAW. Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman, and, Mr. Secretary, I appreciate your taking time to be with us today.

I represent a pretty diverse district, the south side of Chicago and the south suburbs, both city suburbs and a lot of rural areas. I always listen for concerns and thoughts that are fairly consistent, whether you live in the city, the suburbs, or country. This past week I had a meeting with a group of women, entrepreneurs and community leaders, and we talked about the President's budget. Frankly, they liked what the President said about Social Security, but they then question why he would then use the surplus in the Social Security Trust Fund to offset new spending initiatives. They were concerned about, of course, the President proposing to raise the tax burden on Americans to its highest level since World War II, and they were also very concerned about the President's new proposal for a tax increase on a retirement vehicle that many of the women in the group that I met with were using.

I found it interesting. They shared some statistics, and when it comes to annuities which you propose taxing, a majority of these annuities that are sold today are held by women. Ninety percent of them are over 50 years of age, and two-thirds of the women who purchase these make less than $50,000. They're middle-class individuals.

What I was just trying—so I can better understand your tax increase on retirement, I was wondering, how much revenue is generated by your tax increase on retirement?

Mr. SUMMERS. The annuities provision that you're referring to I believe has a revenue impact of approximately $1 billion.

Mr. WELLER. A year?

Mr. SUMMERS. No, $1 billion over 5 years.

Mr. WELLER. So it's a $1 billion tax increase over 5 years on retirement. Money that would have gone toward retirement, that instead will come to Washington and be spent on the President's new spending initiatives?

Mr. SUMMERS. No, Congressman, I think the principal incidence will be on commissions received by those who sell a particular class of financial products, and in particular, those who encourage the churning of those products. Anyone who purchases a deferred annuity and holds the same investments inside the deferred annuity will have no change whatsoever in their tax practice. What will be discouraged is transfers from one deferred annuity to another. And

therefore, those who are involved in encouraging the churning of the deferred annuities and who receive—I think it's been well documented—rather substantial commissions, when those deferred annuities are churned, will be affected. Again, for someone who purchases a deferred annuity and holds the same funds inside the deferred annuity, they will get full inside buildup, with no significant change in——

Mr. WELLER. Let me, Mr. Secretary, let me——

Mr. SUMMERS [continuing]. Tax liability.

Mr. WELLER. Then you really raise an issue of fairness. As a Federal employee, if you're in the Thrift Savings Plan, you can shift your funds around in your Thrift Savings Plan from one fund to another, choose options, without a transaction tax which you're proposing, but you're turning around, and on the women that I met with last week who are using this as part of their retirement plan, imposing a tax on their decision to shift it from one investment option to the other. How is that fair?

Mr. SUMMERS. Congressman Weller, the Congress has, in crafting the legislation in this area, established a set of particular tax preferences for pensions and 401(k)s that are circumscribed, that include limits on contributions, that include top-heavy rules to assure that the benefits are equally shared, and in that category it is, indeed, possible to make transfers.

Deferred annuities have never been thought of as being within that category. There are no top-heavy rules; there are no limits on the quantity of contributions. So I think that is not usually thought of as the appropriate analogy in looking at deferred annuity provisions. Deferred annuities investments are in many ways more like mutual fund investments, although they are mutual fund investments that are very substantially preferred because the inside buildup is preferred, is tax-deferred, unlike the situation with respect to mutual funds.

Mr. WELLER. But, Mr. Secretary, you are taxing one of the choices and one of the options they have, and frankly, I think from a fairness standpoint, it doesn't make sense to tax one and not the other. Of course, I don't support your tax, but the question I have is: You know, in your testimony, you point out that you're spending initiatives are paid for with these tax increases that the President's proposing in his budget. And I was wondering, specifically, which spending initiative does the President pay for with this tax increase on retirement?

Mr. SUMMERS. No. What I suggested, the spending initiatives that the President has undertaken are financed through other spending cuts or are financed through proceeds from the tax settlement. The President's budget is balanced, essentially balanced, in the tax area with tax incentives and tax cuts that are contained in the budget being matched by the revenue-raisers that are included in the budget.

Mr. WELLER. So which spending initiative is matched with those tax increases on retirement——

Mr. SUMMERS. It's a package. That's not a question—money is fungible, Congressman. There's a package of revenue-raisers and a package of tax cuts, and the package of tax cuts is financed by the package of revenue-raisers.

Mr. SHAW. The time of the gentleman has expired.

Mr. WELLER. Thank you, Mr. Chairman.

Mr. SHAW. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

Mr. Summers, just to follow up on Mr. Weller's questioning about the administration's proposals on annuities and variable life products, clarify, if you will, who is taxed when there is, say, an exchange for a life insurance policy, for an annuity? Or if an investor in an annuity, for example, decides to change the mix of the investment within the annuity, who exactly is taxed?

Mr. SUMMERS. If you'll pardon me 1 second, I will consult with the experts behind me and I will give you an answer.

Mr. MCCRERY. Sure.

Mr. SUMMERS. In the area of the deferred annuity, which is 13 percent of the total set of insurance proposals, the holder of the annuity who makes a transfer from one asset to another asset is taxed. A holder who chooses a balanced portfolio and sticks with that balanced portfolio would not bear any tax burden.

Mr. MCCRERY. When you say the "holder," who is that?

Mr. SUMMERS. That's the potential beneficiary.

Mr. MCCRERY. So that's usually the purchaser of the annuity, the consumer?

Mr. SUMMERS. That is usually the purchaser of the annuity, indeed.

Mr. MCCRERY. So at least in this case you are taxing directly or imposing a new tax directly on the consumer of those products, and not the agents or the insurance companies?

Mr. SUMMERS. Well, as I tried to suggest in my answer, this 13 percent of the insurance does affect beneficiaries directly. It also affects those who are involved in encouraging transfers from one deferred annuity contract to another. Depending on what choices are made, it's difficult to sort out the incidence. In response to this tax, people do not churn their investments. Then the result will be that the revenue loss will be to the agents who would have encouraged—would have earned commissions on the churning. If behavior doesn't change and the same commissions are paid, then those individuals who are churning will face a tax treatment on their deferred annuities that is similar on asset transfers, though not similar with respect to inside buildup, to the tax treatment with respect to mutual funds.

Mr. MCCRERY. But at least on the instance which I described, and to which you initially responded, it's the consumer that would experience an increase in taxes. And don't you think that that is contrary to good public policy that should encourage people to plan wisely for their retirement? I mean, if you've got somebody that's 30 years old that enters into an agreement or contract like this, the mix of his investment—I'll wait until your staff gets through, so you could listen. A 30-year-old who enters into one of these contracts is going to have a different investment mix than he will have when he's 55 years old. So shouldn't he have the right to shift those investment choices within that contract without having to face a tax? That seems to me to be totally contrary to what we want people to do, which is wisely plan for their retirement.

Mr. SUMMERS. Well, of course, a 30-year-old who is following a normal path would be making contributions each year, and so would not have difficulty in adjusting their overall mix between stocks and bonds, for example, simply by adjusting the pattern of their contributions, or could do that in the areas where there would be tax neutrality between those within the 401(k)s, within the pensions.

Mr. MCCRERY. I think you're wrong on that. I don't think there is enough flexibility to change the mix just on the basis of new contributions to plans.

Also, before my time is up, I just want to point out that there is a distinct difference between these types of contracts and mutual funds. You try to equate the two, and, in fact, on these kinds of contracts there are penalties for early withdrawal; there are regulatory barriers to people getting out of these before they reach retirement age. So they are not the same as mutual funds, Mr. Summers, are they?

Mr. SUMMERS. They are not the same instruments as mutual funds, obviously, Congressman, but I think the general principle is something that we've long recognized in the tax law, that when an event that is concomitant to, or the same as, a realization of the sale of an asset takes place, that that is something that we tax.

I might note, just parenthetically, that most of these assets are actually marketed to those who have retired or who are about to retire. So the situation of a changing need over the life cycle is not one that arises with any great frequency——

Mr. MCCRERY. That is changing. That is changing, though, Mr. Summers. That statistic won't be the same 5 years from now.

Mr. SUMMERS. Well, I'm not sure. I mean, I think these products have been subject to rather extensive and not wholly favorable analysis in the financial press just in terms of relative rates of return. So I'm not sure what the future will hold for them.

Mr. SHAW. If the gentleman would suspend, the time of the gentleman has expired.

Mr. Summers, I may inquire as to what your schedule is. We have a series of votes on the floor which is going to take the better part of an hour. Can you stay with us?

Mr. SUMMERS. I will have a difficult—I need to get back to my office for a fairly important, quite important meeting sometime between 3:30 and 4 o'clock.

Mr. SHAW. Well, if you could stay with us at least until 3:30, we'll try to wrap it up or make arrangements for you to come back.

Mr. SUMMERS. I'd be delighted to.

Mr. SHAW. Thank you. I appreciate it.

Mr. SUMMERS. Thank you.

Mr. SHAW. The Committee will be in recess for the better part of an hour, but at the conclusion of the votes that are scheduled we shall reconvene.

[Recess.]

Mrs. JOHNSON of Connecticut [presiding]. I'd like to announce that the hearing is formally adjourned. Mr. Summers had to depart and has indicated that he will respond promptly to questions in writing from Members. We thank him for that.

[The following questions submitted by Mr. Houghton, and Deputy Secretary Summers' responses are as follows:]

**Questions Submitted to Deputy Treasury Secretary Summers by Representative Amo Houghton**

(1) REGARDING THE FOREIGN APPLICATION OF THE FREQUENT FLYER TAX:

Last year's tax bill extended the aviation tax to purchases from air carriers of frequent-flyer award miles by credit card companies, hotels, rental car companies, and others to be awarded to their customers. It is my understanding that this new law is being interpreted as applying to foreign-based frequent-flyer programs run by both U.S. and foreign companies, and that foreign application of this tax will have the impact of taxing frequent flyer miles that may never be used for U.S. air travel. I also understand that at least 20 foreign governments have filed protests with the State Department arguing that the tax should not apply when the ultimate air travel largely involves points outside the United States.

Would the Treasury Department support a legislative alternative to apply the tax more directly to travel to and from the United States, since the current foreign application of the tax appears to be overly broad, creates collection problems for the IRS, and will produce revenues that will have little connection to the use of FAA facilities and programs?

QUESTIONS ON REVENUE ESTIMATE FOR PS–REIT ELIMINATION:

Can you share with me some of your methodologies concerning your revenue estimate for the PS–REIT proposal?

*The answers provided below should provide you with a reasonably good understanding of the main assumptions in the methodology used by the Administration to produce the revenue estimate for the PS–REIT proposal.*

Have you had a chance to review the Joint Tax Committee's estimate and do you have any comments on it?

*Given the large amount of uncertainty in predicting the growth rate of acquisitions by paired REITs under current law, the Joint Tax Committee's estimate, although somewhat different from the Administration estimate, does not seem unreasonable.*

In your revenue estimate of the Administration's proposal to limit the tax benefits of the existing paired REITs, what assumptions did you make about the growth rate of the paired REITs under current law?

*Despite the recent large acquisitions by paired REITs, we assumed that growth rates of paired REITs under current law would in the long run be about 10 percent per year.*

What are your assumptions about the revenue loss that occurs under current policy because the attractiveness of the paired-share structure induces some businesses to become REITs that otherwise would have remained C-corporations?

*The only firms that can use the paired-share structure are those that were grandfathered by a provision in the Deficit Reduction Act of 1984. C-corporations cannot elect to become paired-share REITs. Our assumptions concerning the effect of paired-share REITs acquiring C-corporations under current policy is discussed in the answer to Question 3.*

What are your assumptions about the revenue loss that occurs under current policy due to the fact that paired-share REITs can achieve income shifting for tax purposes that ordinary REITs cannot?

*We assumed that nearly all of the estimated revenue loss occurs from paired-share REITs shifting income for tax purposes.*

Assuming the Administration's proposal is implemented, what percentage of those assets that would otherwise have converted to paired-REIT staus do you assume will place their real estate assets in a REIT, and what percentage will continue to operate as non-REIT C-corporations?

*We assumed that nearly all of the assets that would have acquired by the paired REITs under current law would continue to operate as non-REIT C-corporations if the Administration's proposal is implemented.*

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[Whereupon, at 2:53 p.m., the hearing was adjourned subject to the call of the Chair.]

[Submissions for the record follow:]

**Statement of American Bankers Association**

The American Bankers Association (ABA) is pleased to have an opportunity to submit this statement for the record on certain of the revenue provisions of the Administration's fiscal year 1999 budget.

The American Bankers Association brings together all categories of banking institutions to best represent the interests of the rapidly changing industry. Its membership—which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks—makes ABA the largest banking trade association in the country.

The Administration's 1999 budget proposal contains several provisions of interest and concern to banking institutions. Although we believe that the Administration's revenue plan contains several significant tax incentive provisions that would amplify well established policies, we are deeply concerned with a number of its revenue measures. The subject revenue provisions would, in fact, impose new and additional taxes on the banking industry rather than "closing loopholes." As a package, such revenue measures would, inter alia, inhibit job creation and the provision of employee and retiree benefits provided by employers while inequitably penalizing business.

Our preliminary views on the subject provisions are set out below.

REVENUE MEASURES

*Modify the Corporate-Owned Life Insurance Rules*

The ABA strongly opposes the Administration's proposal to modify the corporate-owned life insurance rules. The subject provision would effectively eliminate corporate owned life insurance that is used to offset escalating employee and retiree benefit liabilities (such as health insurance, survivor benefits, etc.)—an activity that promotes socially responsible behavior and should be encouraged rather than discouraged. Cutbacks in such programs may also lead to the reduction of benefits provided by employers.

Specifically, the Administration's proposal would eliminate the exception under the pro rata disallowance rule for employees, officers and directors. Accordingly, as un-borrowed cash values increase, the amount of interest deduction would be reduced. Such modification to current law would have unintended consequences that are inconsistent with other Congressional policies, which encourage businesses to act in a prudent manner in meeting their liabilities to employees.

Corporate owned life insurance as a funding source has a long history in tax law as a respected tool. Moreover, federal banking regulators recognize that corporate owned life insurance serves a necessary and useful business purpose. Their guidelines confirm that purchasing life insurance for the purpose of recovering or offsetting the costs of employee benefit plans is an appropriate purpose that is incidental to banking.

The Administration's proposal seeks to revisit this issue irrespective of the fact that business use of corporate owned life insurance has been closely examined and was, in effect, confirmed by Congress when it passed the Taxpayer Relief Act of 1997. That law created a specific exception for certain key employees. The subject provision would impose a retroactive tax penalty on banking institutions that have fully complied with established rules and have, in good faith, made long term business decisions based on existing tax law. They should be protected from the retroactive effects of legislation that would result in substantial tax and non-tax penalties. Even though the provision is applicable on a prospective basis, the effect is a retroactive tax on policies already written.

We urge you to reject this revenue provision.

*Increased Information Reporting Penalties*

The ABA strongly opposes the Administration's proposal to increase information reporting penalties. The banking industry prepares and files information returns to report items such as employee wages, dividends, and interest annually, in good faith, for the sole benefit of the IRS. The Administration reasons that the current penalty provisions may not be sufficient to encourage timely and accurate reporting. We disagree. Information reporting penalties were raised to the current levels as part of the Omnibus Budget Reconciliation Act of 1989, P.L. 101–239. The suggestion that this proposal would raise revenue presumes that corporations are non-compliant, a conclusion for which there is no substantiating evidence.

Further, penalties typically are intended to discourage "bad" behavior and encourage "good" behavior, not to serve as revenue raisers. The Administration's reasoning that increasing the penalty amounts would decrease the number of taxpayers that

incur penalties suggests that the penalties could be continually increased, from year-to-year to maintain the revenue flow. Certainly, the proposed increase in penalties is unnecessary and would not be based on sound tax policy.

*Repeal Tax-Free Conversions of Large C Corporations to S Corporations*

The ABA opposes the proposal to repeal Internal Revenue Code section 1374 for large S corporations. The proposal would accelerate net unrealized built-in gains (BIG) and impose a corporate level tax on BIG assets along with a shareholder level tax with respect to their stock. The BIG tax would apply to gains attributable to assets held at the time of conversion, negative adjustments due to accounting method change, intangibles such as core deposits and excess servicing rights, and recapture of the bad debt reserve.

The Small Business Job Protection Act of 1996, P.L. 104–188, allowed financial institutions to elect S corporation status for the first time. Effectively, the Administration's proposal would shut the window of opportunity for those financial institutions to elect S corporation status by making the cost of conversion prohibitively expensive. We believe that such a change would be contrary to Congressional intent to permit banking institutions to elect S corporation status.

*Modify the Treatment of Closely Held REITs*

The Administration's proposal to impose additional restrictions on the ownership of real estate investment trusts (REITs) would have the unintended consequence of eliminating a valid method used by banks and thrifts to raise regulatory capital. The proposal would go beyond the current law 100 shareholder requirement for REITs by prohibiting any one entity from owning more than 50 percent (measured by both value and voting power) of a REIT. The proposal appears to be based on the notion that closely held REITs can be used by taxpayers in abusive transactions. However, raising bank capital to protect institutions from future economic downturns is a legitimate use of a closely held REIT.

Currently, banks and thrifts may transfer real estate assets, e.g. mortgage loans, in a REIT, with 100 percent of the common stock of the REIT held by the financial institution and with preferred stock being issued to at least 100 outside investors. The funds raised from the preferred stock issuance count as Tier 1 regulatory capital, which provides a cushion for the safety of the institution and its depositors. The closely held REIT preferred stock issuance is an important alternative for banks to have available as a funding source. The Federal Reserve Board has approved the use of certain preferred stock arrangements as a valid method for raising Tier 1 bank capital, because, otherwise, bank holding companies would be at a competitive disadvantage compared to non-bank financial companies and foreign-owned banking institutions that can use tax advantaged structures to raise capital.

The Administration's proposal is overly broad. Closely held REITs serve valid functions that are consistent with the underlying purposes of the REIT provisions as well as the broader concept of sound tax policy. The Service has demonstrated that it can use regulations and notices to deal with its concerns about specific investment structures without asking Congress to restrict legitimate REIT structures.

*Repeal the Crummey case rule*

The Administration's proposal would overrule the Crummey decision by amending Section 2503(c) to apply only to outright gifts of present interests. Gifts to minors under a uniform act would be deemed to be outright gifts.

The ABA opposes the Administration's proposal to eliminate the Crummey rule (Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968). Many existing trusts, which are administered by banks through their trust departments, rely upon the Crummey rule as a tax planning technique. The Administration asserts, in the General Explanation of its proposal, that "[t]ypically by pre-arrangement or understanding in more recent cases, none of the Crummey withdrawal rights will be exercised" [referencing the Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991)].

We believe the Administration's assertion is incorrect. If there is a pre-arrangement or understanding that the Crummey rights will not be exercised, the Crummey rule will not be applied by the courts. In fact, in Cristofani the Tax Court determined that there was no arrangement or understanding between the decedent, the trustees, and the beneficiaries that the decedent's grandchildren would not exercise their withdrawal rights. The Court said that the question was not whether the power was exercised, but whether it in fact existed.

The proposal to legislatively overrule the Crummey case would not only countermine recent Congressional action to reduce, if not eliminate, "death taxes," but would also seriously undermine at least one of the important reasons taxpayers use trusts for wealth transfer purposes.

*Eliminate Dividends-Received Deduction for Certain Preferred Stock*

The Administration proposes to deny the dividends-received deduction for dividend payments on nonqualified preferred stock that is treated as taxable consideration in certain otherwise non-taxable corporate reorganizations. The Administration argues that such stock is sufficiently free from risk and from participation in corporate growth that it should be treated as debt for purposes of denial of the dividend received deduction. However, such nonqualified preferred stock is not treated as debt for all tax purposes.

The ABA opposes this Administration proposal in that it would establish inconsistent tax policy and would amount to an inequitable tax increase. Certainly, items received in income and treated as debt to a recipient should, at minimum, be correspondingly deductible as interest expense to the payor. The instant proposal would create a "lose-lose" tax trap for corporate taxpayers.

TAX INCENTIVE PROPOSALS

The Administration's budget proposal also contains several significant tax incentive provisions, which ABA fully supports.

*Tax Credits for Holders of Qualified School Modernization Bonds and Qualified Zone Academy Bonds*

The ABA supports the provisions to expand qualified academy zone bonds and to establish school modernization bonds. Banks are very interested in Education Zone Academy Bonds because they could strengthen local communities and benefit the families that reside there. We also believe these bonds will attract investment in enterprise and poor communities by providing tax credits and Community Reinvestment Act credits.

It is important for banks to be involved in all aspects of our local communities. The banking industry recognizes that education is a key component of that involvement and that there is an immediate need for improved infrastructure. We would urge you to include this proposal in the fiscal year 1999 budget legislation.

*Educational Assistance*

The ABA supports the permanent extension of tax incentives for employer provided education. Many industries, including banking and financial services, are experiencing dramatic technological changes. The provision is an important benefit to many entry level employees and will assist in the retraining of employees to better face global competition. Employer provided educational assistance is a central component of the modern compensation package and is often used to recruit and retain vital employees.

*Research and Experimentation Tax Credit Extended for One Year*

The ABA supports the permanent extension of the tax credit for research and experimentation. The banking industry is actively involved in the research and development of new intellectual products, services and technology in order to compete in an increasingly sophisticated and global marketplace. The banking industry has a vested interest in ensuring that the research and experimentation tax credit remains an appropriate incentive for banking institutions to improve efficiencies and remain competitive. Banking institutions increasingly engage in sophisticated and innovative research activities. These activities are currently being unreasonably scrutinized and questioned through narrowly defined Treasury regulations and audit positions, which we believe is inconsistent with Congressional intent. Along with the extension of the tax credit, continued availability of the research and experimentation tax credit in the financial services industry should be an encouraged and Congressionally supported incentive.

*Contributions of Appreciated Stock to Private Foundations*

The ABA supports permanent extension of the full fair market value income tax deduction for gifts of publicly traded stock to private foundations. We agree that allowing donors to deduct the full value of such stock encourages taxpayers to donate the stock for charitable purposes.

*Increase Low Income Housing Tax Credit Per Capita Cap*

The ABA supports the proposal to raise the $1.25 per capita cap and urges its inclusion in the fiscal year 1999 budget legislation.

*Simplify the Foreign Tax Credit Limitation for Dividends from "10/50" Companies*

The Administration proposal would, inter alia, simplify the application of the foreign tax credit limitation by applying the look-through approach immediately to all dividends paid by a 10/50 company, regardless of the year in which the earnings and profits out of which the dividend is paid were accumulated.

The ABA supports legislative efforts to simplify application of the foreign tax credit. We also support proposals to increase the capacity for taxpayers to claim foreign credit for the taxes they actually pay. Further, we support legislative efforts in the foreign tax credit area that recognize efforts by a taxpayer to reduce foreign taxes.

*Access to Payroll Deduction for Retirement Savings*

The ABA supports proposals to encourage and facilitate employee retirement savings. However, it is most important that providing expanded access to the payroll deduction remain at the employer's option. We are most concerned that such proposal could impose unreasonable and overly expensive administrative burdens on certain employers, which is contrary to recent Congressional efforts to reduce administrative tax burdens.

CONCLUSION

We appreciate having this opportunity present our preliminary views on the tax proposals contained in the President's fiscal year 1999 budget. We look forward to working with you in the further development of the revenue proposals to be contained in the fiscal year 1999 budget.

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**Statement of America's Community Bankers**

Mr. Chairman and Members of the Committee:

America's Community Bankers appreciates this opportunity to submit testimony for the record of the hearing on the revenue raising provisions in the Administration's fiscal year 1999 budget proposal. America's Community Bankers (ACB) is the national trade association for 2,000 savings and community financial institutions and related business firms. The industry has more than $1 trillion in assets, 250,000 employees and 15,000 offices. ACB members have diverse business strategies based on consumer financial services, housing finance, and community development.

ACB wishes to focus on two provisions included in the Administration's budget. We urge the Committee to reject the Administration's proposal to change the rules for business-owned life insurance. On the other hand, we recommend that the Committee include in legislation, as soon as possible, the Administration's proposal to increase the low-income housing tax credit.

BANK-OWNED LIFE INSURANCE

ACB strongly disagrees with the Administration's proposal to disallow deductions for interest paid by corporations that purchase permanent life insurance on the lives of their officers, directors, and employees. This disallowance is retroactive in that it would occur with respect to life insurance contracts already in force. The Administration's proposal would revamp a statutory scheme enacted just last year. In 1997 Congress enacted a provision to disallow a proportional part of a business's interest-paid deductions on unrelated borrowings where the business purchases a life insurance policy on anyone and where the business is the direct or indirect beneficiary. Integral to this general rule, however, is an exception for business-owned life insurance covering employees, officers, directors, and 20 percent or more owners. The combination of the general rule and its exception implemented a sensible policy—that the benefits of permanent life insurance, where they are directly related to the needs of a business, should continue to be available to businesses

The Administration is now proposing that the implicit agreement made last year be immediately broken by cutting back retroactively, for contracts issued after June 8, 1997, the exception to omit employees, officers, and directors. It would continue to apply to 20-percent owners. Thus, a portion of the interest-paid deductions of a business for a year would be disallowed according to the ratio of the average unborrowed policy cash values of life insurance, annuities, and endowment contracts to total assets. Insurance contracts would be included in this denominator to the extent of unborrowed cash values. (It also appears that a 1996 exception enacted

would be repealed that permits an interest-paid deduction for borrowings against policies covering key employees.)

The Administration's proposal would result in a significantly larger loss of deductions for a bank or thrift than a similar-sized commercial firm because financial institutions are much more leveraged than commercial firms.

Financial institutions, because of their statutory capital requirements, have been under a special constraint to look to life insurance to fund retirement benefits after the issuance of FASB Statement 106 in December 1990. FASB 106, which was effective for 1992, requires most employers to give effect in their financial statements to an estimate of the future cost of providing retirees with health benefits. The impact of charging such an expense to the earnings of a company could be a significant reduction in capital. Many financial institutions were faced with the necessity of reneging on the commitments they had made to their employees or finding an alternative investment. Many of these institutions have chosen to fund their pension, as well as retiree health care benefits, using permanent life insurance.

The banking regulators have permitted financial institutions to use life insurance to fund their employee benefit liabilities, but restricted the insurance policies that may be used to those that do not have a significant investment component and limited the insurance coverage to the risk of loss or the future liability. See e.g., the OCC's Banking Circular 249 (February 4, 1991) and the OTS's Thrift Activities Regulatory Handbook, Section 250.2. On September 20, 1996, the OCC issued Bulletin 96–51 which recognized the usefulness of permanent life insurance in the conduct of banking and granted banks increased flexibility to use it—consistent with safety and soundness considerations. The bulletin makes clear that the necessity to control a variety of risks created by life insurance ownership (liquidity, credit, interest rate, etc.) requires a bank to limit its purchases to specific business needs rather than for general investment purposes. In addition, bank purchases of life insurance will be limited by the need to maintain regulatory capital levels. (The other bank regulators are apparently in agreement with the OCC position and may shortly formalize similar positions.

The Administration's proposed change in the current law treatment of business-owned life insurance would require many financial institutions, because of the extent of their loss of deductions, to terminate their policies. Policy surrender would, however, subject the banks to immediate tax on the cash value and possible cash-in penalties that would reduce capital.

In most cases financial institutions have purchased life insurance to provide pension and retiree health benefits. If Congress were to make it uneconomical for businesses to purchase life insurance contracts, the employee benefits they fund would inevitably have to be reduced. For the Administration to make business-owned life insurance uneconomical, given its usefulness in providing employee benefits, is inconsistent with the other proposals in the Administration's budget proposal that would enhance pension an other retiree benefits.

The Administration's argument that financial intermediaries are able to "arbitrage" their interest-paid deductions on unrelated borrowings where they own permanent life insurance is unconvincing. The leveraging of their capital by banks and thrifts to make loans is a vital component of a strong economy. The Administration's proposal would punish financial institutions, simply because they are inherently much more leveraged, to a much greater extent than similar-sized commercial firms for making what would otherwise be sound business decisions—to insure themselves against the death of key employees or to provide for the retirement health or security of their employees by means of life insurance.

This is the third year in a row that legislation has been proposed to limit the business use of life insurance. This has now become unfair and unsound tax policy. It is disingenuous to say that the BOLI exception must now be eliminated because there may have been large recent policy purchases. If taxpayers have reason to believe that Congress is about to change its mind with respect to an exception and they rush to act before an opportunity is lost, as may have happened with BOLI, it is a case of blaming the victim to then say that the law is being changed because of taxpayer action. In fact, companies may have been motivated to act as they otherwise would not have, with respect to BOLI purchases, because of a perception that the tax legislative process is fickle. If taxpayers are to focus on long-term business benefits rather than short-term, tax-motivated considerations, they must be confident that there is an implicit premise of consistency in the tax legislative process.

LOW-INCOME HOUSING TAX CREDIT

America's Community Bankers strongly supports the Administration's proposal to increase the per capita limit on the low-income housing tax credit from $1.25 to $1.75. As an important part of the thrift industry's commitment to housing, ACB's member institutions have been participants, as direct lenders and, through operating subsidiaries, as investors, in many low-income housing projects that were viable only because of the LIHTC. The ceiling on the annual allocation of the LIHTC has not been increased since the credit was created by the Tax Reform Act of 1986. Many members institutions have communicated to ACB that there are shortages of affordable rental housing in their communities and that, if the supply of LIHTCs were increased, such housing could be more efficiently be produced to address this shortage.

The LIHTC was created in 1986 to replace a variety of housing subsidies whose efficiency had been called into question. Under Section 42 of the Internal Revenue Code, a comprehensive regime of allocation and oversight was created, requiring the involvement of both the IRS and state and local housing authorities, to assure that the LIHTC is targeted to increase the available rental units for low-income citizens. This statutory scheme has been revised in several subsequent tax acts to eliminate potential abuses.

Every year since 1987, each state has been allocated a total amount of LIHTCs equal to $1.25 per resident. The annual per capita limit may be increased by a reallocation of the unused credits previously allocated to other states, as well as the state's unused LIHTC allocations from prior years. The annual allocation must be awarded within two years or returned for reallocation to other states. State and local housing authorities are authorized by state law or decree to award the state's allocation of LIHTCs to developers who apply by submitting proposals to develop qualified low-income housing projects.

A "qualified low-income project" under Section 42(g) of the Code is one that satisfies the following conditions. (1) It must reserve at least 20 percent of its available units for households earning up to 50 percent of the area's median gross income, adjusted for family size, or at least 40 percent of the units must be reserved for households earning up to 60 percent of the area's median gross income, adjusted for family size. (2) The rents (including utility charges) must be restricted for tenants in the low-income units to 30 percent of an imputed income limitation based on the number of bedrooms in the unit. (3) During a compliance period, the project must meet habitability standards and operate under the above rent and income restrictions. The compliance period is 15 years for all projects placed in service before 1990. With substantial exceptions, an additional 15-year compliance period is imposed on projects placed in service subsequently.

Putting together a qualifying proposal is only the first step, however, for a developer seeking an LIHTC award. The state or local housing agency is required to select from among all of the qualifying projects by means of a LIHTC allocation plan satisfying the requirements of Section 42(m). The allocation plan must set forth housing priorities appropriate to local conditions and preference must be given to projects that will serve the lowest-income tenants and will serve qualified tenants for the longest time.

Section 42 effectively requires state and local housing agencies to create a bidding process among developers to ensure that the LIHTCs are allocated to meet housing needs efficiently. To this end the Code imposes a general limitation on the maximum LIHTC award that can be made to any one project. Under Section 42(b) the maximum award to any one project is limited to nine percent of the "qualified basis" (in general, development costs, excluding the cost of land, syndication, marketing, obtaining permanent financing, and rent reserves) of a newly constructed building. Qualified basis may be adjusted by up to 30 percent for projects in a qualified census tract or "difficult development area." For federally subsidized projects and substantial rehabilitations of existing buildings, the maximum annual credit is reduced to four percent. The nine and four percent annual credits are payable over 10 years and in 1987, the first year of the LIHTC, the 10-year stream of these credits was equivalent to a present value of 70 percent and 30 percent, respectively, of qualified basis. Since 1987, the Treasury has applied a statutory discount rate to the nominal annual credit percentages to maintain the 70 and 30 percent rates.

The LIHTC has to be taken over 10 years, but the period that the project must be in compliance with the habitability and rent and income restrictions is 15 years. This creates an additional complication. The portion of the LIHTC that should be theoretically be taken in years 11 through 15 is actually taken pro rata during the first 10 years. Where there is noncompliance with the project's low-income units

during years 11 through 15, the related portion of the LIHTC that was, in effect, paid in advance will be recaptured.

Where federally subsidized loans are used to finance the new construction or substantial rehabilitation, the developer may elect to qualify for the 70 percent present value of the credit by reducing the qualified basis of the property. Where federal subsidies are subsequently obtained during the 15-year compliance period, the qualified basis must then be adjusted. On the other hand, certain federal subsidies do not affect the LIHTC amount, such as the Affordable Housing Program of the Federal Home Loan Banks, Community Development Block Grants, and HOME investment Partnership Act funds.

The LIHTCs awarded to developers are, typically, offered to syndicators of limited partnerships. Because of the required rent restrictions on the project, the syndications attract investors who are more interested in the LIHTCs and other deductions the project will generate than the unlikely prospect of rental profit. The partners, who may be individuals or corporations, provide the equity for the project, while the developer's financial stake may be limited to providing the debt financing.

The LIHTC is limited, however, in its tax shelter potential for the individual investor. Individuals are limited by the passive loss rules to offsetting no more than $25,000 of active income (wages and business profits) with credits and losses from rental real estate activities. For an individual in the 28% bracket, for example, the benefit from the LIHTC would be limited to $7,000. It should also be borne in mind that such credits are unavailable against the alternative minimum tax liability of individuals and corporations.

The Chairs of the Ways and Means Committee and its Subcommittee on Oversight recently requested the GAO to study the LIHTC program and, specifically, to evaluate: whether the LIHTC was being used to meet state priority housing needs; whether the costs were reasonable; and whether adequate oversight was being performed. The resulting GAO report was generally favorable. See *Tax Credits: Opportunities to Improve Oversight of the Low-Income Housing Program* (GAO/GGD/RCED–97–55, March 28, 1997). The GAO found that the LIHTC has stimulated low-income housing development and that the allocation processes implemented by the states generally satisfy the requirements of the Code. In fact, the GAO found that the LIHTC was being targeted by the states to their very poorest citizens. The incomes of those for whom the credit was being used to provide housing were substantially lower than the maximum income limits set in the statute. While the GAO could find no actual abuses or fraud in the LIHTC program, it did determine that the procedures that some states use to review and implement project proposals need to be improved. The report also recommended a number of changes in the IRS regulations to ensure adequate monitoring and reporting so that the IRS can conduct its own verification of compliance with the law.

The only increase in the total amount of LIHTCs since 1987 has been through population growth, which has been only five percent nationwide over the 10-year period (floor statement of Senator Alphonse D'Amato, October 3, 1997). Had the $1.25 per capita limit been indexed for inflation since the inception of the LIHTC, as is commonly done in other Code provisions, it would be comparable to the $1.75 limit the Administration is proposing. According to the Joint Committee on Taxation, the Consumer Price Index measurement of cumulative inflation between 1986 and the third quarter of 1997 was approximately 47 percent. Using this index to adjust the per capita limit, it would now be approximately $1.84. The GDP price deflator for residential fixed investment indicates 38.1 percent price inflation, which would have increased the per capita limit to approximately $1.73. (See Joint Committee on Taxation, D*escription of Revenue Provisions Contained in the President's Fiscal Year 1999 Budget Proposal* (JCS–4–98), February 24, 1998)

More affordable low-income housing is currently needed. "Nearly 100,000 low cost apartments are demolished, abandoned, or converted to market rate each year. Increasing the LIHTC would allow states to finance approximately 25,000 more critically needed low-income apartments each year" (floor statement of Senator Alphonse D'Amato, October 3, 1997). "In the state of Florida, for example, the LIHTC has used more than $187 million in tax credits to produce approximately 42,000 affordable rental units valued at over $2.2 billion. Tax credit dollars are leveraged at an average of $18 to $1. Nevertheless, in 1996, nationwide demand for the housing credit greatly outpaced supply by a ratio of nearly 3 to 1. In Florida, credits are distributed based upon a competitive application process and many worthwhile projects are denied due to a lack of tax credit authority" (floor statement of Senator Bob Graham, October 3, 1997). "In 1996, states received applications requesting more than $1.2 billion in housing credits—far surpassing the $365 million in credit authority available to allocate that year. In New York, the New York Division of Housing and Community Renewal received applications requesting more than $104

million in housing credits in 1996—nearly four times the $29 million in credit authority it already had available" (floor statement of Senator Alphonse D'Amato, October 3, 1997).

For all of the foregoing reasons, it seems clear to ACB that it is time to increase the LIHTC.

Once again, Mr. Chairman, ACB is grateful to you and the other members of the Committee for the opportunity you have provided to make our views known on the Administration's tax proposals. If you have any questions or require additional information, please contact Jim O'Connor at 202–857–3125 or Brian Smith at 202–857–3118.

**Statement of The New York Clearing House Association, The Securities Industry Association, Independent Bankers Association of America, and America's Community Bankers**

The undersigned associations, which represent a broad range of financial institutions, including both large and small institutions, reiterate their strong opposition to the Administration's proposal to increase penalties for failure to file correct information returns.

The proposed penalties are unwarranted and place an undue burden on already compliant taxpayers. It seems clear that most, if not all, of the revenue estimated to be raised from this proposal would stem from the imposition of higher penalties due to inadvertent errors rather than from enhanced compliance. The financial services community devotes an extraordinary amount of resources to comply with current information reporting and withholding rules and is not compensated by the U.S. government for these resources. The proposed penalties are particularly inappropriate in that (i) there is no evidence of significant current non-compliance and (ii) the proposed penalties would be imposed upon financial institutions while such institutions were acting as integral parts of the U.S. government's system of withholding taxes and obtaining taxpayer information. In addition, we believe the proposal is overly broad in that it applies to all types of information returns, including Forms 1099–INT, –DIV, –OID, –B, –C, and –MISC, as well as Form W–2.

THE PROPOSAL

As included in the President's fiscal year 1999 budget, the proposal generally would increase the penalty for failure to file correct information returns on or before August 1 following the prescribed filing date from $50 for each return to the greater of $50 or 5 percent of the amount required to be reported.[1] The increased penalties would not apply if the aggregate amount that is timely and correctly rlendar year is at least 97 percent of the aggregate amount required to be reported for the calendar year. If the safe harbor applies, the present-law penalty of $50 for each return would continue to apply.

CURRENT PENALTIES ARE SUFFICIENT

We believe the current penalty regime already provides ample incentives for filers to comply with information reporting requirements. In addition to penalties for inadvertent errors or omissions,[2] severe sanctions are imposed for intentional reporting failures. In general, the current penalty structure is as follows:

- The combined standard penalty for failing to file correct information returns and payee statements is $100 per failure, with a penalty cap of $350,000 per year.
- Significantly higher penalties—generally 20 percent of the amount required to be reported (for information returns and payee statements), with no penalty caps—may be assessed in cases of intentional disregard.[3]
- Payors also may face liabilities for failure to apply 31 percent backup withholding when, for example, a payee has not provided its taxpayer identification number (TIN).

[1] A similar proposal was included in President Clinton's fiscal year 1997 and 1998 budgets.

[2] It is important to note that many of these errors occur as a result of incorrect information provided by the return recipients such as incorrect taxpayer identification numbers (TINs).

[3] The standard penalty for failing to file correct information returns is $50 per failure, subject to a $250,000 cap. Where a failure is due to intentional disregard, the penalty is the greater of $100 or 10 percent of the amount required to be reported, with no cap on the amount of the penalty.

There is no evidence that the financial services community has failed to comply with the current information reporting rules and, as noted above, there are ample incentives for compliance already in place.[4] It seems, therefore, that most of the revenue raised by the proposal would result from higher penalty assessments for inadvertent errors, rather than from increased compliance with information reporting requirements. Thus, as a matter of tax compliance, there appears to be no justifiable policy reason to substantially increase these penalties.

### PENALTIES SHOULD NOT BE IMPOSED TO RAISE REVENUE

Any reliance on a penalty provision to raise revenue would represent a significant change in Congress' current policy on penalties. A 1989 IRS Task Force on Civil Penalties concluded that penalties "should exist for the purpose of encouraging voluntary compliance and not for other purposes, such as raising of revenue."[5] Congress endorsed the IRS Task Force's conclusions by specifically enumerating them in the Conference Report to the Omnibus Budget Reconciliation Act of 1989.[6] There is no justification for Congress to abandon its present policy on penalties, which is based on fairness, particularly in light of the high compliance rate among information return filers.

### SAFE HARBOR NOT SUFFICIENT

Under the proposal, utilization of a 97 percent substantial compliance "safe harbor" is not sufficient to ensure that the higher proposed penalties apply only to relatively few filers. Although some information reporting rules are straightforward (e.g., interest paid on deposits), the requirements for certain new financial products, as well as new information reporting requirements,[7] are often unclear, and inadvertent reporting errors for complex transactions may occur. Any reporting "errors" resulting from such ambiguities could easily lead to a filer not satisfying the 97 percent safe harbor.

### APPLICATION OF PENALTY CAP TO EACH PAYOR ENTITY INEQUITABLE

We view the proposal as unduly harsh and unnecessary. The current-law $250,000 penalty cap for information returns is intended to protect the filing community from excessive penalties. However, while the $250,000 cap would continue to apply under the proposal, a filer would reach the penalty cap much faster than under current law. For institutions that file information returns for many different payor entities, the protection offered by the proposed penalty cap is substantially limited, as the $250,000 cap applies separately to each payor.

In situations involving affiliated companies, multiple nominees and families of mutual funds, the protection afforded by the penalty cap is largely illusory because it applies separately to each legal entity. At the very least, any further consideration of the proposal should apply the penalty cap provisions on an aggregate basis. The following examples illustrate why aggregation in the application of the penalty cap provisions is critical.

### EXAMPLE I—PAYING AGENTS

A bank may act as paying agent for numerous issuers of stocks and bonds. In this capacity, a bank may file information returns as the issuers' agent but the issuers, and not the bank, generally are identified as the payors. Banks may use a limited number of information reporting systems (frequently just one overall system) to generate information returns on behalf of various issuers. If an error in programming the information reporting system causes erroneous amounts to be reported, potentially all of the information returns subsequently generated by that system could be affected. Thus, a single error could, under the proposal, subject each issuer for

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[4] Also note that, in addition to the domestic and foreign information reporting and penalty regimes that are currently in place, for payments to foreign persons, an expanded reporting regime with the concomitant penalties is effective for payments made after December 31, 1998. See TD 8734, published in the Federal Register on October 14, 1997. The payor community is being required to dedicate extensive manpower and monetary resources to put these new requirements into practice. Accordingly, these already compliant and overburdened taxpayers should not have to contend with new punitive and unnecessary penalties.

[5] Statement of former IRS Commissioner Gibbs before the House Subcommittee on Oversight (February 21, 1989, page 5).

[6] OBRA 1989 Conference Report at page 661.

[7] For example, Form 1099–C, discharge of indebtedness reporting, or Form 1042–S, reporting for bank deposit interest paid to certain Canadian residents.

whom the bank filed information returns, to information reporting penalties because the penalties would be assessed on a taxpayer-by-taxpayer basis. In this instance, the penalty would be imposed on each issuer. However, the bank as paying agent may be required to indemnify the issuers for resulting penalties.

*Recommendation:*

For the purposes of applying the penalty cap, the paying agent (not the issuer) should be treated as the payor.

EXAMPLE II—RETIREMENT PLANS

ABC Corporation, which services retirement plans, approaches the February 28th deadline for filing with the Internal Revenue Service the appropriate information returns (i.e., Forms 1099–R). ABC Corporation services 500 retirement plans and each plan must file over 1,000 Forms 1099–R. A systems operator, unaware of the penalties for filing late Forms 1099, attempts to contact the internal Corporate Tax Department to inform them that an extension of time to file is necessary to complete the preparation and filing of the magnetic media for the retirement plans. The systems operator is unable to reach the Corporate Tax Department by the February 28th filing deadline and files the information returns the following week. This failure, under the proposal, could lead to substantial late filing penalties for each retirement plan that ABC Corporation services (in this example, up to $75,000 for each plan).[8]

*Recommendation:*

Retirement plan servicers (not each retirement plan) should be treated as the payor for purposes of applying the penalty cap.

EXAMPLE III—RELATED COMPANIES

A bank or broker dealer generally is a member of an affiliated group of companies which offer different products and services. Each company that is a member of the group is treated as a separate payor for information reporting and penalty purposes. Information returns for all or most of the members of the group may be generated from a single information reporting system. One error (e.g., a systems programming error) could cause information returns generated from the system to contain errors on all subsequent information returns generated by the system. Under the proposal, the penalty cap would apply to each affiliated company for which the system(s) produces information returns.

*Recommendation:*

Each affiliated group[9] should be treated as a single payor for purposes of applying the penalty cap.

While these examples highlight the need to apply the type of penalty proposed by the Treasury on an aggregated basis, they also illustrate the indiscriminate and unnecessary nature of the proposal.

CONCLUSION

The undersigned associations represent the preparers of a significant portion of the information returns that would be impacted by the proposal to increase penalties for failure to file correct information returns. In light of the current reporting burdens imposed on our industries and the significant level of industry compliance, we believe it is highly inappropriate to raise penalties. Thank you for your consideration of our views.

The New York Clearing House Association
The Securities Industry Association
Independent Bankers Association of America
America's Community Bankers

[8] If the corrected returns were filed after August 1, the penalties would be capped at $250,000 per plan.

[9] A definition of "affiliated group" which may be used for this purpose may be found in Section 267(f) or, alternatively, Section 1563(a).

AMERICAN COUNCIL FOR AN ENERGY-EFFICIENT ECONOMY
WASHINGTON, DC
*March 2, 1998*

The Hon. Bill Archer
Chairman
Committee on Ways & Means
*U. S. House of Representatives*
*Washington, DC 20515*

Dear Mr. Chairman:

Please accept the attached position statement for the record of the February 25 hearing of the Committee on Ways & Means regarding the Administration's proposals and assumptions for Fiscal Year 1999. The Sustainable Energy Coalition is made up of more than 40 national business, environmental, consumer, and energy policy organizations that support a strong Federal role in research, development, and deployment of energy efficiency and renewable energy technologies.

The Administration's proposals for $3.6 billion in tax incentives over 5 years for the purchase of energy-saving equipment, homes, and vehicles and renewable energy equipment has drawn a great deal of interest. Such measures can reduce energy costs for consumers while contributing to other important national goals, such as improved air quality, reduced energy imports, and improved competitiveness of American businesses. We urge the Committee to carefully consider these proposals in the weeks ahead, and look forward to discussing them further with you and your staff.

Sincerely,

HOWARD GELLER
*Executive Director*

Attachment
cc: Hon. Charles B. Rangel, Ranking Minority Member
Members of the Committee on Ways & Means

**Statement of Sustainable Energy Coalition**

The undersigned members of the Sustainable Energy Coalition are expressing their support for the concept of providing tax incentives and other encouragement for a variety of advanced energy-saving and renewable energy technologies such as:

- superefficient cars and light trucks
- superefficient homes
- highly efficient heating and cooling systems
- highly efficient water heaters
- fuel cell cogeneration systems
- solar photovoltaic and water heating systems
- wind and biomass-based electricity generation
- combined heat and power systems

Tax incentives along these lines will provide multiple benefits:

1) They will stimulate technological innovation and reduce the risk that manufacturers face in introducing and marketing new technologies.

2) They will save consumers billions of dollars by stimulating commercialization of cost-effective energy saving technologies.

3) They will improve air quality, reduce public health hazards, and cut U.S. greenhouse gas emissions by promoting energy efficiency and clean energy sources.

4) They will reduce oil imports, improve our balance of payments, and enhance national security by cutting gasoline use.

5) They will help U.S. companies compete in what surely will be enormous worldwide markets in the next century.

While the details of the Administration's tax proposals have not yet been announced, we urge policy makers to recognize that tax incentives for advanced energy efficiency and renewable energy technologies are a "win-win-win" strategy for manufacturers, consumers, and the environment. They are voluntary, market-based "no regrets" measures that will reduce the cost of energy services such as heating, cooling, and mobility. They are an economic development strategy as well as a climate

technology strategy. Even those who may not support the Kyoto climate change agreement should find ample grounds to support tax incentives for innovative energy efficiency and renewable energy technologies.

*Alliance to Save Energy, American Bioenergy Association, American Council for an Energy-Efficient Economy, American Green, American Public Power Association, American Wind Energy Association, Americans for Clean Energy, Business Council for Sustainable Energy, Cascade Associates, Center for a Sustainable Economy, Clean Fuels Foundation, Environmental & Energy Study Institute, Fuel Cells 2000, Global Biorefineries, Inc., International District Energy Association, National Bio-Energy Industries Association, Public Citizen, Safe Energy Communication Council, Solar Energy Industries Association, Solar Unity Network, SUN DAY Campaign, Union of Concerned Scientists*

UNION OF
CONCERNED
SCIENTISTS

**Support the wind Production Tax Credit extension**
**H.R. 1401**

March 2, 1998

Dear Representative:

Attention: Tax aide

We understand that the House Ways and Means Committee may soon consider H.R. 1401, the wind energy Production Tax Credit (PTC) extension bill. **The Union of Concerned Scientists (UCS) urges you to support H.R. 1401, amended to include biomass as suggested below.**

The current PTC, enacted as part of the Energy Policy Act of 1992, provides a low-cost incentive for clean, renewable, domestic sources of energy. It grants a 1.5 cent per kilowatt-hour credit to wind plants in operation before June 30, 1999. The current PTC is no longer effective as a catalyst for further growth, however, since financing and permitting requirements for wind plants take two to three years. Furthermore, investment has slowed over the last several years due to the uncertainties surrounding electric utility restructuring. Just when needed most, the credit has lost its saliency. Therefore, to continue to support wise investments in wind, it is essential to pass H.R. 1401's five-year extension of the 1.5 cents/kWh credit. In addition, we urge that H.R. 1401 be amended to include biomass, for which the existing 1.5cent/kWh tax credit is also due to expire shortly, and which is equally deserving of support.

The benefits of investment in wind energy are clear: a reduction in air pollution and creation of new jobs. Currently, electric generation from fossil fuels produces about 70% of annual US sulfur dioxide emissions (a major contributor to acid rain and particulates), 30% of nitrogen oxides (interacts with sunlight to form smog), and more than one third of carbon dioxide, the leading greenhouse gas. As an indication of the job creation potential of wind, experts estimate that 157,000 jobs could be created if US wind equipment manufacturers are able to capture just 25% of the global wind equipment market over the next ten years. Likewise, the Department of Energy estimates that biomass could create 150,000 jobs by 2020, mainly in rural areas.

The Union of Concerned Scientists (UCS) is a national organization of scientists and citizens working together for a more sustainable economy and environment. We have been involved in energy policy research and advocacy for more than 20 years and have actively participated in electricity restructuring activities in more than a dozen states as well as at the federal level. For further information, contact me in Cambridge (617) 547-5552. You may also contact my colleagues in our Washington, DC office, Ron Sundergill or Lara Levison, (202) 332-0900.

Sincerely,

Paul Jefferiss
Energy Program Director

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## Statement of American Petroleum Institute

This testimony is submitted by the American Petroleum Institute (API) for the February 25, 1998 Ways and Means hearing on the tax provisions in the Administration's fy 1999 budget proposal. API represents approximately 300 companies involved in all aspects of the oil and gas industry, including exploration, production,

transportation, refining, and marketing. The U.S. oil and gas industry is the leader in exploring for and developing oil and gas reserves around the world.

Our testimony will address the following proposals:

- modify rules relating to foreign oil and gas extraction income;
- prescribe regulatory authority to address tax avoidance through use of hybrids;
- reinstate excise taxes and the corporate environmental tax deposited in the Hazardous Substance Superfund Trust Fund.
- reinstate the oil spill excise tax;
- provide tax credits to promote energy efficiency and alternative energy sources

## I. Modify Rules Relating to Foreign Oil and Gas Extraction Income

President Clinton's latest budget proposal includes some significant changes to the foreign tax credit (FTC) rules impacting companies with foreign oil and gas extraction income (FOGEI) as defined by Code Section 907(c)(1) and foreign oil related income (FORI) as defined by Code Section 907(c)(2). Specifically, the proposal includes the following provisions:

- In situations where taxpayers are subject to a foreign tax and also receive an economic benefit from the foreign country, taxpayers would only be able to claim a credit for such taxes under Code Section 901 if the country has a "generally applicable income tax" that has "substantial application" to all types of taxpayers, and then only up to the level of taxation that would be imposed under the generally applicable income tax.
- Effective for taxable years beginning after the bill's enactment, new rules would be provided for all foreign oil and gas income (FOGI). FOGI would be trapped in a new separate FOGI basket under Code Section 904(d). FOGI would be defined to include both FOGEI and FORI.
- Despite these changes, U.S. treaty obligations that allow a credit for taxes paid or accrued on FOGI would continue to take precedence over this legislation (e.g., the so-called "per country" limitation situations.)

### *A. Introduction and Trade Arguments*

This proposal, aimed directly at the foreign source income of U.S. petroleum companies, seriously threatens the ability of those companies to remain competitive on a global scale, and API strongly opposes the proposal. It is particularly troubling that the Administration would attack the foreign operations of U.S. oil companies in this way, especially when the proposal conflicts with the Administration's announced trade policy and with Commerce and State Department initiatives encouraging those same companies to participate in exploration and production ventures in strategic areas around the world.

The Administration has demonstrated an intention to subscribe to the integration of worldwide trade, with a continuing removal of trade barriers and promotion of international investment (e.g., the GATT and NAFTA agreements). Moreover, because of their political and strategic importance, foreign investments by U.S. oil companies have been welcomed by the U.S. government. For example, participation by U.S. oil companies in the development of the Tengiz oil field in Kazakhstan was praised as fostering the political independence of that newly formed nation, as well as securing new sources of oil to Western nations, which are still too heavily dependent on Middle Eastern imports. (See the April 28, 1996 Washington Post, at p. A–20).

This proposed additional tax burden, like other barriers to foreign investments by U.S. firms, are based on several flawed premises. For example, there is the perception that foreign investment by U.S. business is responsible for reduced investment and employment in the U.S. These investments are perceived to be made primarily in low wage countries at the expense of U.S. labor with such foreign investments also including a shift of research and development ("R&D") spending abroad. However, studies like the 1995 review by the Economic Strategy Institute (*Multinational Corporations and the U.S. Economy* [1995]) show these claims to be unfounded. Over a 20-year period, capital outflows from the U.S. averaged less than 1% of U.S. nonresidential fixed investment, which is hardly sufficient to account for any serious deterioration in U.S. economic growth. Instead, affiliate earnings and foreign loans, not U.S. equity, have financed the bulk of direct foreign investment.

Contrary to another perception, the principal reason for foreign investment is seldom cheap labor. Rather, the more common reasons are a search for new markets, quicker and easier response to local market requirements, elimination of tariff and transportation costs, faster generation of local good will, and other deep rooted host country policies. In this regard, the bulk of U.S. foreign investment is in Europe, where labor is expensive, rather than in Asia and Latin America, where wages are

low. According to one study, almost two-thirds of employment by foreign subsidiaries of U.S. companies was in Canada, Japan, and Europe, all higher wage areas (Sullivan, *From Lake Geneva to the Ganges; U.S. Multinational Employment Abroad*, 71 Tax Notes 539 [4/22/96]. Although some R&D functions have been moved abroad, they make up only 15% of domestic R&D, and are primarily in areas aimed at tailoring products to local demands.

In the case of natural resource extraction and production, the reason for foreign investment is obvious. If U.S. oil and gas concerns wish to stay in business, they must look overseas to replace their diminishing reserves, since the opportunity for domestic reserve replacement has been restricted by both federal and state government policy. A recent API study demonstrates that despite the fact that production outside the United States by U.S. companies increased by 300,000 barells/day over the 10 years 1985–1995, that was not enough to offset the declines in U.S. production, so that U.S. companies' total global production over that period actually declined. Over that same period, production by similar sized oil companies other than those from OPEC countries expanded nearly 60%. These recent supply trends need not be permanent features of the U.S. companies' future role. The opening of Russia to foreign capital, the competition for investment by the countries bordering the Caspian Sea, the privatization of energy in portions of Latin America, Asia, and Africa—all offer the potential for unprecedented opportunity in meeting the challenges of supplying fuel to a rapidly growing world economy. In each of these frontiers U.S. companies are poised to participate actively. However, if U.S. companies can not economically compete, foreign resources will instead be produced by foreign competitors, with little or no benefit to the U.S. economy, U.S. companies, or American workers.

The FTC principle of avoiding double taxation represents the foundation of U.S. taxation of foreign source income. The Administration's budget proposals would destroy this foundation on a selective basis for foreign oil and gas income only, in direct conflict with the U.S. trade policy of global integration, embraced by both Democratic and Republican Administrations.

*B. The FTC Is Intended To Prevent Double Taxation*

Since the beginning of Federal income taxation, the U.S. has taxed the worldwide income of U.S. citizens and residents, including U.S. corporations. To avoid double taxation, the FTC was introduced in 1918. Although the U.S. cedes primary taxing jurisdiction for foreign income to the source country, the FTC operates by preventing the same income from being taxed twice, once by the U.S. and once by the source country. The FTC is designed to allow a dollar for dollar offset against U.S. income taxes for taxes paid to foreign taxing jurisdictions. Under this regime, foreign income of foreign subsidiaries is not immediately subject to U.S. taxation. Instead, the underlying earnings become subject to U.S. tax only when the U.S. shareholder receives a dividend (except for certain "passive" or "Subpart F" income.) Any foreign taxes paid by the subsidiary on such earnings is deemed to have been paid by any U.S. shareholders owning at least 10% of the subsidiary, and can be claimed as FTCs against the U.S. tax on the foreign dividend income (the so-called "indirect foreign tax credit").

*C. Basic Rules of the FTC*

The FTC is intended to offset only U.S. tax on foreign source income. Thus, an overall limitation on currently usable FTCs is computed by taking the ratio of foreign source income to worldwide taxable income, and multiplying this by the tentative U.S. tax on worldwide income. The excess of FTCs can be carried back 2 years and carried forward 5 years, to be claimed as credits in those years within the same respective overall limitations.

The overall limitation is computed separately for various "separate limitation categories." Under present law, foreign oil and gas income falls into the general limitation category. Thus, for purposes of computing the overall limitation, FOGI is treated like any other foreign active business income. Separate special limitations still apply, however, for income: (1) whose foreign source can be easily changed; (2) which typically bears little or no foreign tax; or (3) which often bears a rate of foreign tax that is abnormally high or in excess of rates of other types of income. In these cases, a separate limitation is designed to prevent the use of foreign taxes imposed on one category to reduce U.S. tax on other categories of income.

*D. FTC Limitations For Oil And Gas Income*

Congress and the Treasury have already imposed significant limitations on the use of foreign tax credits attributable to foreign oil and gas operations. In response to the development of high tax rate regimes by OPEC, taxes on foreign oil and gas

income have become the subject of special limitations. For example, each year the amount of taxes on FOGEI may not exceed 35% (the U.S. corporate tax rate) of such income. Any excess may be carried over like excess FTCs under the overall limitation. FOGEI is income derived from the extraction of oil and gas, or from the sale or exchange of assets used in extraction activities.

In addition, the IRS has regulatory authority to determine that a foreign tax on FORI is not "creditable" to the extent that the foreign law imposing the tax is structured, or in fact operates, so that the tax that is generally imposed is materially greater than the amount of tax on income that is neither FORI or FOGEI. FORI is foreign source income from (1) processing oil and gas into primary products, (2) transporting oil and gas or their primary products, (3) distributing or selling such, or (4) disposing of assets used in the foregoing activities. Otherwise, the overall limitation (with its special categories discussed above) applies to FOGEI and FORI. Thus, as active business income, FOGEI and FORI would fall into the general limitation category.

*E. The Dual Capacity Taxpayer "Safe Harbor" Rule*

As distinguished from the rule in the U.S. and some Canadian provinces, mineral rights in other countries vest in the foreign sovereign, which then grants exploitation rights in various forms. This can be done either directly, or through a state owned enterprise (e.g., a license or a production sharing contract). Because the taxing sovereign is also the grantor of mineral rights, the high tax rates imposed on oil and gas profits have often been questioned as representing, in part, payment for the grant of "a specific economic benefit" from mineral exploitation rights. Thus, the dual nature of these payments to the sovereign have resulted in such taxpayers being referred to as "dual capacity taxpayers."

To help resolve controversies surrounding the nature of tax payments by dual capacity taxpayers, the Treasury Department in 1983 developed the "dual capacity taxpayer rules" of the FTC regulations. Under the facts and circumstances method of these regulations, the taxpayer must establish the amount of the intended tax payment that otherwise qualifies as an income tax payment but is not paid in return for a specific economic benefit. Any remainder is a deductible rather than creditable payment (and in the case of oil and gas producers, is considered a royalty). The regulations also include a safe harbor election (see Treas. Reg. 1.901–2A(e)(1)), whereby a formula is used to determine the tax portion of the payment to the foreign sovereign, which is basically the amount that the dual capacity taxpayer would pay under the foreign country's general income tax. Where there is no generally applicable income tax, the safe harbor rule of the regulation allows the use of the U.S. tax rate in a "splitting" computation (i.e., the U.S. tax rate is considered the country's generally applicable income tax rate).

*F. The Proposal Limits FTCs Of Dual Capacity Taxpayers To the Host Country's Generally Applicable Income Tax*

If a host country that had an income tax on FOGI (i.e., FOGEI or FORI), but no generally applicable income tax were to ignore the effect that its tax regime had on the new FTC position of U.S. companies, the proposal would result in disallowing any FTCs on FOGI. This would result in inequitable and destructive double taxation of dual capacity taxpayers, contrary to the global trade policy advocated by the U.S.

The additional U.S. tax on foreign investment in the petroleum industry would not only eliminate many new projects; it could also change the economics of past investments. In some cases, this would not only reduce the rate of return, but also preclude a return of the investment itself, leaving the U.S. business with an unexpected "legislated" loss. In addition, because of the uncertainties of the provision, it would also introduce more complexity and potential for litigation into the already muddled world of the FTC.

The unfairness of the provision becomes even more obvious if one considers the situation where a U.S. based oil company and a U.S. based company other than an oil company are subject to an income tax in a country without a generally applicable income tax. Under the proposal, only the U.S. oil company would receive no foreign tax credit, while the other taxpayer would be entitled to the full tax credit for the very same tax.

The proposal's concerns with the tax versus royalty distinction were resolved by Congress and the Treasury long ago with the special tax credit limitation on FOGEI enacted in 1975 and the Splitting Regulations of 1983. These were then later reinforced in the 1986 Act by the fragmentation of foreign source income into a host of categories or baskets. The earlier resolution of the tax versus royalty dilemma recognized that (1) if payments to a foreign sovereign meet the criteria of an income tax, they should not be denied complete creditability against U.S. income tax on the

underlying income; and (2) creditability of the perceived excessive tax payment is better controlled by reference to the U.S. tax burden, rather than being dependent on the foreign sovereign's fiscal choices.

*G. The Proposal Limits FTCs To The Amount Which Would Be Paid Under the Generally Applicable Income Tax*

By elevating the regulatory safe harbor to the exclusive statutory rule, the proposal eliminates a dual capacity taxpayer's right to show, based on facts and circumstances, which portion of its payment to the foreign government was not made in exchange for the conferral of specific economic benefits and, therefore, qualifies as a creditable tax. Moreover, by eliminating the "fall back" to the U.S. tax rate in the safe harbor computation where the host country has no generally applicable income tax, the proposal denies the creditability of true income taxes paid by dual capacity taxpayers under a "schedular" type of business income tax regime (i.e., regimes which tax only certain categories of income, according to particular "schedules"), merely because the foreign sovereign's fiscal policy does not include all types of business income.

For emerging economies of lesser developed countries, as for post-industrial nations, it is not realistic to always demand the existence of a generally applicable income tax. Even if the political willingness exists to have a generally applicable income tax, such may not be possible because the ability to design and administer a generally applicable income tax depends on the structure of the host country's economy. The available tax regimes are defined by the country's economic maturity, business structure and accounting sophistication. The most difficult problems arise in the field of business taxation. Oftentimes, the absence of reliable accounting books will only allow a primitive presumptive measure of profits. Under such circumstances the effective administration of a general income tax is impossible. All this is exacerbated by phenomena which are typical for less developed economies: a high degree of self-employment, the small size of establishments, and low taxpayer compliance and enforcement. In such situations, the income tax will have to be limited to mature businesses, along with the oil and gas extraction business.

*H. The Proposal Increases The Risk Of Double Taxation*

Adoption of the Administration's proposals would further tilt the playing field against overseas oil and gas operations by U.S. business, and increase the risk of double taxation of FOGI. This will severely hinder U.S. oil companies in their competition with foreign oil and gas concerns in the global oil and gas exploration, production, refining, and marketing arena, where the home countries of their foreign competition do not tax FOGI. This occurs where these countries either exempt foreign source income or have a foreign tax credit regime which truly prevents double taxation.

To illustrate, assume foreign country X offers licenses for oil and gas exploitation and also has an 85% tax on oil and gas extraction income. In competitive bidding, the license will be granted to the bidder which assumes exploration and development obligations most favorable to country X. Country X has no generally applicable income tax. Unless a U.S. company is assured that it will not be taxed again on its after-tax profit from country X, it very likely will not be able to compete with another foreign oil company for such a license because of the different after tax returns.

***EXAMPLE***

| | U.S. OWNED OIL COMPANIES | | FOREIGN COMPETITORS |
|---|---|---|---|
| **Host Country Taxation** | | | |
| Taxable profit | 100 | | 100 |
| Host Country Tax | -85 | | -85 |
| After Host Country Tax | 15 | | 15 |
| **Home Country Taxation** | | | |
| | US Law | | Foreign Competitor's Home Country Tax |
| | Present[1] | Proposed[2] | |
| Taxable Profit | 100 | 100 | Not applicable because foreign income is exempt from taxation if subject to tax in host country. |
| Foreign Tax deduction | None | -85 | |
| Taxable Income | 100 | 15 | |
| Tentative Tax (e.g., U.S. tax at 35%) | 35 | 5.25 | |
| FTC limited to US tax on foreign source income | -35 | N/A | |
| Home Country Tax payable | 0 | 5.25 | |
| **After Tax Profits** | | | |
| Profit before taxes | 100 | 100 | 100 |
| Tax to Host Country | -85 | -85 | -85 |
| Tax to Home Country | 0 | -5.25 | 0 |
| After Tax Profit | **15** | **9.75** | **15** |

[1] Applies to dual capacity and non-dual capacity taxpayers alike.
[2] For dual capacity taxpayers only

Because of the 35% additional U.S. tax, the U.S. company's after tax return will be more than one-third less than its foreign competitor's. Stated differently, if the foreign competitor is able to match the U.S. company's proficiency and effectiveness, the foreigner's return will be more than 50% greater than the U.S. company's return. This would surely harm the U.S. company in any competitive bidding. Only the continuing existence of the FTC, despite its many existing limitations, assures that there will be no further tilting of the playing field against U.S. companies' efforts in the global petroleum business.

*I. Separate Limitation Category For FOGI*

To install a separate FTC limitation category for FOGI would single out the active business income of oil companies and separate it from the general limitation category or basket. There is no legitimate reason to carve out FOGI from the general limitation category or basket. The source of FOGEI and FORI is difficult to manipulate. For example, FORI is generally derived from the country where the processing or marketing of oil occurs. Moreover, Treasury has recently issued regulations addressing this sourcing issue. Also, any FORI that is earned in consuming countries and treated like other business income is very likely taxed currently, before distribution, under the anti-avoidance rules for undistributed earnings of foreign subsidiaries.

*J. The FTC Proposals Are Bad Tax Policy*

Reduction of U.S. participation in foreign oil and gas development because of misguided tax provisions will adversely affect U.S. employment, and any additional tax burden may hinder U.S. companies in competition with foreign concerns. Although the host country resource will be developed, it will be done by foreign competition, with the adverse ripple effect of U.S. jobs losses and the loss of continuing evolution of U.S. technology. By contrast, foreign oil and gas development by U.S. companies increases utilization of U.S. supplies of hardware and technology. The loss of any major foreign project by a U.S. company will mean less employment in the U.S. by suppliers, and by the U.S. parent, in addition to fewer U.S. expatriates at foreign locations. Many of the jobs that support overseas operations of U.S. companies are located here in the United States—an estimated 350,000 according to analysts at Charles River Associates, a Cambridge, Massachusetts-based consulting firm. That figure consists of: 60,000 in jobs directly dependent on international operations of U.S. oil and gas companies; over 140,000 employed by U.S. suppliers to the oil and gas industry's foreign operations; and, an additional 150,000 employed in the U.S. supporting the 200,000 who work directly for the oil companies and their suppliers.

Thus, the questions to be answered are: Does the United States—for energy security and international trade reasons, among others—want a U.S. based petroleum industry to be competitive in the global quest for oil and gas reserves? If the answer is "yes," then why would the U.S. government adopt a tax policy that is punitive in nature and lessens the competitiveness of the U.S. petroleum industry? The U.S. tax system already makes it extremely difficult for U.S. multinationals to compete against foreign-based entities. This is in direct contrast to the tax systems of our foreign-based competitors, which actually encourage those companies to be more competitive in winning foreign projects. What we need from Congress are improvements in our system that allow U.S. companies to compete more effectively, not further impediments that make it even more difficult and in some cases impossible to succeed in today's global oil and gas business environment. These improvements should include, among others, the repeal of the plethora of separate FTC baskets, the extension of the FTC carryback/carryover period for foreign tax credits, and the repeal of section 907.

The Administration's fy 1998 budget included these same proposals which would have reduced the efficacy of the FTC for U.S. oil companies. Congress considered these proposals last year and rightfully rejected them. They should be rejected this year as well.

II. REGULATORY DIRECTIVE TO ADDRESS TAX AVOIDANCE THROUGH USE OF HYBRIDS.

A second fy 1999 budget proposal would adversely affect all U.S. multinationals' international operations. The Administration proposes that Congress grant the Treasury broad new regulatory authority to determine whether the tax consequences of cross border "hybrid transactions" are "appropriate" and "not inconsistent with the purposes of U.S. law." Treasury cites recently issued Notices 98–5 and 98–11 ("the Notices")—in which the IRS announced its intention to issue broad regulations that could significantly impact existing business arrangements' foreign tax credits and deferral—as examples of their use of the requested regulatory authority. The unfettered recognition of hybrid entities is essential to U.S. companies competing in foreign countries. Similarly, the utilization of foreign tax credits must not be subjected to new, unclear and confusing criteria. The Notices, along with the budget proposal, have already had a chilling effect on U.S. multinationals' ability to structure their foreign transactions in the ordinary course of business.

The proposal would give the Treasury broad new authority to propound legislative regulations without further Congressional consideration. In developing U.S. international tax policy, Congress has attempted to balance the competing goals of capital export neutrality and U.S. international competitiveness. Treasury appears to be preparing to change that balance. API recommends that Congress conduct a study of the trade and tax policy issues associated with Notices 98–5 and 98–11 and place a moratorium on further regulatory action by Treasury until specific legislative proposals are enacted.

III. REINSTATEMENT OF THE EXCISE TAXES AND THE CORPORATE ENVIRONMENTAL TAX DEPOSITED IN THE HAZARDOUS SUBSTANCE SUPERFUND TRUST FUND.

The Administration's proposal would reinstate the Superfund excise taxes on petroleum and certain listed chemicals as well as the Corporate Environmental Tax through October 1, 2008. API opposes imposition of any Superfund taxes without substantial reform of the underlying Superfund program and the tax system sup-

porting the fund. It is widely recognized that CERCLA is a broken program that requires major substantive and procedural changes. Furthermore, a restructured and improved CERCLA program can and should be funded through general revenues.

Superfund sites are a broad societal problem, and taxes raised to remediate these sites should be broadly based rather than focused on a few specific industries. EPA has found wastes from all types of businesses at most hazardous waste sites. As consumers, as residents of municipalities, and as residents and taxpayers of a nation, our entire economy benefited in the pre-1980 era from the lower cost of handling waste. To place responsibility for the additional costs resulting from retroactive CERCLA cleanup standards on the shoulders of a very few industries when previous economic benefits were widely shared is patently unfair.

Petroleum-related businesses are estimated to be responsible for less than 10 percent of the contamination at Superfund sites; yet these businesses have historically paid over 50 percent of the taxes that support the Trust Fund. This inequity is of paramount concern to our industry and should be rectified. Congress should first substantially reform the program and then should fund the program through general revenues or some other broad-based funding source.

## IV. Reinstatement of the Oil Spill Excise Tax.

The Administration proposes reinstating the five cents per barrel excise tax on domestic and imported crude oil dedicated to the Oil Spill Liability Trust Fund through October 1, 2008, and increasing the trust fund full funding limitation (the "cap") from $1 billion to $5 billion.

Collection of the Oil Spill Excise Tax was suspended for several months during 1994 because the Fund had exceeded its cap of $1 billion. It was subsequently allowed to expire December 31, 1994, because Congress perceived there was no need for additional taxes. Since that time, the balance in the Fund has remained above $1 billion, despite the fact that no additional tax has been collected. Clearly, the legislated purposes for the Fund have been accomplished without any need for additional revenues. The Administration's proposal to reinstate the tax and eliminate the fund cap is simply a poorly disguised effort to raise revenues to balance the budget. API opposes the proposal.

## V. Tax Credits to Promote Energy Efficiency and Alternative Energy Sources.

The Administration's budget includes a number of tax and spending proposals related to the Kyoto global climate agreement. API would welcome the opportunity to meet with them to discuss the costs and benefits of possible approaches for reducing greenhouse gas emissions. However, we believe it is premature to present formal tax proposals to begin implementing the Kyoto agreement before there has been a thorough and open debate on its implications and before it has been acted on by the U.S. Senate.

During the ratification process, the prioritization and implications of steps needed to reduce the growth in emissions can be clarified—and resulting governmental decisions can then be made after the views of all interested parties have been presented in public hearings. Any programs to expand research and development initiatives should maintain a level playing field for all energy sources and technology and should rely on market forces to bring new technology to consumers and business.

AMERICAN SKANDIA LIFE ASSURANCE CORPORATION
SHELTON, CONNECTICUT
*February 27, 1998*

The Honorable Congressman Bill Archer
Chairman
Committee on Ways and Means
C/O
A. L. Singleton
Chief of Staff
Committee on Ways and Means
*U.S. House of Representatives*
*1102 Longworth House Office Building*
*Washington, D.C. 20515*

Dear Congressman Archer:

We are writing on behalf of American Skandia Life Assurance Corporation ("American Skandia"). American Skandia, headquarted in Shelton Connecticut, is the 6th largest seller of variable annuities in the United States and has over 200,000 contract owners, with more than $12 billion in retirement annuities, who will be adversly impacted by the Administration's budget proposals. We currently employ over 650 people and have an obligation to our employees, our annuity sellers and, most of all, our annuity customers to vigorously oppose this recent unwarranted attack on our industry in specific, and long-term retirement savings in general.

The proposed changes to annuity taxation (deferred annuities, life insurance and immediate annuities would be affected) will directly harm the retirement plans of millions of Americans, including our 200,000 plus annuity contract owners. These proposals are not the product of well thought out public policy, but rather "quick fixes" to find small or illusory amounts of money at the expense of hard-working, honest people saving for retirement. Tax deferral, one of the important features provided by annuities, has proven to be a powerful incentive to middle class Americans to take more responsibility for their retirement through long-term savings.

It makes the most sense for us to focus our comments on the annuity proposals, so we will do so.

1. The revenue numbers expected from these changes are illusory. These proposals are designed to kill the deferred annuity industry in general and the variable annuity industry in particular. If passed, they will do just that. There are two key incentives Congress has provided for long-term savings that have been in place for decades—tax deferral and tax-free reallocation among funding vehicles. The Administration's budget proposals attack both.

The first part of the attack—reducing the tax basis of non-qualified annuities by an imputed insurance expense—will make the product economically uncompetitive against investments with the benefit of capital gains treatment and a stepped-up basis at death. This proposal is also an insult to both market forces and state regulation of insurance. Market forces have been driving down the expenses within variable annuities below the proposed 1.25% imputed cost. This proposal would eliminate any continued incentive to lower costs. It is also a heavy-handed attempt at Federal rate regulation of products that are regulated by the states. Lowering the cost basis of any investment product essentially converts after-tax capital into income or gain, once again taxable by the government. Under the Administration's current proposal, the longer the capital is set aside for retirement, the more it will be taxed again. This sort of double taxation, particularly of retirement savings, is a questionable approach to encouraging Americans to save.

The second part of the attack—taxing transfers between investment options within variable annuities, as well as exchanges between annuity products—destroys key values for savers. Insurers have gone to great lengths to provide an array of investment options, build systems support for asset allocation programs and teach the public about the wisdom of diversification among investment objectives, investment styles and investment managers. This type of diversification is prudent for persons in 401(k) plans, tax-sheltered annuities and IRAs and is equally smart for persons in tax-deferred annuities. All tax deferred programs provide value on this basis alone, since customers can engage in such diversification and risk reduction strategies without incurring taxes every time money is transferred between investment vehicles. Another key value for savers is the opportunity to change their providers.

Any provider of tax-deferred saving vehicle knows that if their performance or service is poor, the customer can go elsewhere without tax penalty. This puts strong pressure on us to perform well, consistently. We, as a company, have thrived on this pressure. It has forced innovation and a constant focus on improving service. This leverage versus big, sophisticated insurers, mutual funds, brokerage houses and banks is good for consumers. Why in the world should it be taken away in the context of variable annuities?

If this two pronged attack is successful, new variable annuity sales will stop, transfers and exchanges will not occur and the projected revenues will not come in. We as a country have learned the hard way that we need to "pay as we go" for the services we want from government. We do not need to go back to budgetary make-believe, spending revenues that will not really appear.

2. These tax proposals are a bad idea because long-term savings must be encouraged, not hampered, and because this proposal discriminates against many working people. Congress tightened up the tax rules for annuities four times in the 1980's. Those changes made annuities a good retirement savings vehicle for two main purposes: (a) supplemental long term savings over and above employer-sponsored plans; and (b) easy access to tax deferral over and above the IRA contribution limits for people who were never or are no longer employed by firms with retirement plans. The Administration's proposals would kill the product, so it could no longer serve these important purposes. We are particularly perturbed that with the impact of this proposal on working people once a working family gets the mortgage paid off and the kids through school. If a working family gets the mortgage paid off and the kids through school, the parents or parent now need to put away more than the inadequate $2,000 a year permitted in an IRA for retirement. They would not be able to get the benefit of tax deferral on that extra savings unless their employer provided a plan. Deferred annuities are an important savings vehicle for middle class Americans. These proposals are just plain unfair to the people who need this break the most.

The annuity business is threatened now by the cloud that has been created by these proposals. I hope the House Committee on Ways and Means will work to remove that cloud quickly, forcefully and sensibly. The annuity product is an excellent retirement savings tool for many Americans. The current tax rules assure that the annuity is not a tax dodge for the rich. It is an important long-term savings product for many middle-class Americans, especially those who are not covered by an employer sponsored retirement plan and need to use these products to save for their retirement. On behalf of American Skandia, we thank you for your consideration of our input on this very important matter.

Sincerely,

WADE DOKKEN
Deputy Chief Executive Officer
American Skandia Marketing, Inc.

GORDON C. BORONOW
Deputy Chief Executive Officer
American Skandia Life Assurance Corporation

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**Statement of Jaime Steve, Legislative Director, American Wind Energy Association**

The American Wind Energy Association,[1] or AWEA, respectfully submits this written testimony in support of a five-year extension of the existing 1.5 cent per kilowatt-hour production tax credit (PTC) for electricity produced using wind energy resources. An immediate extension of this provision is crucial if we are to see significant growth in the domestic wind energy industry. We are grateful for the opportunity to participate in the deliberations of the House Ways and Means Committee as it considers this important issue.

The Energy Policy Act of 1992 (EPAct) enacted the PTC as Section 45 of the Internal Revenue Code of 1986. The credit is phased out if the price of wind generated electricity is sufficiently high. In report language accompanying EPAct (H. Rpt. 102–

[1] The American Wind Energy Association, or AWEA, was formed in 1974 and has nearly 700 members from 48 states. AWEA represents virtually every facet of the wind energy industry, including turbine manufacturers, project developers, utilities, academicians, and interested individuals.

474, Part 6, p. 42), the Ways and Means Committee stated, "The Credit is intended to enhance the development of technology to utilize the specified renewable energy sources and to promote competition between renewable energy sources and conventional energy sources."

Since its inception, the PTC has supported wind energy development and production. In the 1980's, electricity generated with wind could cost as much as 25 cents/kilowatt-hour. Since then wind energy has reduced its cost by a remarkable 80% to the current levelized cost of between 4 and 5 cents per kilowatt hour.

The 1.5 cent/kilowatt-hour credit enables the industry to compete with other generating sources being sold at 3 cents/kilowatt-hour. The extension of the credit will enable the industry to continue to develop and improve its technology to drive costs down even further and provide Americans with significantly more clean, emissions-free electricity generation. Indeed, experts predict the cost of wind equipment alone can be reduced by another 40% from current levels, with an appropriate commitment of resources to research and development and from manufacturing economies of scale.

*Current Provision*: The Production Tax Credit (PTC) provides a 1.5 cents per kilowatt-hour credit (adjusted for inflation) for electricity produced from a facility placed in service after December 31, 1993 and before July 1, 1999 for the first ten years of the facility's existence. The credit is only available if the wind energy equipment is located in the United State and electricity is sold to an unrelated party. Under current law, the tax credit qualification date would expire on July 1, 1999. A five-year extension would create a new sunset date of July 1, 2004.

*Status*: A five-year extension of this provision—through July 1, 2004—was introduced in the House (H.R. 1401) by Rep. Bill Thomas (R–CA). H.R. 1401 has been cosponsored by Ways and Means Committee members Reps. Jim Nussle (R–IA), Jennifer Dunn (R–WA), Robert Matsui (D–CA), Jim McDermott (D–WA), John Lewis (D–GA) and Karen Thurman (D–FL).

As similar bill (S. 1459) has been introduced in the Senate by Senators Chuck Grassley (R–IA) and James M. Jeffords (R–VT) joined by Sens. Frank Murkowski (R–AK), Kent Conrad (D–ND) and Bob Kerrey (D–NE), all members of the Finance Committee. A five-year extension of the wind tax credit also is contained within the Clinton Administration's FY 1999 budget proposal. At present, H.R. 1401 has 20 co-sponsors and S. 1459 has 10 co-sponsors.

*Contributions of Wind Power*: Wind is a clean, renewable energy source which helps to protect public health, secure a cleaner environment, enhance America's national security through increased energy independence, and reduce pollution. In fact, reducing air pollutants in the United States will necessitate the promotion of clean, environmentally-friendly sources of renewable energy such as wind energy. Further, renewable energy technologies such as wind power should play an important role in a deregulated electrical generation market.

Wind power alone has the potential to generate power to provide the electric energy needs of as many as 10 million homes by the end of the next decade. The extension of the PTC will not only assure the continued availability of wind power as a clean energy option, but also it will help the wind energy industry secure its position in the restructured electricity market as a fully competitive, renewable source of electricity.

*Significant Economic Growth Potential of Wind Power*: The global wind energy market has been growing at a remarkable rate over the last several years and is the world's fastest growing energy technology. The growth of the market offers significant export opportunities for U.S. wind turbine and component manufacturers.

The World Energy Council has estimated that new wind capacity worldwide will amount to $150 to $400 billion worth of new business over the next twenty years. Experts estimate that as many as 157,000 new jobs could be created if U.S. wind energy equipment manufacturers are able to capture just 25% of the global wind equipment market over the next ten years. Only by supporting its domestic wind energy production through the extension of the PTC can the U.S. hope to develop the technology and capability to effectively compete in this rapidly growing international market.

*Finally, we must stress that the immediate extension of the PTC is critical to the continued development of the wind energy industry. Since the PTC is a production credit available only for energy actually produced from wind facilities, the credit is conditioned on permitting, financing and construction of the facilities. The financing and permitting requirements for a new wind facility often require two to three years of lead time. With the credit due, wind energy developers and investors are reluctant to commit to new projects without the assurance of the continued availability of the PTC. Moreover, if the credit is not extended this year, it is extremely unlikely that*

*Congress will be able to address an extension of the PTC before its expiration in 1999.*

The American Wind Energy Association appreciates the opportunity to submit written testimony on this matter. We stand ready to assist the Committee in any way regarding the five-year extension of the wind energy Production Tax Credit.

Thank you.

## Statement of Bond Market Association

The Bond Market Association is pleased to comment on several of the revenue-raising provisions in the Clinton Administration's FY 1999 budget. The Association's membership consists of securities firms and banks that underwrite, trade, and sell fixed-income securities in the U.S. and international markets, including nearly all dealers of municipal and corporate bonds. We take an active interest in tax policy issues that affect the ability of corporations and governments to raise capital to finance new investment. As such, we are pleased that the deficit has finally been eliminated, and we commend the leadership of Chairman Archer and other members of the committee in bringing about a balanced federal budget.

Eliminating the deficit has already borne economic fruit. Interest rates are at historic lows, due at least in part to a reduction in federal borrowing brought about by eliminating the deficit. Indeed, one of the most important benefits of balancing the budget is that it leads to lower interest rates and encourages more capital investment. We are dismayed and disappointed, however, that the administration has persisted in advocating tax increases which would have the opposite effect. Several tax increases in the administration's budget would raise capital costs for states, localities and corporations and discourage new capital investment.

In our testimony before this committee last year, we argued against several of the tax provisions which have been re-proposed by the administration. In addition, throughout 1996 and 1997, Congress heard from countless state and local officials, corporate CEOs, public interest groups, and others about the negative effect the administration's proposals would have on borrowing costs and new capital investment. In the end, Congress wisely rejected the administration's tax increases which were targeted at capital investment. Indeed, even the administration itself has retreated from some of the proposed tax increases aimed at capital investment by corporations. However, other proposals are back, along with a new proposed tax increase which would have a particularly negative effect on state and local government borrowing. Since we have repeatedly commented on older administration proposals, our comments today will focus primarily on new aspects of the revenue provisions, although we will also discuss the others. We urge this committee and the entire Congress to once again reject these ill-conceived tax increases.

The proposals we oppose, as described in the "Summary of Tax Provisions in President Clinton's FY 1999 Budget" prepared by the Ways and Means Committee staff, include:

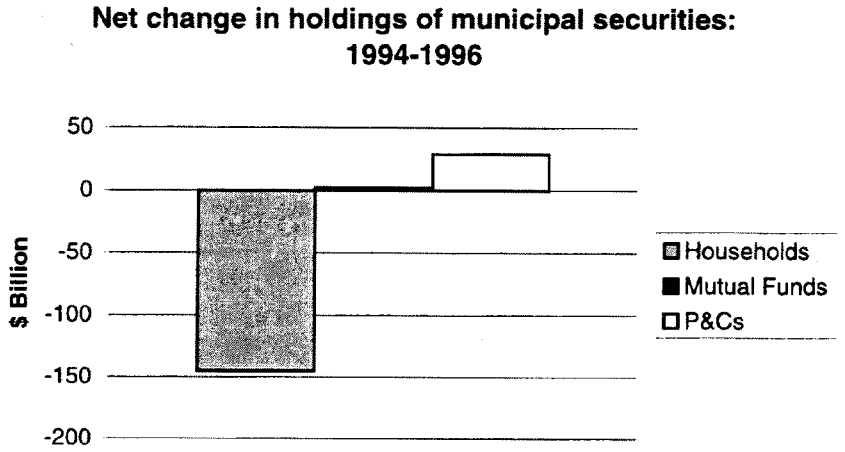
- Increase proration percentage for property and casualty companies.
- Extend pro rata disallowance of tax-exempt interest expense to financial intermediaries.
- Defer original issue discount on convertible debt.
- Deny DRD for preferred stock with certain non-stock characteristics.

### INCREASE PRORATION PERCENTAGE FOR PROPERTY AND CASUALTY COMPANIES

The administration's proposal to increase the proration percentage for property and casualty companies appears to be targeted at the insurance industry. In reality, however, a significant portion of the new tax would be borne by states and localities in the form of higher borrowing costs.

The three largest groups of investors in the tax-exempt bond market, together accounting for over 90 percent of outstanding bonds, are households, mutual funds and property and casualty insurance companies (P&Cs). As of September 30, 1997, P&Cs held approximately $180 billion in municipal securities, or about 14 percent of outstanding tax-exempt bonds. That significant figure belies their true influence in the municipal market, however. In the years 1994 through 1996, households decreased their holdings of municipal bonds by $145 billion. Mutual fund holdings increased by $2 billion. Over the same period of time, net new investment in municipal securities by P&Cs increased by $29 billion. Indeed, over the past several years, P&Cs have been the only major source of new demand for state and local govern-

ment bonds. If not for P&C participation in the municipal market, interest rates faced by states and localities would be significantly higher than they are today.




P&Cs are particularly important in certain sectors of the municipal market. They tend to invest in medium- to long-term municipals of relatively high credit quality with maturities of 12–20 years. These bonds are issued for a variety of purposes, from financing new public school construction to building roads, bridges, water and sewer systems, airports and a variety of other traditional government uses. In many cases, substantial portions of new municipal bond issues are sold to P&Cs. They often represent the primary factor in determining the pricing of new issues. Between 1991 and 1997, P&Cs went from holding 10 percent of all outstanding municipal securities to 14 percent. A table outlining P&C holdings of municipal bonds by state of the issuer is included as an appendix to this statement.

For most investors, interest earned on state and local government bonds is exempt from federal income taxation, but that is not entirely so for P&Cs. A P&C is permitted a deduction for contributions to its reserves for losses. That deduction is reduced by an amount equal to 15 percent of its "proration" income, which includes tax-exempt bond interest, the deductible portion of dividends earned, and tax-exempt or tax-deferred income from certain life insurance products. The application of the deduction disallowance is in effect a 5.25 percent tax on the P&C's "tax-exempt" interest income (15 percent disallowance multiplied by a 35 percent marginal tax rate), known as a "haircut." In addition, 100 percent of "private-activity" bond interest and 75 percent of other municipal bond interest earned by P&Cs is subject to the corporate alternative minimum tax (AMT). For AMT payers, then, non-private-activity municipal bond interest is subject to a 15.75 percent tax (75 percent times the 20 percent AMT rate plus the effect of the "haircut").

The administration has proposed raising the loss reserve deduction disallowance from 15 percent of proration income to 30 percent, thereby doubling the tax rate P&Cs pay on municipal bond interest from 5.25 percent to 10.5 percent. Under current market conditions, interest rates on tax-exempt securities would not be sufficient to continue to attract P&Cs to the municipal market. Unfortunately, in the market sectors where P&Cs are most active, there are few other ready buyers at current interest rates. It is likely that if the administration's proposal were enacted, once municipal bond yields rose to fully reflect the proposal's effects, P&Cs would remain active as municipal market investors. However, interest rates paid by state and local governments on their borrowing would be higher than if the proposal had not been enacted. P&Cs will simply be compensated for their additional tax liability through higher returns on their municipal bond portfolios. The effect for state and local governments would be higher borrowing costs. An analysis by one member firm suggests that municipal borrowing costs would increase by 10–15 basis points (0.10–0.15 percentage point) as a result of this proposal. Implicitly, approximately 40–60 percent—perhaps up to 75 percent—of the tax would be borne not by P&Cs but by state and local governments in the form of higher borrowing costs.

On a typical $200 million tax-exempt bond issue with an average maturity of 15 years, the administration's proposal would cost the state or local issuer $2–3 million in additional interest expense in present value terms over the life of the issue. If

the administration's proposal had been in place when the approximately $207 billion in tax-exempt securities were issued in 1997, it would have cost state and local governments $2–3 billion in additional interest expense over the life of their issues, assuming an average maturity of 15 years. This additional cost would have been related to just one year of borrowing.

The administration has offered little justification for its proposal. The arguments in the Treasury Department's "Green Book"[1] assert only that current law "still enables property and casualty insurance companies to fund a substantial portion of their deductible reserves with tax-exempt or tax-deferred income." The administration's answer, however, simply raising the tax on municipal bond interest earned by P&Cs, is an inappropriate response. First, there is no direct connection between contributions to loss reserves and the amount of municipal bond interest earned. Second, a deduction disallowance of 30 percent, as the administration proposes, is an unjustified, arbitrary figure. Third, as already stated, a substantial portion of this tax would be borne not by P&Cs but by state and local governments.

We urge the committee to consider the negative effects this proposal would have on states and localities and to reject the provision.

### EXTEND PRO RATA DISALLOWANCE OF TAX-EXEMPT INTEREST EXPENSE TO FINANCIAL INTERMEDIARIES

Another proposed tax increase in the administration's budget, while it would nominally apply to corporations, would again in reality be borne by state and local governments in the form of higher financing costs. Rather than closing a "tax loophole" for corporations, the proposal would make it more expensive for state and local governments to finance vital public services. Taken together with the provision related to P&Cs, these two proposals represent a significant attack on the ability of states and localities to finance new investment at the lowest possible cost.

Under current law, investors, including corporations, are not permitted to deduct the interest expense associated with borrowing to finance purchases of tax-exempt securities. Financial institutions that earn non-qualified tax-exempt interest are automatically disallowed a portion of their interest expense deduction in proportion to the ratio of municipal bond holdings to total assets. Securities firms are generally bound to the same rules as banks. However, securities firms are not required to apply the pro rata disallowance to interest expense which is explicitly traceable to activities other than buying or holding municipal bonds. Non-bank corporations that earn tax-exempt interest, in order to avoid a loss of interest-expense deduction, must demonstrate that they did not borrow to finance their purchases. Under an IRS procedure in place since 1972, as long as a corporation's tax-exempt bond portfolio does not exceed two percent of its total assets, the IRS does not attempt to determine whether the corporation borrowed to finance its municipal bond holdings.[2] This is the so-called "two-percent de minimis rule." The administration's proposal would effectively repeal this safe harbor for "financial intermediaries" and apply to them the same rules that now apply to banks.

This provision is similar to one proposed by the administration in last year's budget request. Last year's pro rata disallowance proposal would have applied to non-bank corporations generally, while this year's version is limited to financial intermediaries. Although the term "financial intermediaries" has yet to be formally defined, it is likely to include securities firms, finance companies and certain government-sponsored corporations, among others. The proposal would have three distinct effects on municipal market participants.

*Securities firms' activities*

Securities firms borrow in a very unique way. Securities firms, including the securities subsidiaries of commercial bank holding companies, carry large positions in a variety of securities for various lengths of time. For large firms, the value of these positions is often in the tens of billions of dollars. No firm is able to finance such large positions from its own capital, so all securities firms borrow to finance their holdings. In most cases, this borrowing is secured by the securities being held by the firm. This activity is related to securities firms' unique role as "market-makers." In order to be prepared to buy or sell securities from or to customers at any time, firms must be able to efficiently finance their positions.

For example, in a typical transaction, a securities firm may buy U.S. Treasury bonds from a customer. Unless the firm is able to immediately resell the securities

[1] Department of the Treasury, General Explanations of the Administration's Revenue Proposals, February 1998, page 113

[2] Internal Revenue Service, Revenue Procedure 72–18.

to another customer, it must finance its position. For government securities, this is most often accomplished through repurchase agreements, essentially a form of secured borrowing.[3] Because the interest paid on a repurchase agreement is directly traceable to financing the firm's position in Treasury securities, the interest is not subject to the pro rata deduction disallowance that applies to all general, non-traceable interest of the firm. The justification for this treatment is that the interest expense which is traceable to some specific activity other than buying or holding municipal securities should not be subject to a rule designed to prevent interest deductions for borrowing to finance tax-exempt assets. The same reasoning applies with respect to other traceable interest expense, such as interest paid on margin loans. Indeed, given the unique nature of securities firms' borrowing in many cases, a great deal of interest expense is traceable and hence not subject to the pro rata disallowance.

The administration's proposal would change the way in which the pro rata disallowance is applied to securities firms by applying it to all interest expense, even that which is directly traceable to activities other than buying municipal securities. In doing so, the proposal would significantly increase the cost for securities firms of financing positions in tax-exempt securities—firms' "cost of carry" for municipal bonds—since under the proposal, tax-exempt bonds held by a securities dealer would trigger a much larger interest expense disallowance than under current law. Because securities firms are highly leveraged companies, i.e., they have a very high ratio of debt to total capitalization, they would be hard-hit by the proposal. Estimates of the effects of the proposal on dealer's costs of carrying municipal bonds in inventory range from 40 basis points (0.4 percentage point) to well over a percentage point, depending on the amount of a dealer's interest which under current law is traceable and not subject to the pro rata disallowance.

Because the administration's proposal would raise a dealer's cost of carry for municipal bond inventories, there would be inevitable consequences for state and local bond issuers and investors. Much of the increased cost associated with acting as a market-maker in the municipal market would be reflected in higher costs of dealer services. For example, securities firms that underwrite new issues of municipal securities often carry the bonds in inventory for a period of time. The administration's proposal would increase the cost associated with that activity. These costs would likely be reflected in higher fees paid by states and localities for underwriting services. The proposal would increase costs for dealers of buying bonds in the secondary municipal market, where bonds are bought and sold after they are initially placed with investors, and could affect market liquidity. These effects would be particularly profound in the market for shorter term municipal bonds, where dealers already face a negative cost of carry and where dealers are particularly important in providing liquidity under certain market conditions. Individual investors would likely face higher transaction costs associated with buying and selling securities. In short, a significant portion of the new tax imposed on municipal securities dealers would ultimately be borne by state and local governments and municipal market investors.

*Housing and student loan bonds*

The housing and student loan sectors of the municipal market would also be negatively affected by the administration's proposal. State and local governments issue bonds to finance home mortgage loans for low- and moderate-income families as well as loans for low-income, multi-family rental projects. Both these programs provide limited, targeted, below-market financing for housing. Over the past several decades, state and local housing bonds have provided tens of billions of dollars in rental housing for low-income families and have made home ownership available to families who may not have been able to finance a home through any other source. Student loan bonds are issued to finance below-market loans to college students who may not otherwise be able to obtain tuition financing.

Together, Fannie Mae, Freddie Mac, Sallie Mae and other government-sponsored corporations and agencies hold about $9 billion of outstanding municipals. These entities invest primarily in state and local housing bonds (Fannie Mae and Freddie Mac) and student loan bonds (Sallie Mae). Indeed, it is a condition of Fannie Mae's and Freddie Mac's statutory charters that they help support the market for low- and middle-income housing, and investing in state and local housing bonds is one of the ways in which these agencies carry out that obligation. Under the administration's

[3] Technically, a repurchase agreement is not a loan but a contract to sell a security and to subsequently repurchase it in the future at a price agreed upon at the time the contract is executed. The difference between the sale and purchase price is the interest paid by the "borrower" to the "lender." Repurchase agreements are recognized as a form of secured lending for virtually all tax purposes.

proposal, these organizations would simply stop buying municipals. As a result, the cost of mortgage financing provided through state and local governments would increase substantially.

*Municipal leasing transactions*

The proposal would also have profound effects on municipal leasing. States and localities routinely lease assets and equipment, such as school buses, police cars, and computers. If the administration's proposal were adopted, equipment lessors estimate that their cost of financing for state and local governments would increase dramatically. After originating municipal lease transactions, most lessors generally sell their financing contracts to private funding sources to generate the capital they need to continue to operate their business. Those who invest in tax-exempt leasing include corporations, commercial banks and investment banks. Individuals and mutual funds, through certificates of participation, also purchase tax-exempt leases. Although last year's version of the administration's proposal would not have applied "to certain non-salable tax-exempt bonds acquired by a corporation in the ordinary course of business in payment for goods and services sold to a state or local government," this intended relief was illusory. The vast majority of equipment manufacturers who sell to state and local governments prefer not to hold municipal leases because they do not want to tie up their capital. These companies generally sell their financing contracts to third party investors. The administration's proposal would discourage vendor financing of capital equipment leased to states and localities. As a direct result, the cost of new capital investment by state and local governments would rise substantially.

Because the new taxes imposed by the proposal would be borne to a significant degree by states and localities, we urge that the proposal be rejected.

DEFER ORIGINAL ISSUE DISCOUNT ON CONVERTIBLE DEBT

The administration has proposed to change the tax treatment of original issue discount (OID) on convertible debt securities. OID occurs when the stated coupon of a debt instrument is below the yield demanded by investors. The most common case is a zero-coupon bond, where all the interest income earned by investors is in the form of accrued OID. Under current law, corporations that issue debt with OID may deduct the interest accrual while bonds are outstanding. In addition, taxable OID investors must recognize the accrual of OID as interest income. Under the administration's proposal, for OID instruments which are convertible to stock, issuers would be required to defer their deduction for accrued OID until payment was made to investors in cash. For convertible OID debt where the conversion option is exercised and the debt is paid in stock, issuers would lose the accrued OID deduction altogether. Investors would still be required to recognize the accrual of OID on convertible debt as interest income, regardless of whether issuers took deductions.

The administration's proposal is objectionable on several grounds. First, convertible zero-coupon debt has efficiently provided corporations with billions of dollars in capital financing. The change the administration proposes would significantly raise the cost of issuing convertible zero-coupon bonds, and in doing so would discourage corporate capital investment. Second, the administration's presumptions for the proposal are flawed. The administration has argued that "the issuance of convertible debt instrument[s] is viewed by market participants as a de facto issuance of equity."[4] However, performance does not bear out this claim. In fact, of the convertible zero-coupon debt retired since 1985, approximately 70 percent has been retired in cash, and only 30 percent has been converted to stock. Indeed, the market treats convertible zero-coupon bonds more as debt than as equity.

Third, and perhaps most important, the administration's proposal violates the basic tenet of tax symmetry, the notion that the recognition of income by one party should be associated with a deduction by a counterparty. This fundamental principle exists to help ensure that income is taxed only once. Under the proposal, investors would be taxed fully on the accrual of OID on convertible zero-coupon debt, but issuers' deductions would be deferred or denied. The proposal would compound problems associated with the multiple taxation of investment income, thereby raising the cost of corporate capital.

Because the proposal would exacerbate problems of multiple taxation of corporate income and because it would raise the cost of corporate capital investment, we urge the rejection of the administration's proposal.

[4] Department of the Treasury, page 97.

DENY DRD FOR PREFERRED STOCK WITH CERTAIN NON-STOCK CHARACTERISTICS

Under current law, corporate taxpayers that earn dividends on investments in other corporations are permitted a tax deduction equal to at least 70 percent of those earnings. The deduction is designed to mitigate the negative economic effects associated with multiple taxation of corporate earnings. The administration has proposed eliminating the dividends-received deduction (DRD) for preferred stock with certain characteristics. This proposal would increase the taxation of corporate earnings and discourage capital investment.

The DRD is important because it reduces the effects of multiple taxation of corporate earnings. When dividends are paid to a taxable person or entity, those funds are taxed twice, once at the corporate level and once at the level of the taxpayer to whom the dividends are paid. These multiple levels of taxation raise financing costs for corporations, create global competitiveness problems, and generally reduce incentives for capital formation. The DRD was specifically designed to reduce the burden of one layer of taxation by making dividends largely non-taxable to the corporate owner.

The administration has argued that certain types of preferred stock, such as variable-rate and auction-set preferred, "economically perform as debt instruments and have debt-like characteristics."[5] However, the administration has not proposed that such instruments be formally characterized as debt eligible for interest payment and accrual deductions. The administration has sought to characterize certain preferred stock in such a way as to maximize tax revenue; it would be ineligible for both the DRD and the interest expense deduction.

Eliminating the DRD for these instruments would exacerbate the effects of multiple taxation. The change would be tantamount to a tax increase on corporate earnings since the minimum deduction available to certain investors would fall. This tax increase would flow directly to issuers of preferred stock affected by the proposal who would face higher financing costs as investors demanded higher pre-tax yields. Amplifying the competitive disadvantages of multiple taxation of American corporate earnings would be the fact that many of our largest economic competitors have already adopted tax systems under which inter-corporate dividends are largely or completely untaxed. Eliminating the DRD for preferred stock with certain characteristics would cut U.S. corporations off from an efficient source of financing, thereby discouraging capital investment.

SUMMARY

Government fiscal policy, especially tax policy, can have a profound effect on the ability of governments and corporations to undertake capital investment. Tax proposals as seemingly arcane, technical and focused as "increasing the proration percentage for property and casualty companies" or "extending the pro rata interest expense disallowance to financial intermediaries" would have effects far beyond what is apparent. By affecting the choices and preferences of investors, these proposals would also have a significant negative effect on the ability of borrowers to finance capital investments at the lowest possible cost. We share the belief of many members of this committee that our tax system ought to encourage and facilitate capital investment. The administration's proposals outlined above would have the opposite effect. We urge you to oppose these provisions.

We appreciate the opportunity to present our statement, and we look forward to working with Ways and Means members and staff as the budget debate progresses.

[5] Ibid., page 99

## Appendix

Municipal Holdings of U.S. Property & Casualty Insurance Companies By State of Issuer As of September 30, 1997

| State | ($000s) | State | ($000s) |
|---|---|---|---|
| Alabama | 2,059,021 | Nebraska | 1,126,823 |
| Alaska | 1,306,692 | Nevada | 2,939,837 |
| Arizona | 4,446,074 | New Hampshire | 674,534 |
| Arkansas | 432,179 | New Jersey | 4,495,815 |
| California | 10,349,389 | New Mexico | 951,091 |
| Colorado | 3,323,768 | New York | 10,633,565 |
| Connecticut | 3,538,421 | North Carolina | 2,532,793 |
| Delaware | 784,556 | North Dakota | 346,563 |
| District of Columbia | 839,432 | Ohio | 4,190,349 |
| Florida | 9,657,937 | Oklahoma | 1,157,219 |
| Georgia | 5,804,654 | Oregon | 1,493,789 |
| Hawaii | 2,016,090 | Pennsylvania | 6,585,177 |
| Idaho | 336,904 | Puerto Rico | 754,917 |
| Illinois | 11,641,432 | Rhode Island | 950,926 |
| Iowa | 4,333,908 | South Carolina | 2,200,217 |
| Kansas | 787,849 | South Dakota | 752,454 |
| Kentucky | 1,250,188 | Tennessee | 2,594,871 |
| Louisiana | 2,108,269 | Texas | 23,244,490 |
| Maine | 2,291,331 | Utah | 2,910,860 |
| Maryland | 653,460 | Vermont | 293,421 |
| Massachusetts | 3,699,884 | Virginia | 4,709,072 |
| Michigan | 6,085,316 | Washington | 9,888,956 |
| Minnesota | 5,187,175 | West Virginia | 953,235 |
| Mississippi | 3,080,033 | Wisconsin | 4,568,021 |
| Missouri | 1,243,470 | Wyoming | 433,659 |
| Montana | 1,534,822 | Total | 180,405,996 |

## Statement of Business Insurance Coalition

### Business Insurance Coalition Members

AIG Life Companies (U.S.)
American Council of Life Insurance
American General Corporation
America's Community Bankers
Association for Advanced Life Underwriting
Clarke/Bardes, Inc.
Great West Life and Annuity Insurance Company
Harris, Crouch, Long, Scott, Miller Inc.
The Hartford Financial Services Group
Massachusetts Mutual Life Insurance Company
MetLife
The Mutual of Omaha Companies
National Association of Life Underwriters
National Institute for Community Banking
New York Life Insurance Company
The Newport Group
Pacific Life
Schoenke & Associates
Zurich Centre Group LLC

The Business Insurance Coalition, which is comprised of the above-listed purchasers, issuers, and sellers of business-use life insurance, submits this statement opposing the Administration's FY'99 budget proposal to impose new taxes on businesses that own or benefit from permanent life insurance.

American businesses, large and small, have for many decades used life insurance to assure business continuation, provide employee benefits and attract and retain key employees. There is no justification for discouraging or eliminating these traditional business uses of life insurance, and we urge Members of the Ways and Means Committee to reject the Administration's efforts to impose a tax penalty that would strongly discourage the vast majority of employers from utilizing this important product.

## LIFE INSURANCE ALLOWS BUSINESS CONTINUATION, PROTECTS EMPLOYEES AND FUNDS VITAL EMPLOYEE BENEFIT PROGRAMS

Permanent life insurance protects businesses against the economic losses which could occur after the death of an owner or employee. Life insurance death benefits provide liquid cash to pay estate taxes when a business owner dies, to buy out heirs of a deceased owner or to meet payroll and other ongoing expenses when an income-producing worker dies, terminates or retires.

Permanent life insurance purchased with after-tax dollars smoothes the transition during difficult times, allowing the business—and its employees—to continue working by preventing or mitigating losses associated with these disruptions. Anecdotal evidence of this abounds; every Representative and Senator will hear from constituents whose jobs still exist because their employers were protected from financial loss by life insurance.

Many businesses, both large and small, also use permanent life insurance to finance employee benefit programs, thus enabling them to attract and retain their most important asset: skilled, experienced employees. Insurance-financed benefit programs are as diverse as the companies that use them, ranging from those which provide broad-based health coverage for retirees to individual split-dollar arrangements to non-qualified pensions and savings benefits.

## THE PROPOSAL REVERSES RECENT CONGRESSIONAL ACTION BY IMPOSING NEW TAXES ON BUSINESS-USE LIFE INSURANCE

The Administration's FY'99 budget proposal would severely impact all of the aforementioned business uses of life insurance. Under the proposal, any business with any debt whatsoever would be forced to reduce its deduction for interest paid on that debt by an amount in relation to the net unborrowed cash values in policies owned by, or for the benefit of, the business, unless the policy was on the life of a 20 percent owner. This would impose an indirect tax on accumulating cash values—as unborrowed cash values increase, the business' interest deduction disallowance would correspondingly increase.

The Administration proposal would repeal specific exceptions to a 1997 rule enacted by Congress which generally disallows a portion of a business' deduction for interest paid on unrelated borrowing where the business directly or indirectly benefits from insurance covering the lives of anyone but an employee, officer, director or 20 percent or greater owner. The pending proposal would remove all exceptions except that applicable to 20 percent owners.

In addition, the proposal apparently would repeal the 1996 rule that allows a limited interest deduction for interest paid on loans against the life insurance policy itself when that policy covers a key employee.

The Administration proposal therefore seeks to overturn current law, which was developed after two years of Congressional examination into appropriate business uses of life insurance. It asks Congress to reconsider its August 1997 determination that there is no inappropriate interrelationship between owning (or benefiting from) life insurance on employees, officers and directors and general, unrelated borrowing decisions. More broadly, the proposal seeks to repeal long-standing tax policy which confers on corporations the right to enjoy the same important insurance tax benefits that are available to individuals.

## THE ADMINISTRATION PROPOSAL WOULD SEVERELY IMPACT BUSINESSES THAT RELY ON LIFE INSURANCE

Enactment of the Administration proposal would make it significantly—in most cases, prohibitively—more expensive for businesses to own permanent life insurance. This would increase the number of inadequately protected businesses, which would, in turn, cause more businesses to fail when their owners and/or key workers die (a result directly at odds with the effort to save family-owned businesses as ongoing entities in the estate tax debate).

The Administration proposal also would stifle business expansion and job creation by placing a completely arbitrary tax on normal corporate indebtedness of companies that own life insurance. The net effect would be to increase the cost of business expansion and discourage business growth, which is both bad economic and tax policy.

If enacted, the Administration proposal also would make it more difficult, perhaps impossible, for many businesses to use life insurance to finance broad-based employee and retiree benefits. It would lower the level of retirement income benefit provided by companies to key workers. It would make it more difficult for businesses to attract and retain quality employees.

Finally, the Administration proposal would impose a double tax penalty on certain business policyholders forced to surrender or sell their life insurance policies. The first tax penalty would be paid through reduced interest deductions on the business' unrelated borrowing. The second tax penalty would occur upon surrender of the policy, when the business would again be required to pay tax on the gain generated inside the policy. Plainly, there is no justification for imposing two taxes (a proration tax and a tax on policy surrender) with respect to the same item of income (life insurance inside build-up).

### THE ADMINISTRATION'S "ARBITRAGE" JUSTIFICATION IS WITHOUT MERIT

The Administration asserts that tax legislation is needed to prohibit "arbitrage" with respect to cash value life insurance. This is not the case. Current law (IRC section 264) disallows the deduction of interest on "policy indebtedness" and has always applied to direct borrowing (policy loans) and indirect borrowing (third party debt) where the debt is traceable to the decision to "purchase or carry" life insurance.

What remains outside of section 264, then, is solely debt that is unrelated to a business' decision to "purchase or carry" life insurance, such as a manufacturer's mortgage to purchase a new plant or a travel agency's loan to buy a new copy machine. Under the Administration's proposal, these businesses would be penalized for protecting themselves against the premature death of key persons or funding retiree health benefits through life insurance, even if they have neither borrowed funds to purchase the policies nor taken out loans against the policies.

Current tax law is designed to capture situations involving arbitrage with respect to cash value life insurance. The Administration's attempt to characterize any form of debt as leverage which renders a business' purchase of life insurance tax "arbitrage" is nothing but smoke and mirrors designed to hide its true purpose: the imposition of new taxes on business-use life insurance.

### TAX POLICY SHOULD ENCOURAGE APPROPRIATE BUSINESS-USE LIFE INSURANCE PROGRAMS

At the heart of the debate over the Administration's proposal is the issue of whether business uses of life insurance should be encouraged or discouraged. The Business Insurance Coalition fundamentally disagrees with the Administration's position, which threatens all present and future uses of life insurance by businesses, and its members firmly believe that business-use life insurance falls clearly within the policy purposes supporting the tax benefits presently accorded to life insurance products.

Tax policy applicable to business-use life insurance should encourage appropriate use of business life insurance by embodying the following principles:

- Businesses, in their use of life insurance, should have the benefit of consistent tax laws in order to facilitate reliable and effective long-range planning.
- All businesses, regardless of size or structure, should be able to use life insurance to provide benefits for their workers. Life insurance is an appropriate method of facilitating provision of retirement income, medical and survivorship benefits.
- Businesses must be able to use life insurance as an important part of their financial protection plans, and the insurance industry should respond to new business needs.
- Businesses, like individuals, should be able to use all products which qualify as life insurance under applicable federal and state law.
- Businesses should use life insurance products in ways consistent with the public interest and the intent of the tax laws.
- Businesses should be able to use life insurance to protect against the financial loss of the insured's death, or to meet other financial needs or objectives, including but not limited to:

—successful continuation of business operations following the death of an insured key employee;

—purchase of a business interest, thereby enabling the insured's family to obtain a fair value for its business interest and permitting the orderly continuation of the business by new owners;

—redemption of stock to satisfy estate taxes and transfer costs of an insured stockholder's estate;

—creation of funds to facilitate benefits programs for long-term current and retired employees, such as programs addressing needs for retirement income, post-retirement medical benefits, disability income, long-term care, or similar needs; and

—payment of life insurance or survivor benefits to families or other beneficiaries of insured employees.

• Employers should be able to facilitate employee ownership of and benefit from permanent life insurance death and retirement income protection through split dollar insurance arrangements.

BUSINESSES NEED RELIABLE AND PREDICTABLE TAX RULES TO GUIDE THEIR FINANCIAL DECISIONS

Life insurance is a long-term commitment. It spreads its protection—and premium obligations—over life spans, often 40 or 50 years. Its value base is predicated on the lifetime income-producing potential of the person insured. Thus, the process of selecting, using and paying for permanent insurance is one that contemplates decades of financial planning implications.

Accordingly, the rules governing the choices inherent in constructing a business-use life insurance program must be clear and reliable. Certainty of rules that drive the configuration of decades-long financial commitments is crucial. There must be a stable environment that acknowledges long-established practices.

This need is even more acute today because of the Congressional actions of 1996 and 1997, which created a virtual "road map" for businesses to follow in designing and implementing their business-use life insurance programs. The two years of debate addressed business-use life insurance practices in substantial detail, settling all of the issues raised by the pending Administration proposal. Thus, businesses reasonably thought they could proceed with some certainty under the rules enacted in 1996 and then further refined in 1997. To reopen these issues—which were addressed and settled just six months ago—and then to change them would be unconscionably unfair.

CONCLUSION: THE ADMINISTRATION'S BUSINESS-USE LIFE INSURANCE PROPOSAL UNFAIRLY AND ADVERSELY AFFECTS EVERY BUSINESS WITH CURRENT OR FUTURE DEBT

The Business Insurance Coalition strongly opposes the Administration's FY'99 budget proposal on business-use life insurance, which unfairly and adversely affects every business that has current or future debt unrelated to its ownership of life insurance. The Business Insurance Coalition has demonstrated the appropriateness of the current rules governing business-use life insurance, which underpins business continuation and employee protection.

Life insurance that protects businesses against the loss of key personnel and/or facilitates the provision of employee benefits should not be subject to further changes in applicable tax law. The question before Congress should be: Do current uses of business life insurance serve legitimate policy purposes justifying the tax benefits accorded life insurance generally? We believe that this question should be answered with an emphatic "YES," and urge the Committee to reject the Administration's proposal to impose new taxes on business-use life insurance.

Submitted by:

JOHN F. JONAS
*Patton Boggs, L.L.P.*
*Counsel to the Business Insurance Coalition*

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**Statement of Committee of Annuity Insurers**

The Committee of Annuity Insurers is composed of forty-four life insurance companies that issue annuity contracts. Our member companies represent almost two-thirds of the annuity business in the United States. The Committee of Annuity Insurers was formed in 1981 to address Federal legislative and regulatory issues confronting the annuity industry and to participate in the development of Federal tax policy regarding annuities. A list of the member companies is attached at the end of this statement. We thank you for the opportunity to submit this statement for the record.

The Committee of Annuity Insurers believes that all of the Administration's proposals relating to the taxation of life insurance companies and their products are fundamentally flawed, but the focus of this statement is the Administration's proposals relating to the taxation of annuities. We believe that the Administration's proposals relating to the taxation of annuities represent unsound tax policy, and, if enacted, would have a substantial, adverse effect on private retirement savings in America. The Administration evidently does not understand the important role that annuities play in assuring Americans that they will have adequate resources

during retirement. We hope that the following will help you come to the conclusion that the Administration's proposals involving annuities should be rejected.

Annuities are widely owned by Americans. At the end of 1996, there were approximately 32 million individual annuity contracts outstanding, an increase from approximately 13 million just ten years before. The premiums paid into individual annuities, i.e., the amounts saved by Americans, grew from approximately $26 billion in 1986 to $84 billion in 1996, an increase of 222 percent.

Annuities have unique characteristics that make them particularly well-suited to accumulate retirement savings and provide retirement income. Annuities protect individuals against the risk of outliving their savings by guaranteeing income payments that will continue as long as the owner lives. Deferred annuities also guarantee a death benefit if the owner dies before annuity payments begin.

Non-qualified annuities are a retirement savings product used primarily by middle-income Americans. According to a Gallup survey conducted in February 1997, most owners of non-qualified annuities have moderate annual household incomes. More than 80 percent have total annual household incomes under $75,000. Owners of non-qualified variable annuities have slightly higher household incomes than do fixed annuity owners, but 74 percent of variable annuity owners have household incomes under $75,000. Eight in ten owners of non-qualified annuities state that they plan to use their annuity savings for retirement income (85%) or to avoid being a financial burden on their children (84%).

The tax rules established for annuities have been successful in increasing retirement savings. Eighty-four percent of owners of non-qualified annuities surveyed by Gallup in 1997 reported that they have saved more money than they would have if the tax advantages of an annuity contract had not been available. Ninety-one percent reported that they try not to withdraw any money from their annuity before they retire because they would have to pay tax on the money withdrawn. In fact, only 15 percent of owners who are not receiving regular payouts from their annuity contracts reported having withdrawn money from their annuity contract.

While the tax treatment of annuities is well-targeted to encourage people to save for retirement, this same tax treatment makes annuities significantly less attractive than other investment options for shorter term savings. For instance, savings invested in annuities are allowed to build on a tax-deferred basis, but when those savings are used, i.e., when the owner receives cash from the annuity contract, all gains will be subject to tax at ordinary income rates, not capital gains rates. If an individual invests money in an annuity for a substantial period, the deferral of tax will be a very powerful savings tool which can compare favorably to investments which give rise to long-term capital gain. A recent study by the Economic Policy Consulting Group of Price Waterhouse LLP, Variable Annuities After the 1997 Tax Act: Still Attractive For Retirement Savings, concluded that variable annuities can be attractive investments for long-term savers relative to mutual funds. A monograph by Dr. James Poterba, an economics professor at the Massachusetts Institute of Technology, that was published in September, 1997, The History of Annuities in the United States, reached a similar conclusion.

If an individual takes money out of an annuity before age 59, not only is the amount taxable on an "income-first" basis, but it also is subject to an early withdrawal penalty of 10 percent. If an individual wants to borrow from an annuity, or pledge it as security for a loan, any amount received is treated as a distribution which is subject to ordinary income tax, plus the early withdrawal penalty if before age 59. There are several additional tax rules that make annuities attractive only as a funding vehicle for long-term savings, but the essential point is simply that the annuity tax rules have been carefully crafted by Congress to assure that annuities will be used for retirement income.

The proposals contained in the Administration's FY 1999 budget greatly upset this carefully balanced set of tax rules and jeopardize the continued existence of annuities as a method to save for retirement. The balance of this statement will address the specific proposals.

### 1. Proposal to Tax Exchanges of Variable Annuities and Reallocations of Assets Within Variable Annuities

This proposal applies to "variable" annuities. A variable annuity is a type of annuity where premiums are placed in a "separate account" of a life insurance company, and the funds are invested by the life insurance company in various stocks and bonds. Variable annuities typically offer the owner a choice among several diversified investment options with different, broad investment strategies. These investment options may include, for example, a domestic equity fund, a government bond fund, and a balanced fund. Most variable annuities offer a fixed account investment

option as well. The value of a variable annuity contract is not guaranteed. Instead, its value will vary according to the performance of the investment options that the owner has chosen. This allows the annuity owner to benefit over the long term from the higher rates of return historically provided by the stock market.

Variable annuity contracts typically provide that owners may allocate their premium payments among the several different investment options provided under their contracts. Owners may also periodically reallocate their account values among these investment options. Under present law, these reallocations do not cause the owner to incur a tax so long as the investment remains in the annuity. This flexibility provides an important incentive to encourage people to keep their savings in their annuities to provide for their retirement. Of course, the earnings in the contract are taxed when the owner takes funds out of his or her annuity, typically during retirement.

The Administration would reverse over 40 years of sound tax policy by taxing people before they take money out of their annuity if they reallocate their annuity savings among the available investment options or if they exchange their variable annuity for an annuity issued by another insurer.

There are a number of reasons why Congress should reject this proposal.

Perhaps the most important is that it ds to retirement savings merely because their savings needs have changed. Variable annuities are used for long-term savings. They offer investment options based on diversified pools of stocks and/or bonds, just as section 401(k) plans and IRAs do, although no deduction is ever allowed for a contribution to a non-qualified variable annuity. All retirement savers periodically need to shift their savings among different options as they grow older and in response to changes in the financial markets. Under the Administration's proposal, annuity owners who, as a result of growing older or due to concerns over market performance and the security of their retirement savings, shift their savings from a stock fund to a government bond fund within a variable annuity would be immediately taxed.

Second, the Administration's proposal would tax individuals even though they do not have the proceeds from which to pay the tax. An individual who reallocates his or her retirement savings within an annuity contract has not withdrawn any part of it for current consumption. In fact, it would appear that such an individual would be forced to incur the 10 percent penalty tax for early withdrawal if he or she needed to use part of the amounts invested in a variable annuity to pay this new tax.

Third, the proposal is a disguised tax increase on retired, middle income savers. Five consecutive Gallup surveys conducted since 1992 have shown that more than 80 percent of the owners of non-qualified annuities have total household incomes under $75,000. Moreover, the 1997 Survey shows that the average age of an owner of a non-qualified annuity is 66 and about 60 percent of owners are now retired.

Finally, the proposal undoubtedly would discourage private retirement savings. Congress in recent years has become ever more focused on the declining savings rate in America and on ways to encourage savings and retirement savings in particular. The variable annuity is a well-designed product that is successful in encouraging Americans to commit funds to retirement. As described above, Americans have been saving more and more in annuities, which alone among non-pension retirement investments can provide the owner with a guarantee of an income that will last as long as the owner lives. Taxing annuity owners when they reallocate their savings among different investment options will inevitably reduce private savings.

### 2. Proposal to Reduce the "Investment in the Contract" for Mortality and Expense Charges of Annuities

When the Administration refers to the "investment in the contract" of an annuity contract, it actually is referring to the tax basis that an individual has in the contract. This basis generally equals the premiums paid for the contract. Amounts paid for insurance and other mortality risk and expense charges are included in the contract's tax basis.

The Administration's budget proposal would reduce a policyholder's tax basis in a deferred annuity contract for the mortality and expense charges under the contract. Under the proposal, these charges are deemed to equal 1.25 percent of the contract's average cash value each year (regardless of what is actually paid). Lost basis would be restored only if the policyholder elected to receive annuity payments for life and only if the policyholder used the annuitization rates guaranteed under the contract—even if the insurance company was currently offering annuitization rates that would give the policyholder larger annuity income payments.

Again, there are several very good reasons why Congress should reject this proposal.

First, this proposal is inconsistent with longstanding tax rules which are based on essential fairness and economic reality. Generally, under the Federal income tax, if an individual incurs expenses related to the purchase of an asset, those expenses are included in the basis of the asset for tax purposes. For instance, if sales commissions are charged when an individual buys a share of stock in a company, the commissions are included in the basis of the asset. When the asset is sold, the gain realized does not include the costs incurred to purchase the asset.

Similarly, the tax basis of an asset (e.g., a home or a car) is not reduced by any personal consumption element attributable to the asset (e.g., nondeductible depreciation). The Administration's proposal is equivalent to reducing a taxpayer's basis in his or her car or home by the annual rental value of those assets. It is true that the taxpayer has obtained a benefit from ownership of the car or home, but the tax that the owner pays on a subsequent sale is not increased because of that benefit.

The proposal also would increase the tax burden on retirement savers and create a disincentive to use the valuable protection provided by annuity contracts.

Annuity contracts are designed to accomplish two important, and related, purposes: to accumulate retirement savings, and to insure against mortality-related risks that individuals face (i.e., outliving one's assets). The insurance features are an intrinsic and important part of these contracts. Taxes on income from savings should not be increased just because those savings are accumulated in annuity contracts, which provide insurance protection to the owner and his or her family. Such tax increases would discourage savings by the middle-class Americans who are the predominant purchasers of non-qualified annuities.

In addition, the proposal would substantially increase administrative and compliance costs for little revenue. Under the proposal, life insurance companies would be required to calculate and keep track of two different basis amounts for each annuity contract. One set of basis records would be used in the event that the policyholder annuitized his or her contract for life at the guaranteed rates under the annuity and the other set of basis records would be used if the policyholder took a distribution in any other form from the annuity. These calculations would have to be made and maintained for many years because annuity contracts are used for long-term savings. The increased costs of designing computer and administrative systems to implement this proposal is disproportionate to any revenue gain from what is in all events a proposal that is contrary to generally applicable tax rules.

### 3. Proposal to Deny a Reserve Deduction for Certain Annuity Benefits

Life insurance companies are required by state insurance law to establish reserves in order to fund the benefits promised to policyholders under annuity contracts. These policyholder benefits include the guarantee of an income stream extending over the annuitant's life, a death benefit if the annuitant dies prematurely, and a cash surrender value. In recent years, annuity contract benefits have been expanding and many contracts now offer larger death benefits, incentives for annuitization (such as higher interest credits), and withdrawals without surrender charges if certain conditions exist (e.g., disability or confinement in a nursing home).

Life insurance companies include in their income all of the premiums they receive and the investment income they earn, but are allowed a deduction for their reserve obligations in recognition of the fact that a substantial part of the premiums and investment income will be used to pay policyholder benefits. The reserve for an annuity contract simply represents the present value of all the future benefits guaranteed to the policyholder. Under current law, the deduction is allowed for the greater of (1) the contract's net surrender value, and (2) a Federal tax reserve computed using a Federally prescribed interest rate, a prescribed mortality table, and a reserve method known as the "Commissioners' Annuity Reserve Valuation Method" or "CARVM." CARVM was developed by the National Association of Insurance Commissioners (NAIC), which is the association of state officials responsible for regulating insurance companies. In all events, the deduction is limited to the reserves required under state law.

The Administration's budget proposal would limit the deduction for reserves to the lesser of (1) the contract's net surrender value (plus a small additional percentage that phases out over seven years), and (2) the Federal tax reserve describproposal is based on its belief that the new NAIC actuarial guidelines on CARVM issued in 1997 will result in annuity reserves being increased "substantially" and that annuity reserves will be "excessive."

There are several reasons why Congress should reject this proposal.

First, the proposal is based on a basic misunderstanding by the Treasury Department of the new NAIC guidelines. The new NAIC guidelines did not change the definition of CARVM and did not require any "substantial" increase in annuity re-

serves. Rather, the new NAIC guidelines simply clarified the meaning of a long-standing reserve method. For most companies, the new NAIC guidelines will have no material effect on their annuity reserves—most companies already have been calculating their annuity reserves in the manner described in the new NAIC guidelines. For those companies whose reserves are affected by the new NAIC guidelines, the guidelines simply assure that a company's reserves accurately reflect its liabilities for the types of benefits guaranteed to its policyholders.

Second, the Administration's proposal would increase the cost, and thus reduce the availability, of important policyholder benefits offered under annuity contracts. The effect of the Administration's proposal is to deny a reserve deduction for many of these benefits. Without this deduction, those benefits (which include death benefits, enhanced annuity payments, and the right to make withdrawals free of surrender charges) would be more costly to provide to consumers. Yet those benefits are the very ones being demanded by consumers in the retirement savings marketplace.

In addition, annuity benefits beyond the ability to take a lump-sum cash payment represent true liabilities for which a deduction has been, and should continue to be, allowed. The Administration's proposal seems to be based on the premise that a life insurance company's obligations for the insurance benefits guaranteed under an annuity contract are not true liabilities. That premise is clearly erroneous. It is beyond dispute that a life insurance company has a liability to the purchaser of an immediate life annuity—even though such an annuity typically has no cash value—an obligation to make payments to the annuitant for as long as he or she lives. Likewise, a life insurance company has a liability to provide a purchaser of a deferred annuity all the benefits promised—not just the benefit of taking a lump-sum cash payment.

In conclusion, the Committee of Annuity Insurers urges that the Administration's tax increases involving annuities be rejected. These tax increases have no basis in good tax policy and will discourage Americans from taking the initiative to save for their own retirement.

**The Committee of Annuity Insurers**

Aetna Inc., Hartford, CT
Allmerica Financial Company, Worcester, MA
Allstate Life Insurance Company, Northbrook, IL
American General Corporation, Houston, TX
American International Group, Inc., Wilmington, DE
American Investors Life Insurance Company, Inc., Topeka, KS
American Skandia Life Assurance Corporation, Shelton, CT
Charter National Life Insurance Company, St. Louis, MO
Commonwealth General Corporation, Louisville, KY
Conseco, Inc., Carmel, IN
COVA Financial Services Life Insurance Co., Oakbrook Terrace, IL
Delta Life and Annuity, Memphis, TN
Equitable Life Assurance Society of the United States, New York, NY
Equitable of Iowa Companies, Des Moines, IA
F & G Life Insurance, Baltimore, MD
Fidelity Investments Life Insurance Company, Boston, MA
Great American Life Insurance Co., Cincinnati, OH
GE Financial Assurance, Richmond, VA
Hartford Life Insurance Company, Hartford, CT
IDS Life Insurance Company, Minneapolis, MN
Integrity Life Insurance Company, Louisville, KY
Jackson National Life Insurance Company, Lansing, MI
Keyport Life Insurance Company, Boston, MA
Life Insurance Company of the Southwest, Dallas, TX
Lincoln National Corporation, Fort Wayne, IN
ManuLife Insurance Company, Boston, MA
Merrill Lynch Life Insurance Company, Princeton, NJ
Metropolitan Life Insurance Company, New York, NY
Minnesota Mutual Life Insurance Company, St. Paul, MN
Mutual of Omaha Companies, Omaha, NE
Nationwide Life Insurance Companies, Columbus, OH
New England Life Insurance Company, Boston, MA
New York Life Insurance Company, New York, NY
Ohio National Financial Services, Cincinnati, OH
Pacific Life Insurance Company, Newport Beach, CA
Phoenix Home Mutual Life Insurance Company, Hartford, CT

Protective Life Insurance Company, Birmingham, AL
ReliaStar Financial Corporation, Seattle, WA
Security First Group, Los Angeles, CA
SunAmerica, Inc., Los Angeles, CA
Sun Life of Canada, Wellesley Hills, MA
Teachers Insurance & Annuity Association of America—College Retirement Equities Fund (TIAA–CREF), New York, NY
Travelers Insurance Companies, Hartford, CT
Zurich Kemper Life Insurance Companies, Chicago, IL

**Statement of Corporate Property Investors**

**First Union Real Estate Investments**

**Meditrust**

**Patriot American Hospitality**

**Starwood Hotels & Resorts**

## INTRODUCTION

This testimony outlines the concerns of the five grandfathered paired-share real estate investment trusts (REITs) over the Administration's FY 1999 Budget proposal that would "freeze" the status of paired-share REITs. Each of the grandfathered entities strongly opposes the Administration's proposal. The concerns about this proposal go beyond its harm to these companies' shareholders, each of whom reasonably relied on existing law when their investments were made. The Administration's proposal also would unfairly (i) reverse Congress' historic efforts to encourage utilization of REITs to allow all kinds of investors to own real estate, and (ii) impose unnecessary complexity to the Internal Revenue Code, without raising any significant revenue or resolving any of the issues raised by those opposing the existing grandfather rule.

## DESCRIPTION OF A PAIRED-SHARE REIT

Each grandfathered paired-share REIT consists of two companies, the stock of which are "paired" or "stapled" together, such that the shares trade as a single investment unit and are owned by the same shareholders. One of the paired companies is a REIT, essentially a pass-through entity subject to the Internal Revenue Code's numerous requirements, including distributing 95 percent of its taxable income to shareholders on an annual basis. The other paired company is an operating company that is subject to the regular corporate federal income tax, found in subchapter C of the Internal Revenue Code ("C corporation").

The paired-share structure is typically used to own and operate certain types of real property, like hotels and medical facilities, that cannot be operated by a REIT under the existing Internal Revenue Code. The paired REIT owns the properties and leases such assets to its paired operating C corporation, which operates and manages the properties.

## ANALYSIS OF THE ADMINISTRATION'S PROPOSAL

*I. The 1960 legislation establishing REITs implemented Congressional interest in providing all kinds of investors with the same opportunity to invest in real estate as wealthy investors.*

The 1960 legislation establishing REITs (P.L. 86–779) used the Internal Revenue Code rules for regulated investment companies (RICs) as a model for the new REIT structure. The legislative history indicates that Congress wanted to give small investors an opportunity to invest in professionally managed portfolios of real estate, in the same manner as permitted for investments in stocks through the RIC rules. H.R. Rep. No. 2020, 86th Cong., 2d Sess. (1960), 1960–2 C.B. 819, 820.

The Committee report accompanying the 1960 Act drew parallels between the RIC and REIT investment strategies and noted their common purpose and structure. *Id.* In particular, the Report clarified that both arrangements enable small investors to secure advantages normally available only to those with greater monetary resources. Such advantages include: (1) risk spreading through greater diversification of investments secured through pooling; (2) opportunities to secure the benefits of

expert management advice; and (3) means of collectively financing projects that individual investors would be unable to undertake. *Id*.

During the House Floor debate on the bill, the Chairman of the House Ways and Means Committee, Wilbur Mills, explained the purpose of the REIT legislation. In his statement, Chairman Mills indicated that the bill would not only "provide equitable treatment of existing real estate investment trusts but it would provide a reasonable machinery whereby a large number of small investors would be able to make real estate investment without incurring the penalty of additional income tax at the corporate level." 106 Cong. Rec. H15017 (daily ed. June 29, 1960).

*II. The paired-share structure fulfills the policy goals underlying the basis for establishment of REITs in 1960.*

Congress' 1960 REIT policy is preserved in the paired-share structure that was sanctioned by the Internal Revenue Service (IRS) in the 1970s and early 1980s. In those years, the formation and operation of paired-share REITs were approved by the IRS through the issuance of several broadly written private letter rulings. *See e.g.*, PLR 8002026 (Oct. 16, 1979); PLR 8013039 (Jan. 4, 1980); PLR 8120107 (Feb. 20, 1981).

The structure, as sanctioned by these rulings, was designed to ensure that non-REIT, active income is subject to taxable C corporation treatment. The REIT must operate as a REIT, and the operating C corporation is treated just like any other taxable C corporation. At the same time, the paired-share REIT structure has a sound business purpose unrelated to any tax savings. The structure achieves a better investment result for the public shareholders of a REIT by allowing the shareholders to retain the economic benefits of both the lease payments received by the REIT and the after-tax operating profits realized by the operating C corporation.

The nature of the business advantage to the paired-share structure can be understood in part by considering the problems that exist in management-intensive real estate activities. In the absence of a paired operating company, where the operating entity and the real estate are under separate control, the REIT that owns assets such as a hotel is required to lease such property to an unaffiliated property operator. This structure presents at least two basic problems.

First, in reaching an agreement on the lease terms between the REIT and the operating company, the profitability of the operations may be difficult to determine. In such cases, neither party might wish to undertake the risk of a long-term contract. Further, each party is potentially exposed to the risk of agreeing to lease terms too favorable to the other party. Under a long-term contract, the owner of the real estate may have an insufficient incentive to undertake investments that maintain the profitability of the property, unless the owner believes it is fully compensated for these investments by the terms of the lease agreement.

Second, in the absence of a long-term contract, the operating entity may have a reduced incentive to undertake investments that enhance the long-term value of the operation. The operating entity may not be assured that it will be the actual beneficiary of these investments. These investments may take the form of advertising, capital improvements, and efforts to reward long-term customer loyalty to the operations. If the operating company decides to undertake these investments and is successful in enhancing the profitability of the operation, upon expiration of the initial lease, the real estate owner (REIT) could capture all of the benefits achieved by the operator by increasing the rental payments required under the terms of the lease.

Faced with these structural constraints, the paired-share REIT structure was developed to preserve shareholder value, by eliminating potential conflicts of interest between the owner of the property (the REIT) and the tax-paying entity that operates and manages the REIT's property. Non-paired REITs have responded to these economic and conflict issues in similar ways, through affiliation with taxable C corporations using "preferred stock subsidiary" and "paper clipped REIT" structures.

Further, the changes made by Congress to the Internal Revenue Code's REIT provisions have consistently reflected (i) Congress' 1960 policy of providing small investors with access to real estate ownership via a pass-through entity and (ii) Congress' desire to improve the operation of the REIT rules through the integration of ownership and management of real estate. In other words, when the statute was passed in 1960 based on the RIC paradigm, application of this model to real estate ownership was not fully appreciated. The REIT provisions have been amended nine times since 1960, each time to fine tune this structure for use in the real estate context.

Changes to the REIT rules made over the years indicate that the Congressional tax writers recognized that the value in real estate, unlike stock, is inextricably intertwined with the management of the properties. Without a greater alignment of the owner's and operator's interests in the real estate, the value of such real estate interests cannot be maximized as originally envisioned. In particular, the 1986

and 1997 amendments significantly liberalized the extent to which operational income could be earned by a REIT. *See* Pub. L. No. 99–514, § 663 (allowing certain customary management functions and services); Pub. L. No. 105–34, § 1255 (allowing a small amount of prohibited services not to taint rental income). Thus, Congress indicated that it understood how essential it is for REIT owners to control the management and operations of the properties they own.

In contrast, the 1984 amendment, adding IRC section 269B to limit future paired-share REITs, ignored the need for certain REIT owners to control the management and operations of the properties they own. The provision did not amend the REIT provisions in the Internal Revenue Code, but was instead part of an effort primarily focused on foreign corporations stapled to domestic corporations. It therefore was included in the foreign tax section of the Deficit Reduction Act of 1984. Pub. L. No. 98–369, § 136. When Congress addressed the paired or stapled structure in this statutory provision, it recognized that the IRS had sanctioned this structure. H.R. Conf. Rep. No. 432, 98th Cong., 2d Sess., 1545 (1984). Accordingly, unlike the language providing relief for the foreign-domestic paired entity, which was limited to about 2.5 years, the grandfather rule for the paired-share REITs in existence on the date of introduction of the bill first imposing these limits (June 30, 1983), was unrestricted. The conference report for the Act states that the IRS guidance was the rationale for the unqualified grandfather rule. *Id*.

*III. The paired-share REIT structure meets Congress' expectations, even when analyzed under concerns raised by others.*

A. *The paired-share structure does not represent an abuse of the federal tax laws.*—Use of the paired share structure is simply a way to align ownership and operation of real estate consistently with the limitations on the kinds of income that a REIT may earn. Most REITs face economic and investor pressure not to permit third parties to divert operational income to themselves. REITs use many approaches, including affiliation with taxable C corporations, to remove the potential conflict inherent in third party management. The paired share structure is only one form of C corporation affiliation. The most prominent alternative forms are use of a "preferred stock subsidiary," which is a taxable subsidiary of a REIT that uses multiple classes of stock to comply with REIT rules, and a "paper clipped REIT," which involves a C corporation that is affiliated with the REIT through common directors, common managers, contractual relationships and substantially the same shareholders.

Existing rules applicable to all REITs ensure that transactions between the paired REIT and an affiliated C corporation are conducted on an arm's-length basis. These rules, and the low Joint Tax Committee revenue estimate ($34 million over 5 years/ $217 million over 10 years), demonstrate that the paired-share REIT structure is not abusive.

A study conducted by Price Waterhouse analyzing transfer pricing risks found no evidence of transfer pricing abuses by paired-share REITs. *See* Price Waterhouse LLP, "Federal Income Tax Effects of the Paired-Share REIT Structure of Starwood Lodging," (Nov. 7, 1997). The study tested the returns of Starwood, the largest paired-share REIT, to the compensation ratios of non-paired hotel REITs for the 1995 and 1996 periods. The results of the study indicate that the compensation ratio from leasing hotel properties to the paired operating C corporation is no greater than that of non-paired hotel REITs.

REIT provisions defining non-qualifying income also prevent taxpayers from manipulating the allocation of costs between entities. IRC § 856(c)(2); Treas. Reg. 1.856–4(b)(3). As a consequence, REITs are strongly discouraged from taking aggressive tax positions. Moreover, current law imposes a penalty involving the loss of REIT status and onerous restrictions on reentry into REIT status. IRC § 856(g); Treas. Reg. § 1.856–8.

B. *The structure does not contribute to "disincorporation."*—Historical evidence shows that the existence of the paired-share REIT structure does not encourage the "disincorporation" of U.S. businesses. Significantly, none of the existing paired-share REIT companies began as C corporations. Each began its business as a stand-alone REIT that later added the C corporation management function to maximize shareholder value, avoid conflicts of interest and incorporate an ability to manage the properties owned by the REIT.

Disincorporation is discouraged by Internal Revenue Code rules that impose penalties on conversions of C corporations into REITs. IRS Notice 88–19, 1988–1 C.B. 486. In particular, these rules impose tax on the sale of real estate assets to a REIT.

Furthermore, where services and other non-real estate income provide the greater share of an enterprise's value, a C corporation would not benefit from the establishment of a REIT. Splitting such a business's value between its real estate and other operations would bifurcate important aspects of the business, unless it had a strong

real property component. The mandatory dividend rules applicable to REITs would prevent the company from reinvesting a substantial portion of its cash flow, resulting in either cash flow problems or a substantial change in the capital requirements for that type of business operation.

C. *The paired-share structure does not give an unfair business advantage.*—The tax advantage of paired-share REITs is the same one enjoyed by every other REIT, namely, that the REIT's taxable income is taxed once, not twice. However, the corporate level tax on real estate ownership income, is not unique to the REIT structure. Corporations taxed under Subchapter C of the Internal Revenue Code often achieve the substantive equivalent of one layer of taxation on their real estate. For instance, C corporations have opportunities to reduce double taxation and otherwise lower the cost of capital by incurring higher debt and by using depreciation and other business deductions. REITs, on the other hand, tend to be less leveraged than C corporations to help ensure sufficient earnings for the payment of required dividend distributions to shareholders.

Additionally, stock prices, measured as a multiple of earnings, can be similar for C corporations and non-paired REITs. Such figures reflect shareholder expectations of growth in the future, including an assessment of management expertise, superior workforce, name recognition, infrastructure, customer base, location, as well as any combination of these or other factors.

Historical evidence reflecting on the successes and failures between paired-share REITs and other companies without this structure for acquisitions also demonstrate that such REITs do not have unfair business advantages over C corporations. One company can have a number of advantages over another company, regardless of the REIT or non-REIT structure. For example, two paired-share REITs unsuccessfully bid against Marriott, a C corporation, last year for the Renaissance hotel chain; and this year against Bass PLC, a foreign-based lodging and spirits company, for the Inter-Continental Hotels and Resorts chain.

*IV. The Administration's proposal is a totally inappropriate "solution" to the concerns relating to paired-share REITs.*

The Administration's proposal attempts to "freeze" the grandfathered status of the existing paired-share REITs. Under the proposal, for purposes of determining whether any grandfathered entity is a REIT, the paired entity would be treated as one entity with respect to properties acquired on or after the date of first action by a Congressional committee, and with respect to activities or services relating to such properties that are undertaken or performed by one of the paired entities on or after such date. The proposal would effectively mean that future acquisitions of certain types of property by paired-share REITs would generate "bad income" under the 95 percent gross income test, if the paired-share REIT were to operate such property. As a result, enactment of this proposal would severely limit the ability of paired-share REITs to operate properties that they traditionally have operated, if such properties are acquired after the proposed effective date of the proposal.

The Administration proposal is not projected to raise significant revenue. It represents just one-half of one percent of its overall revenue package, and fails to take into account factors which suggest that paired-share REITs may, in fact, be revenue enhancing. First, since the paired operating C corporation is fully subject to tax, and the REIT must pay out 95 percent of its taxable income to its shareholders as dividends (which are than taxable as current, ordinary income), it is difficult to see how tax revenue is decreased through the paired-share structure. In fact, because individual tax rates are higher than corporate tax rates, and as a result of differences in how REIT dividends are taxed, the profits earned by a REIT may be taxed at higher effective rates than the profits of a regular C corporation. Second, paired-share REITs typically have lower levels of debt than C corporations, which often use interest deductions and depreciation to minimize Federal taxes, and generally distribute far less than 95 percent of their net earnings to shareholders. Thus, any proposal which marginally increases real estate holdings in C corporations, while simultaneously decreasing the level of such assets held by REITs, could result in a loss of Federal tax revenues. A preliminary analysis by Price Waterhouse LLP suggests the possibility of this conclusion; a more thorough study, which is now underway, likely will demonstrate that paired-share REITs are net contributors to the U.S. Treasury.

The Administration's proposal also would increase the complexity of the Code, as outlined by the Joint Tax Committee pamphlet. *Description of Revenue Provisions Contained in the President's Fiscal Year 1999 Budget Proposal*, JCS–4–98, at 209 (1998). The pamphlet raises a number of concerns, particularly relating to how a paired-share REIT would be able to determine when a "new" acquisition has occurred and how the proposal would be applied.

For example, the proposal's use of the term "property" is unclear. Does the term apply to improvements or renovations to existing properties? If a new roof were placed on a building, the taxpayer typically would depreciate it as a separate property. If a new item of property were acquired as part of an existing business operation (e.g., a new bed is purchased for a hospital), would the paired-share REIT have to determine the revenues allocable to the bed? If so, how?

The application of the income tests to the acquisition of a new property also is unclear. For example, if a new hotel were acquired, how would revenues and expenses be allocated? In particular, would there be assumed allocations of overhead, and how would internal management and franchise fees be treated? Would the rent be treated as "good" income or would the entire gross revenue of the property be treated as "bad" income? For purposes of determining the taxable income and distribution requirements of the REIT, would the net income from the property be included in the REIT's income (with a corresponding deduction to the C corporation) or would the single entity treatment only apply for purposes of the REIT qualification tests?

These and many other interpretive issues would have to be settled before the Administration's proposal could be considered. In any event, any adjustment in the treatment of paired-share REIT entities must be clear and unambiguous. Clarity is particularly important because REITs are subject to an all or nothing status test. IRC 856(g). Investors must be able to determine with a high level of certainty whether REIT status could be maintained by a paired-share REIT, and the extent to which the C corporation's operations would be affected.

### CONCLUSION

The Administration's proposal with respect to paired-share REITs is inconsistent with Congress' historic support for business structures that allow public investors to own a diversified portfolio of real estate. Charges that the structure permits abuse or unfair advantage are simply wrong. The existing paired-share REITs are prepared to support and work with Committee staff to develop proposals directly addressing any actual transfer pricing or other problems involving transactions between the two paired entities, or to expand the opportunities for other REITs to operate as paired-share REITs.

## Statement of Employer-Owned Life Insurance Coalition

This statement presents the views of the Employer-Owned Life Insurance Coalition, a broad coalition of employers concerned by the provisions in the Administration's fiscal year 1999 budget that would increase taxes on life insurance policyholders.

### CONGRESS SHOULD REJECT THE ADMINISTRATION'S LIFE INSURANCE PROPOSALS

The Administration's fiscal year 1999 budget proposal would increase taxes on life insurance policyholders in three major respects:

- Businesses that purchase insurance on the lives of their employees would be denied a portion of the deduction to which they are otherwise entitled for ordinary and necessary interest expenses unrelated to the purchase of life insurance.
- Businesses (and individuals) that exchange policies or reallocate policy investments would be taxed on the unrealized appreciation—the inside buildup—because such exchange or reallocation would be treated as a taxable event.
- Taxable gains associated with permanent life insurance and annuity contracts would be artificially inflated by denying basis for the portion of the policy premium that reflects certain mortality charges and expenses.

For the reasons set forth below, we urge the Congress to reject each of these ill-conceived proposals.

### SUMMARY OF OPPOSITION

The Administration's proposals drive at the very heart of traditional permanent life insurance, the so-called "inside buildup" of credits (or cash value) within these policies that permits policyholders to pay level premiums over the lives of covered individuals. Each of the proposals would in one way or another effectively tax inside buildup. This *would change the fundamental tax treatment of level-premium life insurance that has been in place since the federal tax code was first enacted in 1913.*

We believe that the historical tax treatment of these policies is grounded in sound policy and should not be altered.

This is particularly true in light of the efforts by Congress and the Administration over the past two decades to develop strict statutory and regulatory standards designed to ensure that permanent life insurance policies cannot be used to cloak inappropriate investments. Policies that are unable to meet these standards are not eligible for tax treatment as life insurance *under current law*. To the extent the buildup of cash values *is* permitted under current standards, this "investment" feature should if anything be encouraged, not penalized.

With respect to the proposal to deny a portion of a policyholder's deduction for unrelated interest expenses, we find it particularly difficult to comprehend how an otherwise ordinary and necessary business expense loses its status as such merely because a business purchases life insurance on its employees. If the Administration's concern is with the inside buildup in insurance policies, it should say so—and it should address the issue directly. The proposed "tax by proxy" is poorly targeted—it would have widely-varying impacts on similarly-situated taxpayers with identical life insurance policies. More importantly, it would circumvent Congress's steadfast refusal for more than 80 years to permit current taxation of inside buildup.

## Disguised Attack on Historical Treatment of Traditional Life Insurance

The Administration's proposals drive at the heart of permanent life insurance. Although the Treasury Department has characterized the proposals as targeting certain "collateral" uses of life insurance unrelated to its core purpose, in fact, *the proposals go to the very essence of traditional permanent life insurance*: the accumulated cash values inherent in such policies, commonly referred to as inside buildup. Each of the Administration's proposals would impose new taxes on policyholders based on the cash value of their life insurance policies.

For example, the most pernicious of the Administration's proposals would deny a portion of a business's otherwise allowable interest expense deductions based on the cash value of insurance purchased by the business on the lives of its employees. Though thinly disguised as a limitation on interest expenses deductions, the proposal generally would have the same effect as a tax on inside buildup. Similar to a tax on inside buildup, the interest disallowance would be measured by reference to the cash values of the business's insurance policies—as the cash values increase, the disallowance would increase, resulting in additional tax.[1] So while not a direct tax on inside buildup, the effect would be similar—accumulate cash value in a life insurance policy, pay an additional tax.

The Administration's other insurance proposals are more direct in their taxation of cash value. One would tax accumulated cash values in insurance company variable life and annuity contracts every time the contract is exchanged or policy investments reallocated. The other would increase the taxes due on accumulated cash values upon disposition.

## Historical Tax Treatment of Permanent Life Insurance is Sound

The Administration's proposals would change the fundamental tax treatment of traditional life insurance that has been in place since the federal tax code was first enacted in 1913. Congress has on a number of occasions considered, and each time rejected, proposals to alter this treatment. Nothing has changed that would alter the considered judgment of prior Congresses that the historical tax treatment of traditional life insurance is grounded in sound policy and should not be modified.

Among the reasons we believe that these latest attacks on life insurance are particularly unjustified, unnecessary and unwise are—

### *Cash Value is Incidental to Life Insurance Protection*

The cash value of life insurance is merely an incident of the basic plan called "permanent life insurance" whereby premiums to provide protection against the risk of premature death are paid on a level basis for the insured's lifetime or some other extended period of years. In the early years of the policy, premiums necessarily exceed the cost of comparable term insurance. These excess premiums are reflected in the "cash value" of the policy. As fairness would dictate, the insurance company credits interest to the accumulated cash value, which helps finance the cost of coverage in later years, reducing aggregate premium costs.

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[1] As this Committee, to its credit, has recently brought to light in connection with its examination of individual tax rates, a deduction disallowance is a tax increase by another name.

Thus, while a permanent life insurance policy in a sense has an investment component, this feature is incidental to the underlying purpose of the policy. The essential nature of the arrangement is always protection against the risk of premature death.

*The Tax Code Already Strictly Limits Cash Value Accumulations*

The Administration's proposals ignore the major overhauls of life insurance taxation made by Congress over the past 20 years. These reforms have resulted in a set of stringent standards that ensure that life insurance policies cannot be used to cloak inappropriate investments.

The most significant reforms occurred in the 1980's, when Congress and the Treasury undertook a thorough study of life insurance. It was recognized that while all life insurance policies provided protection in the event of death, some policies were so heavily investment oriented that their investment aspects outweighed the protection element. After much study, Congress established stringent statutory guidelines, approved by the Administration, that limit life insurance tax benefits at both the company and policyholder levels to those policies whose predominant purpose is the provision of life insurance protection.

- In 1982, Congress first applied temporary "guideline premium" limitations to certain flexible premium insurance contracts;
- In 1984, Congress revised and tightened these limitations and extended them to all life insurance products;
- In 1986, the Congress again reviewed these definitional guidelines, making additional technical and clarifying changes;
- Finally, in 1988, the Congress again addressed these issues, developing still more restrictive rules for certain modified endowment contracts and modifying the rules applicable to life insurance contracts to require that premiums applicable to mortality charges be reasonable, as defined by Treasury regulation.

As currently applied to life insurance policies, these guidelines (set forth in sections 7702 and 7702A of the Internal Revenue Code) significantly limit the investment element of any policy by requiring specific relationships between death benefits and policy accumulations under complicated technical rules (the so-called cash value test or the guideline premium/cash value corridor tests). *Policies that cannot meet these limitations were deemed "investment oriented" in the judgment of Congress and are not eligible for tax treatment as life insurance.*

On the other hand, Congress and the Administration clearly intended that inside buildup within policies *satisfying* the new criteria would *not* be subject to taxation. In fact, policymakers concluded that with the tightening of the definition of life insurance and the placing of narrower limits on the investment orientation of policies, there was all the more reason for continuing an exemption for inside buildup. Buck Chapoton, then Assistant Secretary of the Treasury for Tax Policy testified on this point before a Ways & Means subcommittee in 1983, explaining that: the treatment of [inside buildup bears] an important relationship to the definition of life insurance; that is, to the extent the definition of life insurance is tightened, thereby placing narrower limits on the investment orientation of a life insurance policy, there is more reason for allowing favorable tax treatment to the [inside buildup] under policies that fall under a tighter definition. [Tax Treatment of Life Insurance; Hearings Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, May 10, 1983, 98th Cong., 1st Sess. 16 (1983).]

Congress proceeded on this basis and, as noted above, in 1984 established a tighter and narrower definition of life insurance.

In addition to blessing the continuation of tax benefits for inside buildup within life insurance contracts when it considered these issues in the 1982, 1984, 1986 and 1988 legislation described above, Congress did so on numerous other occasions by failing to enact treasury proposals to tax inside buildup. For example, notwithstanding Treasury proposals to tax inside buildup contained in the 1978 Blueprints for Tax Reform, the November, 1984 Treasury Tax Reform proposals, the 1985 Tax Reform Proposals and various budget proposals in the 90's, Congress consistently refused to tax inside buildup within life insurance policies.

Moreover, the Congress implicitly endorsed continuation of inside buildup in 1996 when it considered and addressed certain perceived problems with policy loans (repealing the deduction for interest on policy loans) and in 1997, when it became concerned that Fannie Mae intended to use its quasi-federal status and preferred borrowing position to purchase coverage for its customers (denying a portion of Fannie Mae's otherwise applicable interest deductions). On both occasions, conventional life insurance policies were unaffected; tax preferences for inside buildup were retained.

The 1997 experience is of particular relevance. When drafting the interest disallowance for Fannie Mae, Congress distinguished its concerns regarding what was

considered to be Fannie Mae's inappropriate efforts to exploit its preferred borrowing position from the typical situation involving employer-owned policies, providing a clear exemption for policies purchased by a business on employees, officers, directors and 20-percent owners. In late 1997, Congress further demonstrated its commitment to preserving tax-favored status for employer policies by proposing additional technical corrections to clarify the scope of this intended relief (e.g. to cover former employees, group contracts, etc.). Those technical corrections, adopted by the House and attached to the IRS restructuring bill last fall, are now awaiting Senate consideration.

Given the detailed 1996–97 review of life insurance policies, which triggered narrow reforms rather than any cutback of the core tax benefits afforded with respect to inside buildup, individuals and employers reasonably relied on the continued availability of inside buildup with respect to the policies they previously held, as well as subsequent purchases. Similarly, carriers reasonably relied on the continued availability of inside buildup in developing and marketing insurance policies. Treasury's attempt to reverse that Congressional decision and undercut policyholder and carrier reliance through these thinly disguised attacks on inside buildup is unconscionable and should, consistent with every prior Congressional decision on this issue, AGAIN be summarily rejected.

## APPRECIATION IN CASH VALUE SHOULD NOT BE TAXED

*Long-Term Investment Should be Encouraged, Not Penalized*

Permanent life insurance provides significant amounts of long-term funds for investment in the U.S. economy. These funds are attributable to *permitted* levels of policy investment, a portion of which represents the "prepayment" element needed to permit level premium policies which remain affordable as covered individuals age. Without this prepayment/investment feature premium costs would increase rapidly with age, making insurance unaffordable when it is most needed.

The incidental investment element inherent in permanent life insurance should, if anything, be encouraged, not penalized. Congress and the Administration have repeatedly emphasized the need to increase U.S. savings, especially long term and retirement savings. Recent efforts have used the tax code to *encourage* savings, not penalize them. Consider, for example, the recent expansion of IRAs, the introduction of Roth IRAs and education IRAs, as well as small employer savings vehicles like the SIMPLE. Given these savings goals, the Administration proposal to significantly reduce or eliminate savings through life insurance appears especially misguided.

*Unrealized Appreciation Should Not be Taxed*

There is another, more fundamental, reason why the incidental investment inherent in permanent life insurance should not be taxed currently: accumulating cash values represent unrealized appreciation. Taxing a policyholder currently on the increase in the cash value of a life insurance policy would be like taxing a homeowner each year on the appreciation in value of the home even though the home has not been sold. This would be inconsistent with historical and fundamental concepts of the federal income tax and contrary to the traditional principle that the government should not tax unrealized amounts which taxpayers cannot receive without giving up important rights and benefits. Taxing life insurance policyholders on accumulating cash values would single out life insurance by withdrawing the protection generally provided against taxation of an amount the receipt of which is subject to substantial restrictions. Given that much of this "investment" actually reflects a prepayment of premiums designed to spread costs levelly over the insured's life, this would be especially inappropriate.

## ORDINARY AND NECESSARY INTEREST EXPENSES SHOULD BE DEDUCTIBLE

The Administration's proposal to disallow otherwise deductible interest expenses is inconsistent with fundamental income tax principles.

*Interest Payments are an Ordinary and Necessary Business Expense*

It is difficult to comprehend how an otherwise ordinary and necessary business expense loses its status as such solely because a business purchases life insurance on its employees. For example, few would argue that if Acme Computer borrows funds to help finance the cost of a new supercomputer assembly plant, the interest Acme pays on the debt is a legitimate business expense that is properly deductible. How can it be that if Acme decides it is prudent to purchase life insurance on the leader of the team that developed the supercomputer—to help offset the inevitable transition costs that would follow the team leader's unexpected death—that a por-

tion of the interest payments is suddenly no longer considered a legitimate business expense? This is precisely the effect of the Administration's proposal.

To fully appreciate this provision, apply the underlying rationale to an individual taxpayer: Should any homeowner who purchases or holds life insurance be denied a portion of the otherwise applicable deduction for mortgage interest? Or, carrying the analogy a bit further, should any homebuyer who contributes to an IRA or a section 401(k) plan (thereby receiving the tax benefits of tax deferral or, in the case of a Roth IRA, tax exemption) be denied a portion of the otherwise applicable deduction for mortgage interest?

The Treasury Department asserts that the deduction denial would prevent tax arbitrage in connection with cash value policies. However, the proposal does not apply to debt directly or even indirectly secured by cash values; interest on such amounts is nondeductible under current law. Section 264 of the Internal Revenue Code disallows a deduction for interest on policy loans from the insurer as well as on loans from third parties to the extent the debt is traceable to the decision to purchase or maintain a policy. Thus, the only interest deductions that would be affected by the proposal would be those attributable to unrelated business debt—loans secured byThe arbitrage concern is a red herring; the real target is inside buildup.

If the Administration has concerns about the insurance policy purchased on the life of the team leader, then it should say so—and it should address the issue directly. It is inappropriate to deny instead a legitimate business expense deduction as an indirect means of taxing inside buildup. Congress, for sound policy reasons, has steadfastly refused to enact proposals that more directly attack inside buildup; it should similarly refuse to enact this proposal.

*Disproportionate Impact on Similar Businesses*

The Administration's proposal to impose a tax penalty on businesses that purchase life insurance on their employees would have a disproportionate impact on highly-leveraged businesses. This is inconsistent with a fundamental tenet of the tax laws that, to the extent possible, taxation should be neutral with respect to core business decisions such as the appropriate degree of debt. It is also patently unfair and without policy justification.

To illustrate the disproportionate burden on highly-leveraged businesses, take the following example: Assume two competing companies, each with $50 million in assets. Company A has $2 million in outstanding debt, with an annual interest expense of $150,000. Company B has $20 million in outstanding debt, with an annual interest expense of $1.8 million.

- If Company A purchases an insurance policy on the life of its resident genius, Company A would be required to forego a portion of the interest expense on its outstanding debt. For example, if the cash value of the policy is $5 million, one-tenth of the annual interest expense, or $15,000, would not be deductible.
- If Company B buys the same policy for its resident genius, it too would be required to forego one-tenth of its interest expense deduction. However, for Company B, this amounts to a foregone deduction of $180,000—*12 times the amount foregone by Company A*.

The deduction disallowances illustrated above would occur *each year*, compounding the disproportionate impact on Company B. Over a span of 30 years, Company B could lose interest deductions in excess of $5.4 million—while Company A might lose closer to $450,000.

Whatever one's beliefs about the proper tax treatment of life insurance policies, what possible justification exists for imposing a tax penalty associated with the purchase of such a policy that varies with the level of a company's outstanding debt?

## CONCLUSION

For the reasons explained above, we believe the Congress, consistent with its long-standing interest in preserving tax benefits for inside buildup within life insurance contracts, should reject the Administration's insurance proposals, which would effectively subject inside buildup to current taxation.

Submitted by:

KENNETH J. KIES
*Price Waterhouse LLP*

**Statement of Kenneth C. Karas, Chairman and CEO, Enron Wind Corp.**

My name is Ken Karas, and I am the Chairman and Chief Executive Officer of Enron Wind Corp., a subsidiary of Enron Renewable Energy Corporation. Enron Wind Corp., one of the largest producers in the U.S. wind energy industry, offers a fully integrated range of services including wind assessment, project siting, engineering, project finance, turbine production, construction, and operation and maintenance of wind energy facilities. Among the projects currently under development by Enron Wind Corp. are a 112.5 megawatt project in Iowa and a 107 megawatt project in Minnesota. Upon completion, these projects will be operated by Enron Wind Corp. and the power produced will be sold to MidAmerican Energy Company and Northern States Power Company, respectively. As a committed member of the wind energy industry, Enron Wind Corp. strongly endorses the Administration's proposal to extend the Wind Energy Production Tax Credit ("PTC") by five years.

The current Wind Energy PTC, first enacted under the Energy Policy Act of 1992, provides a 1.5-cent-per-kilowatt-hour tax credit, adjusted for inflation after 1992, for electricity produced from wind or "closed-loop" biomass. The credit is available for wind energy production facilities placed in service prior to July 1, 1999, and applies to wind energy produced for the first ten years after the facilities are brought on line. The revenue impact of the Administration's proposal to extend the credit is projected by the Office of Management and Budget to be only $191 million between fiscal years 1999 and 2003. The Joint Committee on Taxation has projected an even lower cost of $144 million over the same period.

The Administration's proposal is identical in substance to H.R. 1401 introduced by Representative Bill Thomas (R–CA) in this Committee in 1997. H.R. 1401 currently has eighteen cosponsors including Representatives Dunn, Nussle, Matsui, Ehlers, Fazio, McDermott, Minge, Lewis, Rivers, Schaefer, Bartlett, Thurman, Shaw, Tauscher, Klug, Skaggs, Woolsey and Pallone.

Wind energy has made phenomenal advances in the last fifteen years achieving improvements in reliability, efficiency, and cost per kilowatt hour. The world market for wind power continues to grow rapidly having had a $1.3 billion year in 1996 and a $1.5 billion year in 1997 as new wind power capacity continued to be installed. However, the U.S. wind energy industry has seen very little growth in recent years due in part to uncertainty surrounding deregulation of the electric power industry. The failure to extend the Wind Energy PTC, which is now scheduled to expire in little more than a year, will only add to this uncertainty. As most wind energy projects require a minimum of two years to develop, extension of the Wind Energy PTC is critical now to ensure the availability of long-term, low-cost financing for wind energy projects. Despite these difficulties, close to 800 megawatts will be installed in 1998 and the first half of 1999, prior to the June 30, 1999 date for expiration of the credit.

Extension of the Wind Energy PTC is a targeted investment in renewable energy that will provide significant returns to the country, including:

- Continuing to Reduce the Cost of Wind Power: Dramatic advances have been made in the cost of wind power with some current projects currently based upon a cost of below 5 cents per kilowatt hour. Stimulating investment through the Wind Energy PTC will continue to bring these costs down as wind energy begins to achieve economies of scale;
- Achieving Reduced $CO_2$ Emissions: The Department of Energy has cited wind power as one of the emerging electricity supply technologies needed to reduce the emissions of carbon dioxide ($CO_2$) caused by burning fossil fuels; and
- Creating Jobs and Export Revenues: A healthy domestic wind energy industry creates the momentum to continue developing wind energy technologies for export abroad into the booming world market for renewable power, which in turn creates more jobs at home.

We at Enron Wind Corp. are excited to be at the forefront of one of the most promising renewable energy technologies available, and believe that the Wind Energy PTC represents a sound investment in the American economy, renewable energy and our environment. I urge your support for this important and cost-effective initiative.

**Statement of Export Source Coalition**

The Export Source Coalition is a group of US companies and associations concerned about the ability of the United States to compete in world markets. The Coalition includes both large and small US exporters. A list of our members is attached hereto as Exhibit #1.

The President has once again proposed changing the export source rule to an "activities based rule" as part of his FY 1999 budget submission to the Congress. Such a change would effectively repeal this rule which has been in effective for more than 75 years, and we urge the Committee to reject this proposal as it did last year.

In March of last year the Committee heard testimony from two members of the Export Source Coalition, Douglas Oberhelman, Chief Financial Officer and Vice President of Caterpillar Inc., and William C. Barrett, Director of Tax, Export and Customs for Applied Materials, Inc., who explained in detail how this rule helps reduce the double taxation companies face competing overseas, thereby increasing their ability to produce in the US for export markets. Two noted economists, Gary Hufbauer and Dean DeRosa, also presented testimony before the Committee supporting these conclusions and giving specific estimates on the costs and benefits of the export source rule over the next five years. A copy of that study is attached hereto as Exhibit #2.

Increasing exports is vital to the health of the US economy and fundamental to our future standard of living. There is virtually no dispute among economists that jobs in export industries pay approximately 15% higher wages. The Hufbauer-DeRosa study estimates that for the year 1999 alone, the export source rule will account for an additional $30.8 billion in exports, support 360,000 jobs, and add $1.7 billion to worker payrolls as a result of the export related wage premium cited above.

The complex rules by which the US taxes its companies doing business in foreign jurisdictions put them at a disadvantage when competing abroad. The export source rule is one of the few favorable tax rules which mitigate the harm done by other distortive US tax rules that cause many US multinationals to suffer significant double taxation on income earned from their international operations.

Increasing exports is a bipartisan goal. Given the dangers posed to our exports by the current crisis in Asia, repeal of a rule, such as the export source rule, which clearly helps increase exports would be even more unwise and counterproductive than it was last year.

DESCRIPTION OF THE RULE

The export source rule is a technical tax rule which has been in operation for approximately 75 years. Since 1922, regulations under IRC section 863(b) and its predecessors have contained a rule which allows the income from goods that are manufactured in the U.S. and sold abroad (with title passing outside the U.S.) to be treated as 50% U.S. source income and 50% foreign source income. This export source rule (sometimes referred to as the "title passage" rule) has been beneficial to companies who manufacture in the U.S. and export because it increases their foreign source income and thereby increases their ability to utilize foreign tax credits more effectively. Because the U.S. tax law restricts the ability of companies to get credit for the foreign taxes which they pay, many multinational companies face double taxation on their overseas operations, i.e. taxation by both the U.S. and the foreign jurisdiction. The export source rule helps alleviate this double taxation burden and thereby encourages U.S.-based manufacturing by multinational exporters.

ADMINISTRATION PROPOSAL

The President's FY1999 Budget proposal would eliminate the 50/50 rule and replace it with an "activities based" test which would require exporters to allocate income from exports to foreign or domestic sources based upon how much of the activity producing the income takes place in the U.S. and how much takes place abroad. The justification given for eliminating the rule is essentially that it provides U.S. multinational exporters that also operate in high tax foreign countries a competitive advantage over U.S. exporters that conduct all their business activities in the U.S. The Administration also notes that the U.S. tax treaty network protects export sales from foreign taxation in countries with which we have treaties, thereby reducing the need for the export source rule. As discussed below, both these arguments are seriously flawed.

### THE EXPORT SOURCE RULE SERVES AS AN EFFECTIVE EXPORT INCENTIVE

The export source rule, by alleviating double taxation, encourages companies to produce goods in the U.S. and export, which is precisely the tax policy needed to support the goal of increasing exports. The effectiveness of the rule as an export incentive was examined by the Treasury Department in 1993, as a result of a directive in the 1986 Tax Reform Act. The Treasury study found that if the rule had been replaced by an activity-based rule in 1992, goods manufactured in the U.S. for export would have declined by a substantial amount. The most recent study of the costs and benefits of the rule by Gary Hufbauer and Dean DeRosa estimates that for the year 1999 alone, the export source rule will account for an additional $30.8 billion in exports, support 360,000 jobs, and add $1.7 billion to worker payrolls in the form of export-related wage premiums. The Hufbauer-DeRosa study concludes that the export source rule furthers the goal of achieving an outward-oriented economy, with more exports and better paying jobs.

### INCREASING EXPORTS IS VITAL TO THE HEALTH OF THE U.S. ECONOMY

Exports are fundamental to our economic growth and our future standard of living. Although the U.S. is still the largest economy in the world, it is a slow-growing and mature market. As such, U.S. employers must export in order to expand the U.S. economy by taking full advantage of the opportunities in overseas markets. The U.S. is continuing to run a trade deficit (i.e. our imports exceed our exports) of over $100 billion per year. Increasing exports helps to reduce this deficit.

In 1996, exports of manufactured goods reached a record level of $653 billion. In recent years, exports have accounted for about one-third of total U.S. economic growth. Today, 96% of U.S. firms' potential customers are outside the U.S. borders, and in the 1990's 86% of the gains in worldwide economic activity occurred outside the U.S.

### EXPORTS SUPPORT BETTER JOBS IN THE U.S.

According to the Commerce Department, exports are creating high paying, stable jobs in the U.S. In fact, jobs in export industries pay 13–18 percent more and provide 11 percent higher benefits than jobs in non-exporting industries. Exporting firms also have higher average labor productivity. In 1992, value-added per employee, one measure of productivity, was almost 16% higher in exporting firms than in comparable non-exporting firms.

Over the last several years more than one million new jobs were created as a direct result of increased exports. In 1995, 11 million jobs were supported by exports. This is equivalent to one out of every twelve jobs in the U.S. Between 1986 and 1994, U.S. jobs supported by exports rose 63%, four times faster than overall private job growth. Since the late 1980s, exporting firms have experienced almost 20% faster employment growth than those which never exported, and exporting firms were 9% less likely to go out of business in an average year.

### EXPORT SOURCE RULE ALLEVIATES DOUBLE TAXATION

In theory, companies receive a credit for foreign taxes paid, but the credit is not simply a dollar for dollar calculation. Rather it is severely limited by numerous restrictions in the U.S. tax laws. As a result, multinational companies often find themselves with "excess" foreign tax credits and facing "double" taxation, i.e. taxation by both the U.S. and the foreign country. How much credit a company can receive for foreign taxes paid depends not only on the tax rates in the foreign country, but also on the amount of income designated as "foreign source" under U.S. tax law.

For example, for purposes of U.S. foreign tax credit rules, a portion of U.S. interest expense, as well as research and development costs, must be deducted from foreign source income (even though no deduction is actually allowed for these amounts in the foreign country). On the other hand, if the company incurs a loss from its domestic operations in a year, it is restricted from ever using foreign source earnings in that year to claim foreign tax credits.

These restrictions in the U.S. tax law, which reduce or eliminate a company's foreign source income, result in unutilized or "excess" foreign tax credits. The export source rule, by treating approximately half of the income from exports as "foreign source," increases the amount of income designated "foreign source" thereby enabling companies to utilize more of these excess foreign tax credits, thus reducing double taxation.

## EXPORT SOURCE RULE HELPS TO "LEVEL THE PLAYING FIELD"

The export source rule does not provide a competitive advantage to multinational exporters vis-à-vis exporters with "domestic-only" operations. Exporters with only domestic operations never incur foreign taxes and thus, are not even subjected to the onerous penalty of double taxation. Also, domestic-only exporters are able to claim the full benefit of deductions for U.S. tax purposes for all their U.S. expenses, e.g., interest on borrowings and R&D costs because they do not have to allocate any of those expenses against foreign source income. Thus, the export source rule does not create a competitive advantage, rather it helps to "level the playing field" for U.S.-based multinational exporters.

## EXPORT SOURCE RULE AFFECTS DECISION TO LOCATE PRODUCTION IN THE U.S.

Just as labor, materials, and transportation are among the costs factored into a production location decision, so is the overall tax burden. The export source rule, by alleviating double taxation, helps reduce this tax cost, thereby making it more cost efficient to manufacture in the U.S. For example, for one coalition member, the export source rule was the determining factor in deciding to fill a German customer order from a U.S. rather than a European facility making the identical product. By allowing half the income from the sale to be considered "foreign source," thereby helping the company utilize foreign tax credits, the export source rule outweighed other cost advantages such as transportation, and American workers filled the customer's order.

## FSC REGIME AND TREATY NETWORK NOT SUBSTITUTES FOR EXPORT SOURCE RULE

If the export source rule is eliminated, the FSC regime will not be a sufficient remedy for companies facing double taxation because of excess foreign tax credits. Instead of using a FSC, many of these companies may decide to shift production to their foreign facilities in order to increase foreign source income. Since more and more U.S. companies are finding that they must have production facilities around the globe to compete effectively, this situation is likely to become more and more common. The risk that these companies (which by definition are facing double taxation because they already have facilities overseas) would shift production abroad if the rule is repealed is significant and not worth taking.

Our tax treaty network is certainly no substitute for the export source rule since it is not income from export sales but rather US restrictions on their ability to credit foreign taxes paid on their overseas operations, which are the main cause of the double taxation described above. To the extent the treaty system lowers foreign taxation, it can help to alleviate the double tax problem, but only with countries with which we have treaties, which tend to be the most highly industrialized nations of the world.

The US treaty network is limited to less than 60 countries, leaving many more countries (approximately 170) without treaties with the US. Moreover, many of the countries without treaties are developing countries, which are frequently high growth markets for American exports. For example, the US has no treaty with any Central or South American country.

## CONCLUSION

While this technical tax rule was not originally intended as an export incentive, it has evolved into one of the few WTO-consistent export incentives remaining in our tax code. It is also justified on the basis of administrative convenience. This 50/50 sourcing rule is working as originally intended to avoid endless disputes and problems which would inevitably arise in administering an activity-based rule.

Given the acknowledged role of exports in sustaining growth in the U.S. economy and supporting higher paying U.S. jobs, and the effectiveness of this tax rule in encouraging exports, any attempt to reduce or eliminate the rule is counterproductive and unwise. We urge you to strenuously oppose the provision contained in the President's FY 1999 budget which would effectively repeal the export source rule.

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EXHIBIT 1

## EXPORT SOURCE COALITION

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### Membership List

Abbott Laboratories
ALCOA
AlliedSignal Inc.
American Automobile Manufacturers Association
American Electronics Association
Applied Materials
Armstrong World Industries
Bison Gear and Engineering Corporation
Cargill, Incorporated
Caterpillar Inc.
Chemical Manufacturers Association
Coltec Industries Inc.
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Exxon Corporation
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Rockwell International Corporation
Sara Lee Corporation
Sun Microsystems Incorporated
Tandem Computers Incorporated
Textron Inc.
Thiokol Corporation
TRW Inc.
United Technologies Corporation
U.S. Chamber of Commerce
U.S. Council for International Business
3M Corporation

## Exhibit 2

### Costs and Benefits of the Export Source Rule, 1998–2002[1] by Gary C. Hufbauer and Dean A. DeRosa

The Export Source Rule of the Internal Revenue Code of 1986 provides U.S. companies, both large and small, with a mechanism for apportioning their net income from exports between domestic and foreign sources. Broadly, it permits them to attribute about 50 percent of their net export income to foreign sources. Firms that have excess foreign tax credits can utilize the Export Source Rule to "absorb" part of those excess credits, thereby alleviating the double taxation of foreign income.

This report presents our assessment of the costs and benefits of the Export Source Rule for 1998, with projections over the 5-year period 1998–2002. As seen in the accompanying table, our projections indicate that the Export Source Rule supports significant additional U.S. exports and worker earnings—all at costs to the U.S. Treasury that are lower than usually estimated. For example, in 1999, for an adjusted net tax revenue cost of $1.1 billion, the United States will ship an additional $30.8 billion of exports and add $1.7 billion to worker payrolls in the form of the export earnings premium. The additional exports will support 360 thousand workers in export-related jobs who in a full employment economy would otherwise be working in lower paid sectors of the U.S. economy.

Projected Export and Revenue Impact of the Export Source Rule, 1998–2002 (Central projections based on Kemsley data and parameters)

| | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|
| Benefits to U.S. Economy | | | | | |
| Additional U.S. exports ($ millions) | 28,223 | 30,763 | 33,532 | 36,550 | 39,839 |
| Jobs supported by additional exports | 343,779 | 360,093 | 377,182 | 395,081 | 413,831 |
| Additional wages and salaries ($ millions) | 1,572 | 1,708 | 1,857 | 2,018 | 2,194 |
| Costs to U.S. Treasury ($ millions) | | | | | |
| Tax revenue forecasts | 891 | 1,474 | 1,555 | 1,750 | 1,855 |
| Revenue offsets (arising from wage and salary premiums) | n.a. | 367 | 399 | 434 | 472 |
| Adjusted tax revenue forecasts | n.a. | 1,107 | 1,156 | 1,316 | 1,383 |

Sources and Notes: See Tables 1 and 4 of the report.

The revenue cost estimates are based on the current U.S. Treasury forecasts of the tax revenue gains associated with repeal of the Export Source Rule. The Treasury estimates reflect the likelihood that, if the Export Source Rule is repealed, erstwhile users of the Export Source Rule among U.S. firms would instead turn to a Foreign Sales Corporation. Under the Foreign Sales Corporation legislation, a U.S. exporter can exclude up to 15 percent of its net export income from U.S. taxation. Unlike the Treasury estimates, our adjusted revenue cost estimates also reflect additional tax receipts derived from individual workers who enjoy premium earnings in export-related jobs supported by the Export Source Rule.

The benefits of the Export Source Rule are measured in terms of additional exports, the jobs supported by additional exports, and the premium on worker earnings in export-related jobs. These benefits are assessed using three different analytical approaches from two recent econometric studies, and one older, more traditional, quantitative study. In all cases, we assume that, in the absence of the Export Source Rule and its 50–50 division of export profits between foreign and domestic source income, U.S. firms would instead sell their exports through a Foreign Sales Corporation and exclude up to 15 percent of their export profits from U.S. taxation.

Our findings demonstrate that the Export Source Rule furthers the goal of achieving an outward-oriented economy, with more exports and better-paying jobs. One

[1] This report was prepared for the Export Source Coalition, a group of U.S. companies and associations concerned about the ability of the United States to compete in world markets.

key to these broad conclusions is the fact that export-oriented industries and jobs are highly productive, partly because U.S. producers and workers engaged in export production face the considerable discipline of highly competitive international markets for traded goods and services. A second key is the sensitivity of plant location to the tax environment. Not right away perhaps, but over a period of years a country that penalizes export production with high taxes will forfeit first investment and then export sales.

This second point deserves amplification. Recent empirical research by several scholars—Grubert and Mutti, Hines, Kemsley, and Wei—indicates far higher response rates of investment decisions to tax rates than previously believed. The new evidence is summarized in our report. A one percentage point increase in the corporate tax rate (e.g., from 18 percent to 19 percent) apparently induces a decline of 1.5 percent (and perhaps as much as 3 or 5 percent) in investment committed to export and import-competing production. The consequent impact, in terms of lost exports (or higher imports), is much larger than previously believed. The policy implications of the new scholarship extend well beyond the Export Source Rule. Countries that impose high corporate tax rates will significantly erode their competitive position in the world economy.

### 1. U. S. Exports and the Export Source Rule

Continued robust exports by U.S. firms in a wide variety of manufactures and especially advanced technological products—such as sophisticated computing and electronic products and cutting-edge pharmaceuticals—are critical for maintaining satisfactory rates of GDP growth and the international competitiveness of the U.S. economy. Indeed, it is widely acknowledged that strong export performance ranks among the primary forces behind the economic well-being that U.S. workers and their families enjoy today, and expect to continue to enjoy in the years ahead.

The Export Source Rule (Section 863(b) of the Internal Revenue Code of 1986) plays an important role in supporting U.S. exports of manufactures and other merchandise, above levels that would otherwise occur. The rule provides U.S. companies, both large and small, with a mechanism for apportioning their net income from exports between domestic and foreign sources. Under the Export Source Rule, U.S. companies attribute about 50 percent of their net export income to foreign sources. Firms that have excess foreign tax credits utilize the Export Source Rule to enlarge their foreign source income and "absorb" part of those excess foreign tax credits, thereby alleviating the double taxation of foreign income.[2] Under such circumstances, the U.S. exporter will pay no additional U.S. tax on the foreign source portion of its export earnings. Moreover, as a general rule, foreign countries do not tax the export earnings of U.S. firms, so long as the production and distribution activity does not take place within the foreign territory. Of course, the U.S. firm will pay U.S. tax at the normal 35 percent rate on the domestic source portion of its export earnings. The net result, for U.S. firms with excess foreign tax credits that use the Export Source Rule, is to pay a "blended" tax rate of 17.5 percent on their export earnings—zero percent on half and 35 percent on half.

Those U.S. firms that export can also utilize another provision of the Internal Revenue Code, Section 862(a)(6) enacted under the Deficit Reduction Act of 1984, which allows companies to establish a Foreign Sales Corporation (FSC). The FSC is a successor to the former Domestic International Sales Corporation (DISC). Under the FSC provisions, U.S. firms can conduct their export sales through a Foreign Sales Corporation and exclude a maximum of 15 percent of their net export earnings from U.S. taxation. In this case, the "blended" rate is 29.75 percent—zero percent on 15 percent of export earnings and 35 percent on 85 percent of export earnings.

This report assesses the costs and benefits of the Export Source Rule for 1998, with projections over the 5-year period 1998–2002.[3] The revenue cost estimates are based on the current U.S. Treasury forecasts of the tax revenues associated with the Export Source Rule. (The Joint Committee on Taxation (JCT) has published very similar revenue forecasts.) These revenue cost estimates reflect likely changes in corporate operations in response to a change in the tax laws. Hence, they assume that, if the Export Source Rule is repealed, erstwhile users among U.S. exporters

[2] Excess foreign tax credits can arise from various circumstances: higher rates of corporate taxation abroad than in the United States; U.S. interest, and research and experimentation allocation rules that attribute a share of these expenses to foreign source income; U.S. rules that effectively recharacterize domestic losses as foreign source losses in some circumstances; U.S. rules that create hermetic "baskets of income" so that foreign taxes on one type of foreign income cannot be attributed to another type of foreign income; etc.

[3] Our projections of costs and benefits are made on a calendar year basis, even though, strictly speaking, our projections of tax revenue costs refer to U.S. fiscal years.

would instead turn to the Foreign Sales Corporation. Our "adjusted" revenue cost estimates go one important step further. Namely, they take into account the revenues that would be lost to the U.S. Treasury owing to the loss of premium earnings by manufacturing workers in export-related jobs supported by the Export Source Rule.

We measure the benefits of the Export Source Rule in terms of additional exports, the jobs supported by additional exports, and the premium on worker earnings. We assess these benefits using three very different analytical approaches. In all cases, we assume that, in the absence of the Export Source Rule and its 50–50 division of export profits between foreign and domestic source income, U.S. firms would instead sell their exports through a Foreign Sales Corporation, and that, to an important extent, they would export less and produce more abroad.

## 2. Three Approaches to Estimating Benefits

U.S. exports and jobs supported by the Export Source Rule are estimated using three different analytical approaches, first for a base year (1992) and, subsequently, for the 5-year period 1998–2002. The three approaches to estimating benefits of the Export Source Rule are based on the findings of two recent econometric studies of U.S. export levels and investment location behavior in response to tax rates (Kemsley 1997; Grubert and Mutti 1996), and a much older study of the former Domestic International Sales Corporation (DISC) provisions of the U.S. tax law, carried out by the U.S. Department of the Treasury (1983).

### *Direct Estimates Based on Kemsley Parameters*

The first approach to estimating the benefits of the Export Source Rule is based on the findings of Kemsley (1997). The Kemsley sample data, which are compiled from the financial statements of U.S. multinational firms, consist of information on the worldwide assets, U.S. exports, foreign sales, and U.S. and foreign tax rates of 276 U.S. firms during the 9-year period 1984–92. As seen in the upper panel of Table 1, these data may be divided into two sub-samples: data for the companies with "binding FTC positions" and data for the companies with "nonbinding FTC positions." The companies with binding foreign tax credit (FTC) positions are companies with excess foreign tax credits. These corporations are assumed to use the Export Source Rule. Under the Export Source Rule, half the profits are characterized as foreign source income, and can be used to absorb excess foreign tax credits, thereby reducing the "blended" U.S. tax rate on their export profits to 17.5 percent.[4] The companies in nonbinding FTC positions (i.e., without excess foreign tax credits) are assumed to exclude 15 percent of their export profits from U.S. taxation by using a Foreign Sales Corporation (FSC), thereby reducing the "blended" U.S. tax rate on their export profits to 29.75 percent.[5]

Kemsley investigated the amount of export sales per company associated with U.S. export tax rules using an econometric equation that includes the "marginal export tax incentive" facing companies with binding FTC positions and companies with nonbinding FTC positions as separate explanatory variables. By the design of his econometric analysis, coupled with his assignment of companies predominantly utilizing a Foreign Sales Corporation to the sub-sample of companies with nonbinding FTC positions, Kemsley associated the estimated coefficient on the marginal export tax incentive variable for firms with binding FTC positions with the impact of the Export Source Rule. Based on Kemsley's coefficients, it can be calculated that the Export Source Rule supports $42 million additional exports per company for 140 companies in a binding FTC position.[6]

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[4] A company could be in a "partially binding FTC position"—i.e., the company could have excess FTCs, but in an amount less than the additional FTC "capacity" generated by the Export Source Rule. In those cases, the blended effective tax rate would be higher than 17.5 percent. Our study does not take such intermediate case into account.

[5] This assumption probably overstates the tax benefits of the FSC, since many companies are not able to exclude the full 15 percent of export profits.

[6] To make this calculation, we assume that the "blended" U.S. tax rate component of the marginal export tax incentive (METI) variable for firms with binding FTC positions rises from an average value of 17.5 percent with the Export Source Rule to an average value of 29.75 percent without the Export Source Rule. The hypothetical increase in U.S. taxation of export earnings, 12.25 percentage points, or 0.1225, is multiplied by the average ratio of foreign pre-tax income to foreign sales (ES in Kemsley's notation), or 0.106 for firms with binding FTC positions, to obtain the relevant value for Kemsley's METI variable, namely 0.013. This value of METI is multiplied by the estimated coefficient for the regression variable FTCBIND*METI, 2.437, and also multiplied by mean foreign sales for firms in a binding FTC position, $1,332 million, to obtain an estimate of additional exports resulting from the Export Source Rule, namely $42 mil-

However, this figure is an understatement for an important reason recognized by Kemsley. His data on exports only count exports to unaffiliated foreign buyers. According to a survey by the U.S. Department of Commerce (1996c), exports by U.S. multinational firms to their foreign affiliates accounted for 38 percent of the total exports of these firms in the year 1994 (this proportion has remained practically constant since 1989). Assuming that exports to affiliated foreign firms are impacted to the same extent as exports to unaffiliated firms, the impact per U.S. parent firm can be calculated at $68 million ($42 million divided by 0.62).

Kemsley's figure of 140 companies in a binding FTC position represents an average for the entire period 1984–92. However, for the period after the Tax Reform Act of 1986, Kemsley found that the Export Source Rule had a stronger positive impact on exports. The reason is that, with a lower U.S. corporate tax rate, and with the adoption of various rules that block U.S. firms from crediting foreign taxes, more companies found themselves in an excess foreign tax credit position, and thus more firms made use of the Export Source Rule. Kemsley's data indicate that 74 of his sample firms had a binding FTC position before the Tax Reform Act of 1986, and 173 firms had a binding FTC position after the Act. Even this figure understates the number of firms that rely on the Export Source Rule. Kemsley estimates that his sample firms may account for only 70 percent of all firms that utilize the Export Source Rule. In other words, the "true" average number of impacted firms, during the period 1987–92, could be about 247 companies (173 divided by 0.70). Thus, as reported in Table 1, for 1992, the total value of U.S. exports supported by the Export Source Rule can be estimated, based on Kemsley's econometric findings, at $16.8 billion ($68 million per company for 247 U.S. firms).

Using a rate of 15.5 thousand jobs supported in the U.S. economy per $1 billion of goods exported in 1992, as estimated by the U.S. Department of Commerce (1996b), the number of U.S. jobs supported by the Export Source Rule can be calculated at 260 thousand jobs for 1992. These jobs might not represent additional employment in the current circumstances of the U.S. economy, where the unemployment rate is relatively low. Instead, additional exports may draw already employed workers from other jobs, rather than from the ranks of unemployed workers. Under this assumption—which is usually made by JCT and Treasury analysts when evaluating tax changes—the Export Source Rule may not be attributed with creating new jobs.

However, the Export Source Rule does shift the composition of output—towards more output for export markets and less output for domestic use. The shift of output towards exports can be expected to benefit U.S. workers. There is significant evidence, such as that reported recently by Richardson and Rindall (1996), that both blue collar and white collar workers in exporting firms enjoyed earnings that were about 15 percent higher on average in 1992 than similar workers in non-exporting firms. The U.S. Department of Commerce (1996b) reports an earnings advantage of 12 percent for manufacturing workers supported directly and indirectly by exports in 1994. Hence, a change in the composition of output can be expected to improve the earnings of workers, even if they are drawn from other sectors and not from the ranks of the unemployed. Based on the Department of Commerce earnings premium of 12 percent, and average annual earnings of manufactures workers of just over $30,500 in 1992, the wage and salary premium is $3,660 per worker in that year. For all workers drawn to export-related employment by the Export Source Rule, the aggregate wage and salary premium is estimated at $1.0 billion in 1992. For 1999, the figure rises to $1.7 billion (see Table 4).

*Production Response Approach Based on Grubert-Mutti Parameters*

The second approach to estimating the benefits of the Export Source Rule is based on estimates of the location of production facilities in response to different tax rates. Our calculations for this approach rely on the recent econometric findings of Grubert and Mutti (1996). Grubert and Mutti investigate the location of investment abroad by U.S. controlled foreign corporations, typically in manufacturing facilities to support foreign exports to third-country destinations. They are interested in changes in investment location induced by differences in corporate tax rates between foreign countries. Among other findings, the two authors report a statistically significant estimate of 3.0 for the elasticity of total capital invested in individual foreign countries with respect to the foreign tax rate.[7] For the purposes of this report,

lion ($0.0130 \times 2.437 \times \$1{,}332 = \$42$). The methodology is spelled out in footnote 23 of Kemsley's paper.

[7] An elasticity coefficient indicates the percentage change for variable $x$ in response to a 1.0 percent change in variable $y$. In this case, an elasticity of 3.0 means that total capital invested in a foreign country is increased three percent for every one percentage point increase in the

the Grubert-Mutti elasticity estimate of 3.0 is multiplied by the incremental inducement provided by the Export Source Rule, and then applied to total exports per company by the Fortune 50 Top U.S. Exporters (Fortune 1995). The key assumption underlying this calculation is that U.S. export production facilities can be regarded as if they were an additional overseas location for production of tradable goods by U.S. multinational firms. Without the Export Source Rule, firms would shift production abroad: in fact, they would relocate 3 percent of their production facilities abroad for each 1 percent increase in the effective U.S. tax rate.[8] Further, it is assumed that a 10 percentage point decrease in U.S. production facilities translates into a 10 percentage point decrease in U.S. exports. Other assumptions should also be noted. We assume that, without the Export Source Rule, companies would ship their exports through a Foreign Sales Corporation. Hence, the calculation of additional exports only reflects the incremental inducement provided by the Export Source Rule, beyond the inducement provided by the Foreign Sales Corporation (12.25 percentage points in the "blended" U.S. tax rate). We also assume that only half of the Fortune Top 50 U.S. Exporters are in a binding FTC position. This is based on Kemsley's full sample of company years, which reports half the company-years in a binding position and half in a nonbinding position. Finally, for this calculation, we assume that only these 25 large exporters use the Export Source Rule.

Applying the Grubert-Mutti parameter estimate, with these supplementary assumptions, leads to the finding that the Export Source Rule supported $1.2 billion additional exports per company, or $31.2 billion additional exports for the 25 large exporters in 1992 (Table 2). With regard to U.S. jobs, the earnings estimates based on the Grubert-Mutti parameters indicate that 482 thousand U.S. jobs are supported by the Export Source Rule. The aggregate earnings premium for U.S. workers attributable to the Export Source Rule is $1.8 billion in 1992. The figure for 1999 is $3.2 billion (see Table 4).

*Other Estimates of Production Location*

The proposition that higher business taxes can prompt the relocation of production is not new to economics. Ohlin (1933) and Haberler (1936), among other pioneers in the modern theory of international trade and investment, were keenly aware of the impact of taxes. What is new is empirical calculation of the size of the response.

In a recent paper, Hines (1996a) surveyed the empirical literature on the response of U.S. direct investment abroad and foreign direct investment in the United States to different tax rates. While the 20-odd studies (dating from 1981) surveyed by Hines cannot be summarized by a single number, a rough characterization is that a 1 percentage point increase in the effective business tax rate induces a 1 percent decrease in the stock of plant and equipment. In other words, the "modal study," to use an unscientific concept, finds an elasticity coefficient of 1.0.

However, some scholars detect significantly larger effects. Grubert and Mutti estimated an elasticity coefficient of 3.0. In another paper, Hines (1996b) estimates an elasticity coefficient of 10 for the impact of different state tax rates on the state-by-state location of foreign direct investment entering the United States. Finally, in a paper studying the effect of taxation and corruption on direct investment flows from 14 countries to 34 "host" countries, Wei (1997) estimates an elasticity of 5 for the impact of the host country's tax rate on inward foreign direct investment by multinational firms.

To summarize: production location decisions are highly sensitive to effective tax rates. We cannot definitely say that the response rate is 1-for-1, 3-for-1, or higher. In our judgment, a response rate of 3-for-1 (the Grubert-Mutti parameter) may be high, but it is not out of the ballpark.

*Textbook Approach Based on Export Elasticity Parameters*

The last approach is the familiar textbook approach based on export demand and supply elasticities for estimating the impact of an exchange rate, price, or tax change on exports. Our use of this approach to calculate the benefits of the Export Source Rule is based on the quantitative analysis of the former Domestic International Sales Corporation (DISC) undertaken by the U.S. Department of the Treasury (1983). The DISC was replaced in 1984 by the present-day Foreign Sales Cor-

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profitability (per unit of output) of production in the country attributable to lower corporate taxation in the country.

[8] The 3-for-1 response rate reflects an average across a large number of firms. Some companies will not shift any production in response to a tax change, other companies will shift big segments of production.

poration (FSC). The U.S. Treasury (1993) adopted a similar approach to evaluate the FSC in the period 1985 to 1988.

The Treasury studies use simple demand-supply balance models to calculate the impact of tax provisions on U.S. exports. In this approach, familiar price elasticities of demand and supply for exports determine the responsiveness of export sales to changes in after-tax profits. In Table 3, we assume a profit-to-export-sales ratio of 0.12 for exports.[9] Also, we assume "high" values of the price elasticities of demand and supply for U.S. exports of manufactures, −10 and 20 respectively, in order to calculate the largest possible impacts consistent with the export elasticities approach.[10] Finally, we assume that the Export Source Rule is used by only 25 of the Fortune Top 50 U.S. Exporters (the same assumption made for the Grubert-Mutti approach).

Applying the export elasticities approach to the 25 U.S. exporters indicates that the Export Source Rule supported $228 million additional exports per company in 1992, or $5.7 billion additional exports for the 25 firms (Table 3). With regard to U.S. jobs, the estimates based on the export elasticities approach indicate that about 88 thousand U.S. jobs were supported by the Export Source Rule in 1992. The aggregate earnings premium for U.S. workers attributable to the Export Source Rule was $0.3 billion in 1992. The figure for 1999 is $0.6 billion (see Table 4).

### 3. Comparison of Approaches

In our judgment, the export response suggested by the Kemsley findings, about $30 billion in 1999 (see Table 4), best captures the likely long-run contribution of the Export Source Rule to U.S. export performance. The calculations grounded on Kemsley's analysis reflect direct empirical observation. Also, Kemsley explores the impact of the Export Source Rule without imposing a theoretical framework on his econometric equations, and he examines a very large number of companies, pooled across nearly 10 years. Finally, Kemsley also takes into account factors other than tax rules that affect the export performance of different companies.

That said, the calculations grounded on Kemsley's analysis will strike many experts as "too high." The reason for this impression is that the estimated export effects are much larger, relative to the loss of tax revenue, than can be derived by application of the familiar textbook model which relies on export demand and supply elasticities. In our view, the fact that Kemsley's findings cannot be squared with textbook models is a reason for questioning the textbooks, not an argument for discarding Kemsley's results.

Our view is based on two considerations. In the first place, the calculations of additional exports that are grounded on the Grubert-Mutti production response coefficients are even larger than the Kemsley estimates. The Grubert-Mutti production response coefficient of 3.0 is somewhat larger, but in the same range, as production response coefficients estimated by other scholars. The "modal" production response coefficient of 1.0 would indicate export effects one-third the size of the figures presented for Grubert-Mutti in Table 4, but still about twice the size of the textbook export elasticities approach.

The second consideration in favor of Kemsley's results is that the textbook demand and supply elasticity model may be better suited to the measurement of responses to "transitory" fluctuations in exchange rates and inflation rates, than to "permanent" (or at least semi-permanent) changes in tax variables.

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[9] This figure is based on the following considerations. According to FSC data for 1985, 1986 and 1987, the "combined taxable income" of parent U.S. corporations and their FSCs averaged about 0.08 of export sales (U.S. Treasury, 1993). We think export profits in those years were depressed by the very strong dollar. According to data collected by Kemsley (1997) over the 9-year period 1984–92, foreign pre-tax income averaged about 0.12 of foreign sales for his full sample of firms. In our judgment, this figure better reflects the profit-to-export sales ratio now prevailing for U.S. firms.

[10] The reason we calculated "upper bound" estimates for the export elasticity approach was to discover whether there was an overlap with the production response approach. There was not. Estimates of long-run price elasticities of demand and supply for U.S. exports, compiled from the econometric findings of a number of investigators, are presented in Table 5. It will be seen that the figures we use are at the upper end of econometric findings. High values for price elasticities (−10 for demand and 20 for supply) imply a "multiplier" of 6.0. This multiplier relates the proportional change in export sales to the tax-induced change in export income (expressed as a percentage of export sales) attributable to the Export Source Rule. Even a multiplier as large as 6.0 does not yield trade effects that are as big as those suggested by the production response approach.

4. COST AND BENEFIT FORECASTS, 1998–2002

Forecasts of the U.S. export and employment-related benefits of the Export Source Rule derived from the three different approaches to estimating the benefits are presented for the 5-year period 1998 to 2002 in Table 4. These forecasts of benefits are based on the estimates for 1992 presented in Tables 1, 2, and 3. Specifically, the export benefit estimates for 1992 are projected forward to the years 1998–2002 using the observed average annual rate of growth of U.S. manufactures exports during 1992–96 (about 9 percent).[11] The employment and earnings benefit estimates for 1992 are projected forward using observed average annual rates of growth of both U.S. manufactures exports and U.S. labor productivity during 1992–1996 (about 4 percent for labor productivity).

For 1999, the calculated additional exports attributable to the Export Source Rule range between a high value of $57.1 billion based on the production response approach (Grubert-Mutti parameters) to a low value of $10.4 billion based on the textbook approach (export elasticity parameters). Throughout the 5-year forecast period, the additional exports calculated using the Kemsley parameters fall about equidistant between the estimates found using the other two approaches.

The 5-year forecasts of employment and earnings also reveal the centrality of the jobs and worker earnings calculated using the Kemsley estimates. Thus, in the year 1999, the Export Source Rule is forecast to support central figures of nearly 360 thousand manufacturing jobs and about $1.7 billion in premium wages and salaries for manufacturing workers employed in export-oriented industries.

Forecasts of the U.S. tax revenue costs attributable to the Export Source Rule for the 5-year period 1998–2002 are also presented in Table 4. These tax revenue forecasts, which are projections by the Treasury (OMB 1997), are supposed to reflect obvious changes in business behavior.[12] If the Export Source Rule is repealed, U.S. companies would exclude up to 15 percent of their export profits from U.S. taxation by selling exports through a Foreign Sales Corporation. Accordingly, both Treasury and JCT revenue forecasts reflect an adjustment for greater use of Foreign Sales Corporations.

In our view, the tax revenue forecasts should be further reduced to reflect the additional revenues the Treasury collects from individual workers who enjoy premium earnings attributable to the Export Source Rule. While this is not a "standard" adjustment, it is justified by the fact that export jobs pay higher wages and salaries on average than other jobs. Therefore, Table 4 presents forecasts of the appropriate tax revenue offsets and adjusted net U.S. tax revenue for the 4-year period 1999–2002. We start with 1999 because that is the first year when repeal of the Export Source Rule would have its full impact. The revenue offsets are estimated by applying the relevant marginal U.S. income tax rate for individuals (21.5 percent) to the estimates in the table of additional U.S. earnings supported by the shift in output towards export industries as a consequence of the Export Source Rule.[13] The adjusted revenue forecasts are calculated to be the standard revenue forecasts minus the revenue offsets.

It is apparent from the estimates presented in Table 4 that the magnitude of the revenue offsets associated with the Export Source Rule depends importantly on which method of estimating U.S. export and employment-related benefits is assumed. Based on the Kemsley estimates of Export Source Rule benefits, the tax rev-

[11] The historical and projected values of U.S. total and manufacturing exports are presented in Table 6.

[112] Projections of "tax expenditures," which are regularly reported by the Administration and Congress (e.g., OMB (1996) and JCT (1996)), are typically greater in magnitude than tax revenue forecasts and provide the basis for projecting tax revenues. However, tax expenditure forecasts assume that business firms do not change their behavior in response to a change in tax law. Hence, they do not take into account the recourse that U.S. firms utilizing the 50–50 division of export profits between domestic and foreign source income under the Export Source Rule have to excluding up to 15 percent of their export profits from U.S. taxation by selling exports through a Foreign Sales Corporation. For discussion on how tax expenditures are estimated by the U.S. Department of the Treasury and further discussion of the difference between tax expenditure and tax revenue estimates, see Rousslang (1994) and JCT (1996) respectively.

[13] We estimate the relevant marginal tax rate in the following manner. In 1998, average manufacturing earnings will be about $38,100 per worker (Table 4). The average premium of 12 percent for workers directly and indirectly supported by exports would put their average earnings at $42,700. Currently, a marginal Federal tax rate of 28 percent applies to married couples with taxable income above $36,000 and to single persons with taxable income above $22,000. Below those cut-off amounts, the marginal tax rate is 15 percent. Taking into account deductions and exemptions, we assume that half of workers supported by exports pay marginal tax rates of 28 percent and half pay 15 percent. The relevant "average marginal tax rate" is thus 21.5 percent (28 + 15 divided by 2).

enue offsets are estimated at $0.4 billion in 1999, increasing to $0.5 billion by the year 2002. Based on the Grubert-Mutti estimates of Export Source Rule benefits, the tax revenue offsets are estimated at $0.7 billion in 1999, increasing to $0.9 billion by the year 2002. And finally, based on the textbook elasticities approach, the tax revenue offsets are estimated at $0.1 billion in 1999, increasing to $0.2 billion in 2002.

The adjusted revenue forecasts provide the most appropriate basis for judging the final budgetary costs of the Export Source Rule to the U.S. Treasury, because the adjusted figures take into account the substantial tax revenues that will be collected from individuals who enjoy premium wages and salaries, so long as the Export Source Rule remains in place. The adjusted revenue forecasts based on the textbook elasticities approach are not much different from the standard Treasury and JCT revenue forecasts. However, the adjusted revenue forecasts based on the Kemsley estimates and the Grubert-Mutti estimates are significantly lower than the standard revenue forecasts—about 25 percent lower in the case of the forecasts based on the Kemsley estimates and about 50 percent lower in the case of the forecasts based on the Grubert-Mutti estimates.

## 5. Conclusions

This report has assessed the medium-term cost and benefits of the Export Source Rule, based on the findings of two recent econometric studies, and the older more traditional textbook approach. Our calculations indicate that, for a plausible range of estimates, the Export Source Rule supports significant U.S. exports, jobs, and worker earnings—all at costs to the U.S. Treasury that are lower than usually estimated. For example, in the year 1999, for an adjusted net revenue cost of $1.1 billion (based on Kemsley's estimates), the United States will ship an additional $30.8 billion of exports, support 360 thousand jobs, and add $1.7 billion to worker payrolls in the form of the export earnings premium.

One key to these broad conclusions is the fact that export-oriented industries and jobs are highly productive, partly because U.S. producers and workers engaged in export production face the considerable discipline of highly competitive international markets for traded goods and services. A second key is the sensitivity of plant location to the tax environment. Not right away perhaps, but over a period of years a country that penalizes export production with high taxes will forfeit first investment and then export sales.

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Table 1. Calculated Impact of the Export Source Rule in 1992: Direct Estimates based on Kemsley Parameters

| | Companies with binding FTC positions | Companies with nonbinding FTC positions | All sample companies |
|---|---|---|---|
| Sample mean values per company [1] | | | |
| Total assets ($ millions)3,805 | 2,889 | 3,254 | |
| Foreign sales ($ millions)1,33 | 286 | 41,100 | |
| Foreign tax rate (%) | 48.63 | 35.72 | 42.25 |
| U.S. tax rate (%) | 35.00 | 35.00 | 35.00 |
| U.S. tax rate with ESR or FSC (%) [2] | 17.50 | 29.75 | n.a. |
| Addenda: No. of companies per Kemsley | 140 | 136 | 276 |
| Adjusted no. of companies | 247 | n.a. | n.a. |
| Additional U.S. exports ($ millions) [3] | | | |
| Per company | 68 | 0 | n.a. |
| All companies | 16,792 | 0 | 16,792 |
| Jobs supported by additional exports [4] | | | |
| All companies | 259,725 | 0 | 259,725 |
| Wage and salary premium ($ millions) [5] | | | |
| All companies | 951 | 0 | 951 |

Sources: Authors' calculations based on D. Kemsley, "The Effect of Taxes on Production Location," Columbia University, January 1997, mimeo; U.S. Department of Commerce, "U.S. Jobs Supported by Exports of Goods and Services," November 1996; J.D. Richardson and K. Rindal, Why Exports Matter: More! (Washington, D.C.: Institute for International Economics and The Manufacturing Institute, 1996); and Bureau of the Census, Economics and Statistics Administration, U.S. Department of Commerce, Statistical Abstract of the United States 1996, October 1996.

Notes: Companies with "binding FTC positions" are companies in an excess foreign tax credit (FTC) position; companies with "nonbinding FTC positions" are other companies. The estimates are based on the assumption that companies with binding FTC positions take advantage of the Export Source Rule (IRC Section 863(b)); while companies with nonbinding FTC positions utilize the Foreign Sales Corporation (FSC) provisions.

[1] The full pooled cross-sectional sample of data, compiled by Kemsley (1996) from the financial statements of U.S. multinational companies, consists of 2,486 manufacturing company-years for the period 1984–92. For the calculations presented in the table, the sample mean values are conservatively interpreted as 1992 values.

[2] It is assumed that companies with binding FTC positions (i.e., with excess foreign tax credits) exclude half their export profits from U.S. taxation by using the Export Source Rule. This reduces the effective U.S. tax rate on such profits from the normal rate of 35 percent to 17.5 percent. It is assumed that companies in nonbinding FTC positions (i.e., without excess foreign tax credits) exclude up to 15 percent of their export profits from U.S. taxation by using the Foreign Sales Corporation (FSC) provisions, thereby reducing the effective U.S. tax rate on such profits from the normal rate of 35 percent to 29.75 percent.

[3] Estimates are based on econometric findings investigating the magnitude of exports per company associated with U.S. export tax incentives reported by Kemsley (1997), adjusted for the larger number of companies that use the Export Source Rule after the Tax Reform Act of 1986, and also adjusted for the larger impact per company, taking into account exports to foreign affiliates (see text).

[4] These calculations assume that manufacturing exports support employment at the rate of 15,500 jobs per $1 billion of goods exported in 1992.

[5] Calculated as an earnings premium of 12 percent of average manufacturing earnings ($30,500 per worker) in 1992, or $3,660 per worker.

Table 2. Calculated Impact of the Export Source Rule in 1992: Production Response Approach based on Grubert and Mutti Parameters

| | Companies with binding FTC positions | Companies with nonbinding FTC positions | All sample companies |
|---|---|---|---|
| Sample mean values per company [1] | | | |
| Total exports ($ millions) | 2,585 | 2,585 | 2,585 |
| Foreign tax rate (%) | 48.63 | 35.72 | 42.25 |
| U.S. tax rate (%) | 35.00 | 35.00 | 35.00 |
| U.S. tax rate with ESR or FSC (%) [2] | 17.50 | 29.75 | n.a. |
| Addendum: number of companies | 25 | 25 | 50 |
| Additional U.S. exports ($ millions) [3] | | | |
| Per company | 1,247 | 0 | n.a. |
| All companies | 31,164 | 0 | 31,164 |
| Jobs supported by additional exports [4] | | | |
| All companies | 482,012 | 0 | 482,012 |
| Wage and salary premium ($ millions) [5] | | | |
| All companies | 1,766 | 0 | 1,766 |

Sources: Authors' calculations based on D. Kemsley, "The Effect of Taxes on Production Location," Columbia University, January 1997, mimeo; H. Grubert and J. Mutti, "Do Taxes Influence Where U.S. Corporations Invest?," Paper prepared for the Conference on Trans-Atlantic Public Economics Seminar, Amsterdam, Netherlands, May 29–31, 1996 (revised August 1996), mimeo; U.S. Department of Commerce, "U.S. Jobs Supported by Exports of Goods and Services," November 1996; J.D. Richardson and K. Rindal, Why Exports Matter: More! (Washington, D.C.: Institute for International Economics and The Manufacturing Institute, 1996); Bureau of the Census, Economics and Statistics Administration, U.S. Department of Commerce, Statistical Abstract of the United States 1996, October 1996; and Fortune, "The Top 50 U.S. Exporters," November 13, 1995.

Notes: Companies with "binding FTC positions" are companies in an excess foreign tax credit (FTC) position; companies with "nonbinding FTC positions" are other companies.

[1] The figure for total exports per company is based on the experience of the Fortune Top 50 U.S. Exporters, 1994 data adjusted back to 1992 using the average annual growth rate of U.S. manufactures exports. The 25–25 division of Fortune Top 50 Exporters between those with binding FTC positions and those with nonbinding FTC positions is based on Kemsley's full sample which classified 1,258 company-years as binding and 1,228 company-years as nonbinding.

[2] It is assumed that companies with binding FTC positions (i.e., with excess foreign tax credits) exclude half their export profits from U.S. taxation by using the Export Source Rule to characterize those profits as foreign source income (thereby absorbing part of their excess foreign tax credits). This reduces the effective U.S. tax rate on such profits from the normal rate of 35 percent to 17.5 percent. It is assumed that companies in nonbinding FTC positions (i.e., without excess foreign tax credits) exclude up to 15 percent of their export profits from U.S. taxation by using the Foreign Sales Corporation (FSC) provisions of the Internal Revenue Code, thereby reducing the effective U.S. tax rate on such profits from the normal rate of 35 percent to 29.75 percent.

[3] Grubert and Mutti (1996) estimate an elasticity of 3.0 for total capital invested by U.S. companies in foreign countries with respect to foreign tax rates. We assume that the ratio between capital invested and export sales is constant. Hence, the Grubert-Mutti elasticity of 3.0 is multiplied by the incremental inducement provided by the Export Source Rule, and then applied to total exports of companies with binding FTC positions. The key assumption in this calculation is that U.S. export production facilities can be regarded as if they were an additional overseas location for production of tradable goods by U.S. multinational firms. Further, it is assumed that, without the Export Source Rule, companies would ship their exports through a Foreign Sales Corporation. Hence, the calculation of additional exports only reflects the incremental inducement provided by the Export Source Rule, beyond the inducement provided by the Foreign Sales Corporation—i.e., an incremental reduction of 12.25 percentage points in the effective tax rate.

[4] These calculations assume that manufacturing exports support employment at the rate of 15,500 jobs per $1 billion of goods exported in 1992.

[5] Calculated as an earnings premium of 12 percent of average manufacturing earnings ($30,500 per worker) in 1992, or $3,660 per worker.

Table 3. Calculated Impact of the Export Source Rule in 1992: Textbook Approach based on Export Elasticity Parameters

| | Companies with binding FTC positions | Companies with nonbinding FTC positions | All sample companies |
|---|---|---|---|
| Sample mean values per company [1] | | | |
| Total exports ($ millions) | 2,585 | 2,585 | 2,585 |
| Foreign tax rate (%) | 48.63 | 35.72 | 42.25 |
| U.S. tax rate (%) | 35.00 | 35.00 | 35.00 |
| U.S. tax rate with ESR or FSC (%) [2] | 17.50 | 29.75 | n.a. |
| Addendum: number of companies | 25 | 25 | 50 |
| Additional U.S. exports ($ millions) [3] | | | |
| Per company | 228 | 0 | n.a. |
| All companies | 5,700 | 0 | 5,700 |
| Jobs supported by additional exports [4] | | | |
| All companies | 88,163 | 0 | 88,163 |
| Wage and salary premium ($ millions) [5] | | | |
| All companies | 323 | 0 | 323 |

Sources: Authors' calculations based on D. Kemsley, "The Effect of Taxes on Production Location," Columbia University, January 1997, mimeo; U.S. Department of the Treasury, The Operation and Effect of the Domestic International Sales Corporation Legislation: 1981 Annual Report (Washington, D.C., July 1983); U.S. Department of Commerce, "U.S. Jobs Supported by Exports of Goods and Services," November 1996; J.D. Richardson and K. Rindal, Why Exports Matter: More! (Washington, D.C.: Institute for International Economics and The Manufacturing Institute, 1996); Bureau of the Census, Economics and Statistics Administration, U.S. Department of Commerce, Statistical Abstract of the United States 1996, October 1996; and Fortune, "The Top 50 U.S. Exporters," November 13, 1995.

Notes: Companies with "binding FTC positions" are companies in an excess foreign tax credit (FTC) position; companies with "nonbinding FTC positions" are other companies.

[1] The figure for total exports per company is based on the experience of the Fortune Top 50 U.S. Exporters, 1994 data adjusted back to 1992 using the average annual growth rate of U.S. manufactures exports. Tax rates are from Kemsley. The 25–25 division of Fortune Top 50 Exporters between those with binding FTC positions and those with nonbinding FTC positions is based on Kemsley's full sample which classified 1,258 company-years as binding and 1,228 company-years as nonbinding.

[2] It is assumed that companies with binding FTC positions (i.e., with excess foreign tax credits) exclude half their export profits from U.S. taxation by using the Export Source Rule to characterize those profits as foreign source income (thereby absorbing part of their excess foreign tax credits). This reduces the effective U.S. tax rate on such profits from the normal rate of 35 percent to 17.5 percent. It is assumed that companies in nonbinding FTC positions (i.e., without excess foreign tax credits) exclude up to 15 percent of their export profits from U.S. taxation by using the Foreign Sales Corporation (FSC) provisions of the Internal Revenue Code, thereby reducing the effective U.S. tax rate on such profits from the normal rate of 35 percent to 29.75 percent.

[3] Estimates are derived by applying the textbook export elasticities approach to measuring the trade effects of export tax incentives, as outlined in U.S. Treasury Department (1983). The profit-to-export-sales ratio for all companies is assumed equal to 0.12. High values of the price elasticities of demand and supply for U.S. exports of manufactures, −10 and 20 respectively, are assumed in order to calculate the largest possible impacts of the Export Source Rule under the elasticities approach. These price elasticity estimates imply a "multiplier" value of 6.0, relating the proportional change in export sales to the tax-induced change in export income (expressed as a percentage of export sales) attributable to the Export Source Rule. The Export Source Rule saves firms 12.25 percentage points of taxation; assuming a profit-to-export sales ratio of 0.12, this translates into additional export income equal to 1.47 percent of export sales. Applying the "multiplier" of 6.0 indicates export gains of 8.82 percent.

[4] These calculations assume that manufacturing exports support employment at the rate of 15,500 jobs per $1 billion of goods exported.

[5] Calculated as an earnings premium of 12 percent of average manufacturing earnings ($30,500 per worker) in 1992, or $3,660 per worker.

Table 4. Projected Export and Revenue Impact of the Export Source Rule, 1998–2000

| | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|
| Additional U.S. exports ($ millions) | | | | | |
| Based on Kemsley parameters | 28,223 | 30,763 | 33,532 | 36,550 | 39,839 |
| Based on Grubert-Mutti parameters | 52,379 | 57,093 | 62,231 | 67,832 | 73,937 |
| Based on export elasticities approach | 9,580 | 10,443 | 11,382 | 12,407 | 13,523 |
| Employment and earnings Jobs supported by additional exports | | | | | |
| Based on Kemsley estimates | 343,779 | 360,093 | 377,182 | 395,081 | 413,831 |
| Based on Grubert-Mutti estimates | 638,013 | 668,291 | 700,006 | 733,225 | 768,021 |
| Based on export elasticities approach | 116,695 | 122,233 | 128,033 | 134,109 | 140,474 |
| Addenda: jobs per $1 bill. of exports [1] | 12,181 | 11,705 | 11,248 | 10,809 | 10,387 |
| Additional wages and salaries ($ m) [2] | | | | | |
| Based on Kemsley estimates | 1,572 | 1,708 | 1,857 | 2,018 | 2,194 |
| Based on Grubert-Mutti estimates | 2,917 | 3,171 | 3,446 | 3,746 | 4,071 |
| Based on export elasticities approach | 534 | 580 | 630 | 685 | 745 |
| Addenda: average earnings per worker in manufacturing ($) [1] | 38,104 | 39,538 | 41,026 | 42,570 | 44,171 |
| Tax revenue forecasts ($ millions) [3] | | | | | |
| U.S. Treasury | 891 | 1,474 | 1,555 | 1,750 | 1,855 |
| Revenue offset ($ millions) [4] | | | | | |
| Based on Kemsley parameters | n.a. | 367 | 399 | 434 | 472 |
| Based on Grubert-Mutti parameters | n.a. | 682 | 741 | 805 | 875 |
| Based on export elasticity parameters | n.a. | 125 | 136 | 147 | 160 |
| Adjusted tax revenue forecasts ($ m) [5] | | | | | |
| Based on Kemsley parameters | n.a. | 1,107 | 1,156 | 1,316 | 1,383 |
| Based on Grubert-Mutti parameters | n.a. | 792 | 814 | 945 | 980 |
| Based on export elasticity parameters | n.a. | 1,349 | 1,419 | 1,603 | 1,695 |

Sources: Tables 1, 2, and 3; International Trade Administration, U.S. Department of Commerce, U.S. Foreign Trade Highlights, October 28, 1996; J.D. Richardson and K. Rindal, Why Exports Matter: More! (Washington, D.C.: Institute for International Economics and The Manufacturing Institute, 1996); U.S. Department of Commerce, "U.S. Jobs Supported by Exports of Goods and Services," November 1996; Bureau of the Census, Economics and Statistics Administration, U.S. Department of Commerce, Statistical Abstract of the United States 1996, October 1996; and Office of Management and Budget, Budget of the United States Government, Fiscal Year 1998, February 6, 1997.

Notes: Projections of additional U.S. exports and employment are based on the estimates for 1992 presented in Tables 1, 2, and 3. Additional exports are projected using the recorded average annual growth rate of U.S. exports of manufactures during 1992–96 (9 percent).

[1] The addenda items reflect an annual growth rate of labor productivity in U.S. manufacturing sectors of 4 percent, based on the record of labor productivity in U.S. industry during 1985–93.

[2] Additional U.S. wages and salaries in 1992 are estimated using the jobs estimates multiplied by the average annual earnings of workers in manufacturing industries in that year ($30,500) and by the higher increment to wages and salaries (12 percent) enjoyed by workers in export manufacturing plants, the latter figure as reported by the U.S. Department of Commerce (1996). The projections for the years 1998 to 2002 are derived in the same manner as those for additional exports and employment.

[3] Tax revenue forecasts are supposed to reflect obvious changes in business behavior that are induced by a change in the tax law. If the Export Source Rule is repealed, U.S. multinational companies would exclude up to 15 percent of their export profits from U.S. taxation by utilizing the FSC provisions of the Internal Revenue Code. This change is reflected in the Treasury revenue forecasts (Office of Management and Budget 1997).

[4] The tax revenue offsets are the additional tax revenues related to the higher earnings enjoyed by the workers who produce the exports supported by the Export Source Rule. The tax revenue offsets are estimated by applying the average marginal U.S. income tax rate for individuals in 1996 (calculated at 21.5 percent) to the estimates in the table of additional U.S. earnings supported by the shift in output towards export industries as a consequence of the Export Source Rule.

[5] Under each of the three approaches to estimation of the impact of the Export Source Rule, the adjusted revenue forecasts are equal to the tax revenue forecasts minus the calculated tax revenue offsets.

Table 5. Estimates of Long-Run Price Elasticities of Demand and Supply for U.S. Exports

| Investigator | Demand | Supply |
|---|---|---|
| Manufacturing exports | | |
| Stern and Francis (1976) | −1.24 | n.a. |
| Junz and Rhomberg (1973) | −3.88 | n.a. |
| Artus and Sosa (1978) | −0.77 | 3.10 |
| Lawrence (1978) | −1.85 | n.a. |
| Dunlevy (1978) | n.a. | 2.10 |
| U.S. Treasury (1983) | −10.00 | 20.00 |
| Total exports | | |
| Houthakker and Magee (1969) | −1.51 | n.a. |
| Magee (1970) | n.a. | 11.50 |
| Stern and Francis (1976) | −1.41 | n.a. |
| Goldstein and Khan (1978) | −2.32 | 6.60 |
| Gylfason (1978) | n.a. | 2.40 |
| Geraci and Prewo (1980) | n.a. | 12.20 |

Sources: R.M. Stern and J. Francis, Price Elasticities in International Trade: An Annotated Bibliography (London: Macmillan for the Trade Policy Research Centre, 1976); U.S. Department of the Treasury, The Operation and Effect of the Domestic International Sales Corporation Legislation: 1981 Annual Report (Washington, D.C.: July 1983); and M. Goldstein and M. Khan, "Income and Price Effects in Foreign Trade," in Handbook of International Economics, Vol. II, eds., R.W. Jones and P.B. Kenen (Amsterdam: North-Holland, 1985).

Notes: The price elasticities of demand for U.S. exports reported by Stern and Francis (1976) are "mean" estimates compiled by the two authors from econometric studies by other investigators. The elasticities in U.S. Treasury (1983) are assumed values that are intended to represent "high" estimates of price elasticities of demand and supply for U.S. exports of manufactures.

Table 6. U.S. Merchandise and Manufactures Trade, 1985–2002

(Billions of U.S. dollars, Census basis)

| Year | Total Goods [1] | | | Manufactured Goods [2] | | |
|---|---|---|---|---|---|---|
| | Exports | Imports | Balance | Exports | Imports | Balance |
| 1985 | 218.8 | 336.5 | −117.7 | 168.0 | 257.5 | −89.5 |
| 1986 | 227.2 | 365.4 | −138.3 | 179.8 | 296.7 | −116.8 |
| 1987 | 254.1 | 406.2 | −152.1 | 199.9 | 324.4 | −124.6 |
| 1988 | 322.4 | 441.0 | −118.5 | 255.6 | 361.4 | −105.7 |
| 1989 | 363.8 | 473.2 | −109.4 | 287.0 | 379.4 | −92.4 |
| 1990 | 393.6 | 495.3 | −101.7 | 315.4 | 388.8 | −73.5 |
| 1991 | 421.7 | 488.5 | −66.7 | 345.1 | 392.4 | −47.3 |
| 1992 | 448.2 | 532.7 | −84.5 | 368.5 | 434.3 | −65.9 |
| 1993 | 465.1 | 580.7 | −115.6 | 388.7 | 479.9 | −91.2 |
| 1994 | 512.6 | 663.3 | −150.6 | 431.1 | 557.3 | −126.3 |
| 1995 | 584.7 | 743.4 | −158.7 | 486.7 | 629.7 | −143.0 |
| 1996 | 616.6 | 783.0 | −166.4 | 521.3 | 653.9 | −132.6 |
| 1997 | 672.1 | 568.2 | | | | |
| 1998 | 732.6 | 619.4 | | | | |
| 1999 | 798.5 | 675.1 | | | | |
| 2000 | 870.4 | 735.9 | | | | |

Sources: International Trade Administration, U.S. Department of Commerce, U.S. Foreign Trade Highlights, October 28, 1996; and Bureau of Economic Analysis, U.S. Department of Commerce, Commerce News: U.S. International Trade in Goods and Services, September 1996, November 20, 1996.

Notes: All values for 1996 are extrapolated from reported values for the first nine months. Values of exports during 1997–2002 are projected, assuming an annual average growth rate of 9 percent.

[1] Includes nonmonetary gold, military grant aid, special category shipments, trade between the U.S. Virgin Islands and foreign countries, and undocumented exports to Canada. Adjustments were also carryover. Import values are based on transaction prices whenever possible

[2] Manufactured goods include commodity sections 5–9 under SITC Rev. 3. Manufactures include undocumented exports to Canada, nonmonetary gold (excluding gold ore, scrap, and base bullion), and special category shipments.

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**Statement of John Porter, Tax Director, Financial Executives Institute**

INTRODUCTION

Mr. Chairman and Members of the Committee:

The FEI Committee on Taxation is pleased to present its views on the Administration's Budget proposals and their impact on the international competitiveness of U.S. businesses and workers. FEI is a professional association comprising 14,000 senior financial executives from over 8,000 major companies throughout the United States. The Tax Committee represents the views of the senior tax officers from over 30 of the nation's largest corporations.

The FEI thanks the House Ways & Means Committee for scheduling these hearings on the Administration's budget proposals. We support a few of the proposals, for example, the extension of the tax credit for research. This provision should help improve the competitive position of U.S. companies. However, in many of the other tax proposals, the Administration replaced sound tax policy with some unwise revenue raisers. These latter proposals do nothing to achieve the objective of retaining U.S. jobs and making the U.S. economy stronger. For example, provisions are found in the Budget to extend Superfund taxes with no concomitant improvement of the cleanup programs, arbitrarily change the sourcing of income rules on export sales by U.S. based manufacturers, and restrict the ability of "dual capacity taxpayers" to take credit for certain taxes paid to foreign countries.

Targeting publicly held U.S. multinationals doing business overseas for budget revenue raisers is unwise and the FEI urges that such proposals not be adopted by Congress. Businesses establish foreign operations to serve local overseas markets so they are able to compete more efficiently with foreign based competition. In addition to assisting with the growth of exports and consequently job creation in the U.S., investments abroad help the U.S. balance of payments. The long-standing creditability of foreign income taxes is intended to alleviate the double taxation of foreign income. Replacing such credisult in double taxation and greatly increase the costs of doing business overseas, which will place U.S. multinationals at a competitive disadvantage versus foreign based companies.

U.S. jobs and the economy overall would be best served by Congress working with the Administration to do all it can to make the U.S. tax code more friendly; a position already afforded our international competitors by their home country governments. The budget should be written with the goal of reintegrating sound tax policy into decisions about the revenue needs of the government. Provisions that merely increase business taxes by eliminating legitimate business deductions should be avoided. Ordinary and necessary business expenses are integral to our current income based system, and needless elimination of them will only distort that system. Higher business taxes impact all Americans, directly or indirectly. It should be kept in mind that millions of ordinary Americans are shareholders, through their retirement plans, of corporate America and that proposals that decrease the competitiveness of U.S. business harm those persons both as shareholders and employees.

EFFECTIVE DATES

The FEI would like to voice its view that it is bad tax policy to add significant tax burdens on business in a retroactive manner. Businesses should be able to rely on the tax rules in place when making economic decisions, and expect that those rules will not change while their investments are still ongoing. It seems plainly unfair to encourage businesses to make economic decisions based on a certain set of rules, but then change those rules midstream after the taxpayer has made significant investments in reliance thereon. Thus, whenever possible, we call on Congress to assure that significant tax changes do not have retroactive application. To do otherwise can have a chilling effect on business investments which could be adversely impacted by rumored tax changes.

PROVISIONS THAT SHOULD NOT BE ADOPTED

Sound and paramount when deciding on taxation of business—not mere revenue needs. In this light, the FEI offers the following comments on certain specific tax increase proposals set forth in the Administration's budget:

REPEAL OF CODE SECTION 863(B)

When products manufactured in the U.S. are sold abroad, Code Sec. 863(b) enables the U.S. manufacturer to treat half of the income derived from those sales as foreign source income, as long as title passes outside the U.S. Since title on export sales to unrelated parties often passes at the point of origin, this provision is more often applied to export sales to foreign affiliates.

The Administration proposes to repeal Sec. 863(b) because it allegedly gives multinational corporations a competitive advantage over U.S. exporters that conduct all of their business activities in the U.S. It also believes that replacing Sec. 863(b) with an allocation based on actual economic activity will raise $6.6 billion over five years. This proposal is nonsensical.

First, to compete effectively in overseas markets, most U.S. manufacturers find that they must have operations in those foreign markets to sell and service their products. Many find it necessary to manufacture products specially designed for a foreign market in the country of sale, importing vital components of that product from the U.S. wherever feasible. Thus, the supposed competitive advantage over a U.S. exporter with no foreign assets or employees is a myth. There are many situations in which a U.S. manufacturer with no foreign activities simply cannot compete effectively in foreign markets.

Second, except in the very short term, this proposal could reduce the Treasury's revenues rather than increase them. This is because the multinational corporations, against which this proposal is directed, may have a choice. Instead of exporting their products from the U.S., they may be able to manufacture them abroad to the extent of excess capacity in foreign plants. If even a small percentage of position to make such a switch, the proposal will fail to achieve the desired result and taxes on manufacturing profits and manufacturing wages will go to foreign treasuries, instead of to the U.S. Amazingly, the Administration seems to encourage this result by calling for an allocation based on "actual economic activity," which would cause a behavioral response to increase economic activity in foreign jurisdictions that could result in more foreign jobs, investment, and profits.

At present, the U.S. has too few tax incentives for exporters, especially compared to foreign countries with VAT regimes. The U.S. should be stimulating the expansion of exports. Given our continuing trade deficit, it would be unwise to remove a tax incentive for multinational corporations to continue making GATT legal export sales from the United States. Ironically, this proposal could result in multinationals using existing foreign manufacturing operations instead of U.S. based operations to produce export products. We encourage Congress not to adopt it.

LIMITING USE OF "HYBRID" ENTITIES

It is troubling that the Administration (i.e., Treasury) feels compelled to request congressional authority to issue potentially sweeping legislative regulations after non-specific tax guidance has been given. If Treasury has specific issues to address, it should do so through specific legislative proposals. This would permit normal congressional consideration, including hearings on such proposals.

One such proposal would limit the ability of certain foreign and U.S. persons to enter into transactions that utilize so-called "hybrid entities," which are entities that are treated as corporations in one jurisdiction, but, as branches or partnerships in another jurisdiction. Although most hybrid transactions do not attempt to generate tax results that are "inconsistent with the purposes of U.S. tax law," the Administration feels that there are enough taxpayers taking unfair advantage of the current rules thatxtend the earlier government issued tax guidance (Notices 98–5 and 98–11) on this subject.

U.S. multinationals compete in an environment wherein foreign competitors use tax planning techniques to reduce foreign taxes without incurring home country tax. The use of "hybrid entities" allows U.S. multinationals to compete on a level playing field and promotes additional U.S. exports. The use of hybrids is consistent with the initial balance between competitiveness and export neutrality that was intended by Congress in enacting the "Subpart F" rules. Although Congress specifically enacted a branch rule for foreign base company sales under Code Sec. 954(d)(3), similar rules were not enacted for foreign personal holding company income. If enacted, these proposals would represent an unwarranted extension of legislative authority by Congress to the Executive Branch to impose new rules by regulation without Congressional debate.

Notices 98–5 and 98–11 have a chilling effect on the ability of U.S. companies to structure their foreign operations consistent with the commercial objective to regionalize businesses. They also adversely impact companies' abilities to effectively reduce their overall costs by reducing local taxes in their overseas operations. The No-

tices are drafted so broadly and so vaguely that they confuse U.S. taxpayers and their advisors, and introduce a compelling need to seek clarification as to whether taxpayers can continue to rely on the simple "check-the-box" regulations issued just last year. All these effects are exacerbated by the Notices' immediate effective dates.

The world has changed dramatically since enactment of the Subpart F rules in 1962. We feel that it would be more appropriate for Congress to request a study regarding the trade and tax policy issues associated with Notices 98–5 and 98–11. In this regard, a moratorium on further regulatory action by Treasury should be imposed until enactment of specific legislative proposals resulting

### Foreign Built-In Losses

Another proposal would require the Treasury to issue regulations to prevent taxpayers from "importing built-in losses incurred outside U.S. taxing jurisdictions to offset income or gain that would otherwise be subject to U.S. tax." The administration argues that although there are rules in the Code that limit a U.S. taxpayer's ability to avoid paying U.S. tax on built-in gain (e.g., Code Secs. 367(a), 864(c)(7), and 877), similar rules do not exist that prevent built-in losses from being used to shelter income otherwise subject to U.S. tax and, as a result, taxpayers are avoiding Subpart F income inclusions or capital gains tax. We believe that this directive, which is written extremely broadly, is unnecessary due to the existence of rules already available in the Code, e.g., the anti-abuse provisions of Code Secs. 269, 382, 446(b), and 482. Both this proposal, and the one immediately above regarding the use of hybrid entities, would severely impact the ability of U.S. multinationals to compete on an equal footing against foreign-based companies.

### Foreign Oil and Gas Income

The President's budget proposal dealing with foreign oil and gas income moves in the direction of limiting use of the foreign tax credit on foreign oil and gas income. This selective attack on a single industry's utilization of the foreign tax credit is not justified. U.S. based oil companies are already at a competitive disadvantage under current law since most of their foreign based competition pay little or no home country tax on foreign oil and gas income. Perversely, this proposal cedes an advantage to overseas competitors by subjecting foreign oil and gas income to U.S. double taxation, which will severely hinder U.S. oil companies in the global oil and gas exploration, production, refining and marketing arena.

### Superfund Taxes

The three taxes that fund Superfund (corporate environmental tax, petroleum excise tax, and chemical feed stock tax) all expired on December 3 would reinstate the two excise taxes at their previous levels for the period after the date of enactment through September 30, 2008. The corporate environmental tax would be reinstated at its previous level for taxable years beginning after December 31, 1997 and before January 1, 2009. In addition, the funding cap for the Oil Spill Tax would be increased from the current $1 Billion amount, to a much higher level of $5 Billion.

These taxes, which were previously dedicated to Superfund, would instead be used to generate revenue to balance the budget. This use of taxes historically dedicated to funding specific programs for deficit reduction purposes should be rejected. The decision whether to re-impose these taxes dedicated to financing Superfund should instead be made as part of a comprehensive examination of reforming the entire Superfund program.

### Payments to 80/20 Companies

Currently, a portion of interest or dividends paid by a domestic corporation to a foreign entity may be exempt from U.S. withholding tax provided the payor corporation is a so-called "80/20 Company," i.e., at least eighty percent of its gross income for the preceding three years is foreign source income attributable to the active conduct of a foreign trade or business. The Administration believes that the testing period is subject to manipulation and allows certain companies to improperly avoid U.S. withholding tax on certain distributions attributable to a U.S. subsidiary's U.S. source earnings. As a result, it proposes to arbitrarily change the 80/20 rules by applying the test on a group-wide (as opposed to individual company) basis. However, there is little evidence that these rules have been manipulated on a broad scale in the past and we do not believe such a drastic change is needed at this time.

### MODIFYING THE SUBSTANTIAL UNDERSTATEMENT PENALTY

The Administration proposed to make any tax deficiency greater than $10 million "substantial" for purpose of the penalty, rather than applying the existing test that such tax deficiency must exceed 10% of the taxpayer's liability for the year. While to the individual taxpayer or even a privately-held company, $10 million may be a substantial amount of money—to a publicly-held multinational company, in fact, it may not be "substantial." Furthermore, a 90% accurate return, given the agreed-upon complexities and ambiguities contained in our existing Internal Revenue Code, should be deemed substantial compliance, with only additional taxes and interest due and owing. There is no policy justification to apply a penalty to publicly-held multinational companies which are required to deal with much greater complexities than are all other taxpayers.

The difficulty in this area is illustrated by the fact that the Secretary of the Treasury has yet to comply with Code Sec. 6662(d)(2)(D), which requires thepositions being taken for which the Secretary believes there is not substantial authority and which would affect a significant number of taxpayers. The list is to be revised not less frequently than annually. Taxpayers still await the Secretary's first list.

### INCREASED PENALTIES FOR FAILURE TO FILE RETURNS

The Administration also proposed to increase penalties for failure to file information returns, including all standard 1099 forms. IRS statistics bear out the fact that compliance levels for such returns are already extremely high. Any failures to file on a timely basis generally are due to the late reporting of year-end information or to other unavoidable problems. Under these circumstances, an increase in the penalty for failure to timely file returns would be unfair and would fail to recognize the substantial compliance efforts already made by American business.

### LIMITING MARK-TO-MARKET ACCOUNTING

Certain trade receivables would no longer be eligible for treatment under the mark-to-market accounting rules. Under those rules, certain taxpayers who purchase and sell their own trade receivables are exempt from the mark-to-market method of accounting unless they elect to be included. If they do, those taxpayers can currently write-off certain non-interest bearing receivables, and account, note, and trade receivables unrelated to the active business of a security dealer. There appear to be no tax policy reasons for prohibiting taxpayers from accelerating their bad debt deductions for these trade receivables, only government revenue considerations.

### REPEALING LOWER OF COST OR MARKET INVENTORY METHOD

Certain taxpayers can currently determine their inventory values by applying the lower of cost or market method, or by writing down the cost of goods that are not salable at normal prices, or not usable because of damage or other causes. The Administration is proposing to repeal these options and force taxpayers to recognize income from changing their method of writing down unusable or non-salable goods somehow "understates taxable income." We strongly disagree with this unwarranted proposal. In addition, we believe that in the least, the lower of cost or market method should continue to be permissible when used for financial accounting purposes, to avoid the complexity of maintaining separate inventory accounting systems.

### MODIFICATION OF THE CORPORATE-OWNED LIFE INSURANCE ("COLI") RULES

The Administration proposes to substantially change the taxation of business-owned life insurance by disallowing a pro-rata portion of a business' general deduction for interest expense. Moreover, the Administration has proposed retroactive application of the new tax to existing life insurance contracts. This proposal should not be adopted.

Life insurance has long been used by businesses to protect against financial loss caused by the death of key employees and to finance the soaring cost of employee benefits, especially post-retirement health benefits. Life insurance provides a secure and stable source of financing for such employee benefits, and it is particularly well suited to this purpose because its long-term nature matches the correspondingly long-term nature of the liabilities. The Administration's proposal would have a devastating effect on employee benefit programs and key-person protection by effectively taxing life insurance contracts out of existence. Businesses should not be dis-

couraged from providing employee health benefits or from seeking to protect themselves from key-person losses.

Moreover, the Administration's proposal would apply retroactively to existing life insurance contracts that were purchased by businesses in good faith, based on existing law. There can be no question of abuse: business use of life insurance is well known and the taxation of insurance contracts has been settled for many years. In addition, Congress has reviewed the taxation of business-owned life insurance in each of the last two yearrved the existing taxation of business-owned life insurance on the lives of employees. The Administration's proposal represents the worst kind of retroactive tax—it would not only cause the termination of most or all existing contracts, but, would also have the effect of taxing past earnings under those contracts.

### DEFERRAL OF OID ON CONVERTIBLE DEBT

The Administration has included a number of past proposals aimed at financial instruments and the capital markets, which were fully rejected during the last session of Congress. These reintroduced proposals should again be rejected out of hand. One proposal would defer deductions by corporate issuers for interest accrued on convertible debt instruments with original issue discount ("OID") until interest is paid in cash. The proposal would completely deny the corporation an interest deduction unless the investors are paid in cash (e.g., no deduction would be allowed if the investors convert their bonds into stock). Investors in such instruments would still be required to pay income tax currently on the accrued interest. In effect, the proposal defers or denies an interest deduction to the issuer, while requiring the holder to pay tax on the interest currently.

The FEI opposes this proposal because it is contrary to sound tax policy and symmetry that matches accrual of interest income by holders of OID instruments with the ability of issuers to deduct accrued interest. There is no justifiable reason for treating the securities as debt for one side of the transaction and as equity for the other side. There is also no reason, economic or otherwise, to distinguish a settlement in cash from a settlement in stock.

Moreover, the instruments in question are truly debt rather than equity. Recent statistics show that over 70 percent of all zero-coupon convertible debt instruments were retired with cash, while only 30 percent of these instruments were convertible to common stock. Re-characterizing these instruments as equncorrect and will put American companies at a distinct disadvantage to their foreign competitors, who are not bound by such restrictions. These hybrid instruments and convertible OID bond instruments have allowed many U.S. companies to raise tens of billions of dollars of investment capital used to stimulate the economy. Introducing this imbalance and complexity into the tax code will discourage the use of such instruments, limit capital raising options, and increase borrowing costs for corporations.

### ELIMINATING THE "DRD" FOR CERTAIN PREFERRED STOCK

Another proposal would deny the dividend received deduction ("DRD") for certain types of preferred stock, which the Administration believes are more like debt than equity. Although concerned that dividend payments from such preferred stock more closely resembles interest payments than dividends, the proposal does not simultaneously propose to allow issuers of such securities to take interest expense deductions on such payments. Again, the Administration violates sound tax policy and, in this proposal, would deny these instruments the tax benefits of both equity and debt.

The FEI opposes this proposal as not being in the best interests of either tax or public policy. Currently, the U.S. is the only major western industrialized nation that subjects corporate income to multiple levels of taxation. Over the years, the DRD has been decreased from 100% for dividends received by corporations that own over 80 percent of other corporations, to the current 70% for less than 20 percent owned corporations. As a result, corporate earnings have become subject to multiple levels of taxation, thus driving up the cost of doing business in the U.S. To further decrease the DRD would be another move in the wrong direction.

### PRO RATA DISALLOWANCE

The FEI strongly opposes the Administration's proposal to extend the pro rata disallowance of tax-exempt interest expense to all corporations. By reducing corporate demand for tax-exempts,he financing costs of state and local governments. The application of the pro rata rule on an affiliated company basis penalizes companies that hold tax-exempt bonds to satisfy state consumer protection statutes, such as

state money transmitter laws, but happen to be affiliated with other businesses that have interest expense totally unrelated to the holding of the tax-exempt bonds. These corporate investors, holding principally long-term bonds, are critical to the stable financing of America's cities and states. Treasury currently has the authority to prevent any abuse in this area by showing that borrowed funds were used to carry tax-exempt securities; this more targeted approach provides appropriate protection without disrupting the public securities market.

Secondly, corporations often invest some operating funds in tax-exempt bonds for cash management reasons. No evidence exists that these corporations are engaged in improper interest-rate arbitrage. Not only are there no tax-motivated abuses in this area which merit increasing the borrowing costs of state and local governments, these investors help support an active and liquid short-term municipal bond market vital to states and localities. Again, the result of the Administration's proposal would be to reduce demand for tax-exempt bonds and drive up costs for state and local governments. This is something that Congress should not do when it is looking to these very same state and local governments to do more.

### Positive Tax Proposals

As stated above, certain of the Administration's tax proposals will have a positive impact on the economy. For example:

### Extension of Research Tax Credit

The proposal to extend the research tax credit is to be applauded. The credit, which applies to amounts of qualified research in excess of a company's base amount, has served to promote research that otherwise may never have occurred. The buildup of "knowledge capital" is absolutely essential to enhance the competitive position of the U.S. in international markets—especially in what some refer to as the Information Age. Encouraging private sector research work through a tax credit has the decided advantage of keeping the government out of the business of picking specific winners or losers in providing direct research incentives. The FEI recommends that Congress work together with the Administration to extend the research tax credit on a permanent basis.

### Accelerating Effective Date of 10/50 Company Change

Another proposal would accelerate the effective date of a tax change made in the 1997 Tax Relief Act affecting foreign joint ventures owned between ten and fifty percent by U.S. parents (so-called "10/50 Companies"). This change will allow 10/50 Companies to be treated just like controlled foreign corporations by allowing "look-through" treatment for foreign tax credit purposes for dividends from such joint ventures. The 1997 Act, however, did not make the change effective for such dividends unless they were received after the year 2003 and, even then, required two sets of rules to apply for dividends from earnings and profits ("E&P") generated before the year 2003, and dividends from E&P accumulated after the year 2002. The Administration's proposal will, instead, apply the look-through rules to all dividends received in tax years after 1997, no matter when the E&P constituting the makeup of the dividend was accumulated.

This change will result in a tremendous reduction in complexity and compliance burdens for U.S. multinationals doing business overseas through foreign joint ventures. It will also reduce the competitive bias against U.S. participation in such ventures by placing U.S. companies on a much more level playing field from a corporate tax standpoint. This proposal epitomizes the favored policy goal of simplicity in the tax laws, and will go a long way toward helping the U.S. economy by strengthening the competitive position of U.S. based multinationals.

### Netting of Underpayments and Overpayments

The proposal to requiyments and underpayments for purposes of calculating interest (commonly referred to as "global interest netting") is a large step forward towards fairness and equity. A new interest rate would be added to Code Sec. 6621 that equalizes interest in cases of overlapping periods of mutual indebtedness for tax periods not barred by an expiring statute of limitations. In other words, no interest would accrue on a deficiency to the extent that a taxpayer is owed a refund in the same amount, during periods that both are outstanding. We suggest that this change be made to apply to all open tax years, consistent with Congress' long-stated position on this issue.

CONCLUSION

The FEI urges Congress not to adopt the revenue raising provisions identified above when formulating its own budget proposals. They are based on unsound tax policy. Congress, in considering the Administration's budget, should elevate sound and justifiable tax policy over mere revenue needs. Revenue can be generated consistent with sound tax policy, and that is the approach that should be followed as the budget process moves forward.

The Administration's proposals would add complexity in direct contrast to the Administration's stated need to simplify the tax law in order to assist the Internal Revenue Service in more effectively filling its role as the nation's tax collector.

**Statement of Michael W. Yackira, President, FPL Energy, Inc.**

Mr. Chairman and members of the Committee, my name is Michael W. Yackira, and I am the President of FPL Energy, Inc. I thank you for the opportunity to submit this statement on behalf of my company on the importance of extending the wind energy production tax credit (PTC) for an additional five years.

FPL Energy, an affiliate of Florida Power & Light Company and subsidiary of FPL Group, Inc., has interests in over 700 megawatts of operating wind power facilities located in California and Northern Ireland. This makes FPL Energy the largest owner/producer of wind generated electric energy in the United States. FPL Energy also has interests in more than 375 megawatts of utility scale wind power generation facilities under construction or development in Iowa, Minnesota, Texas, Oregon, and California. We are committed to clean energy sources and believe that, among renewable energy technologies, wind energy has the greatest future potential to economically satisfy large scale demand across the largest geographic regions in the United States.

I want to commend Representatives Bill Thomas and Bob Matsui, and all of the cosponsors of H.R. 1401, and Senators Charles Grassley and Kent Conrad, and all of the cosponsors of S. 1459, for their leadership in supporting legislation to extend the wind energy PTC until the year 2004. I also want to commend President Clinton for including, and funding, a five-year extension of the wind energy PTC in the Administration's FY 1999 Budget.

I hope the Congress will take swift action to extend the wind energy PTC by enacting the provisions of H.R. 1401—S. 1459 before the end of the second session.

I. BACKGROUND OF THE WIND ENERGY PTC

The wind energy PTC, enacted as part of the Energy Policy Act of 1992, provides an inflation-adjusted 1.5 cents/kilowatt-hour credit for electricity produced with wind equipment for the first ten years of a project's life. The credit is available only if the wind energy equipment is located in the United States and electricity is generated and sold. The credit applies to electricity produced by a qualified wind energy facility placed in service after December 3, 1993, and before July 1, 1999. The credit is set to expire on July 1, 1999.

II. WHY DO WE NEED A WIND ENERGY PTC?

*A. The wind energy PTC supports wind energy development and production.*

The credit assists wind-generated energy in competing with fossil fuel-generated power. In the 1980s, electricity generated with wind could cost as much as 25 cents/kilowatt-hour. Since that time, the efficiency of wind energy production has increased by over 80% to the current cost of 4.5 cents/kilowatt hour. The 1.5 cent/kilowatt-hour credit enables the industry to compete with other generating sources being sold at 3 cents/kilowatt-hour. The extension of the credit will enable the industry to continue to develop and improve its technology so it will be able to fully stand on its own in only a few short years. Indeed, experts predict the cost of wind equipment alone can be reduced by another 40% from current levels. This is exactly what Congress envisioned when it enacted the wind energy PTC, the development and improvement of wind energy technology.

*B. Wind power will play an important role in a deregulated electrical market.*

The electrical generation market is going through radical changes as a result of efforts to restructure the industry at both the Federal and State levels. If the wind energy PTC is extended, renewable energies such as wind power are certain to play

an important role in a deregulated electrical generation market. Wind power alone has the potential to generate power to as many as 10 million homes by the end of the next decade. Extending the credit will help the wind energy industry secure its position in the deregulated marketplace as a fully competitive, renewable source of electricity.

*C. Wind power contributes to the reduction of greenhouse emissions.*

Wind-generated electricity is an environmentally-friendly form of renewable energy that produces no greenhouse gas emissions. "Clean" energy sources such as wind power are particularly helpful in reducing greenhouse gas emissions. The reduction of greenhouse gas emissions in the United States will necessitate the promotion of clean, environmentally-friendly sources of renewable energy such as wind energy. The extension of the wind energy PTC will assure the continued availability of wind power as a clean, renewable energy source.

*D. Wind power has significant economic growth potential.*

1. Domestic.—Wind energy has the potential to play a meaningful role in meeting the growing electricity demand in the United States. As stated above, with the appropriate commitment of resources to wind energy projects, wind power could generate power to as many as 10 million homes by the end of the next decade. There currently are a number of wind power projects operating across the county. These projects are currently generating 1,761 megawatts of wind power in the following states: New York, Minnesota, Iowa, Texas, California, Hawaii and Vermont.

There also are a number of new wind projects currently under development in the United States. These new projects will generate 670 megawatts of wind power in the following states: Texas, Colorado, Minnesota, Iowa, Wyoming and California.

The domestic wind energy market has great potential for future growth because, as the sophistication of wind energy technology continues to improve, new geographic regions in the United States become suitable for wind energy production. The top twenty states for future wind energy potential include:

| | | |
|---|---|---|
| 1. North Dakota | 8. Oklahoma | 15. New York |
| 2. Texas | 9. Minnesota | 16. Illinois |
| 3. Kansas | 10. Iowa | 17. California |
| 4. South Dakota | 11. Colorado | 18. Wisconsin |
| 5. Montana | 12. New Mexico | 19. Maine |
| 6. Nebraska | 13. Idaho | 20. Missouri [1] |
| 7. Wyoming | 14. Michigan | |

2. International.—The global wind energy market has been growing at a remarkable rate over the last several years and is the world's fastest growing energy technology. The growth of the market offers significant export opportunities for United States wind turbine and component manufacturers. The World Energy Council has estimated that new wind capacity worldwide will amount to $150 to $400 billion worth of new business over the next twenty years. Experts estimate that as many as 157,000 new jobs could be created if United States wind energy equipment manufacturers are able to capture just 25% of the global wind equipment market over the next ten years. Only by supporting its domestic wind energy production through the extension of the wind energy PTC can the United States hope to develop the technology and capability to effectively compete in this rapidly growing international market.

*E. The immediate extension of the wind energy PTC is critical.*

Since the wind energy PTC is a production credit available only for energy actually produced from new facilities, the credit is inextricably tied to the financing and development of new facilities. The financing and permitting requirements for a new wind facility often require up to two to three or more years of lead time. With the credit due to expire in less than a year and a half (July 1999), wind energy developers and investors are concerned about the cost impact of halting and restarting new wind development. Moreover, if the credit is not extended this year, it is extremely unlikely Congress will be able to address an extension of the wind energy PTC before its expiration in 1999. The immediate extension of the wind energy PTC is therefore critical to the continued development of the wind energy market.

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[1] Source: An Assessment of the Available Windy Land Area and Wind Energy Potential in the Contiguous United States, Pacific Northwest Laboratory, 1991.

## III. Conclusion

Extending the wind energy PTC for an additional five years is critical for a number of reasons. The credit enables wind-generated energy to compete with fossil fuel-generated power, thus promoting the development of an industry that has the potential to meet the electricity demands of millions of homes across the United States. If the wind energy PTC is extended, wind energy is certain to be an important form of renewable energy in a deregulated electrical market, and also is an environmentally-friendly energy source that could aid in the reduction of greenhouse gas emissions. The economic opportunities of the wind energy market are significant, both domestically and internationally. As such, I recommend that Congress act quickly to extend the wind energy PTC until the year 2004 so that the industry can continue to develop this important renewable energy resource.

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# Statement of Hybrid Branch Coalition [1]

## Overview

The Hybrid Branch Coalition (the "Coalition") is composed of U.S. companies representing a broad cross-section of industries that are competing in the global marketplace. The Coalition opposes the proposal in the President's budget that would grant Treasury broad regulatory authority to "address tax avoidance through the use of hybrids." To a large extent, the President's proposal requests from Congress the legal authority needed to issue regulations implementing two notices issued by the IRS, one in December of 1997 and the other in January of 1998. In addition, the proposal would give the IRS legislative authority to issue regulations well beyond the scope of the two notices.

The two notices describe in very general terms the content of regulations that the IRS plans to issue, and contain a few examples illustrating the intended application of those regulations. The notices provide that the regulations are intended to apply to certain transactions retroactively to the date the notices were issued. The Coalition strongly believes that the IRS has no current authority to issue these retroactive regulations, and opposes any request for legislation that would allow retroactive effect.

More fundamentally, however, the Coalition believes that the regulations described in the notices would be misguided and out of step with traditional and long-standing U.S. tax principles. The regulations would also inhibit a wide range of legitimate business transactions in which the only perceived abuse is a reduction of foreign taxes, a result that U.S. tax policy has historically favored. The Coalition therefore opposes any grant of regulatory authority along the lines proposed. Instead, Congress should enact legislation codifying the current rules.

## Introduction

In Notice 98–11 and Notice 98–5, the Internal Revenue Service and the Treasury Department announced their intention to issue retroactive regulations that would reverse long-standing fundamental principles underlying the U.S. taxation of international transactions. These notices are nothing less than an attempt to add new provisions to the Internal Revenue Code—a task that is not within the regulatory purview of either agency. According to the notices, the regulations will seek to define "appropriate tax results" when transactions involve a hybrid entity (an entity classified in one jurisdiction as a corporation and in another as a partnership or branch) or a hybrid security (an instrument treated as debt in one jurisdiction and as equity in another).

Following the issuance of the notices, the executive branch sought statutory authority to support its retroactive initiatives. The Administration's fiscal 1999 Budget Proposal asks Congress to give the IRS regulatory authority to determine unilaterally the "appropriate tax results with respect to hybrid transactions."

This standard is far too vague to be worthy of Congressional endorsement. In its analysis of the President's request for regulatory authority in this area prepared the in conjunction with this hearing, the Joint Committee on Taxation ("JCT") stated that a broad grant of regulatory authority to specify the tax consequences of hybrid

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[1] This testimony was prepared by Arthur Andersen on behalf of the Hybrid Branch Coalition.

transactions may not be appropriate.[2] Furthermore, said the JCT, broad regulatory authority without specific parameters could severely impact transactions entered into in the ordinary course of business operations. We agree with both conclusions.

The regulations described by the notices, if promulgated, would drastically depart from long-accepted principles underlying the U.S. taxation of taxpayers operating overseas. Notice 98–11 seeks to impose current U.S. tax on transactions where the benefit derived by the taxpayer is the reduction of its foreign tax liability—a policy previously encouraged by Treasury because the resulting reduced foreign tax credit increases the ultimate U.S. tax. This result would be reached by giving tax effect to payments between branches or divisions of a single taxpayer, an approach that until now has been almost unheard of in U.S. tax policy. Notice 98–5 seeks to impose a nebulous "economic return" prerequisite for claiming foreign tax credits, although one searches the Code in vain for any such requirement.

One of the responsibilities of the IRS and Treasury is to provide guidance to U.S. taxpayers. These notices provide no guidance. Rather, they undermine previously settled guidance and introduce substantial and needless uncertainty into international taxation. If the government is concerned about abusive transactions, there are a number of anti-abuse rules already in the Code that have so far provided ample ammunition to attack such arrangements. If Congress believes additional anti-abuse provisions are needed, they should be carefully and narrowly drafted to clearly distinguish the targeted abuse from normal business transactions. The proposed rules are extremely vague and go farther than anti-abuse; they upset the balance, stability, and certainty in tax matters that U.S. companies must have to remain competitive in the global marketplace.

In this testimony, we will review the genesis of the notices—the so-called "check-the-box" regulations that facilitated the use of hybrids in the international setting. We will show that the Treasury adopted these regulations only after careful thought, taxpayer input, and full consideration of the U.S. tax policy concerns that the regulations might raise. We will then describe how the notices not only reverse substantial portions of Treasury's own "check the box" regulation but also fundamentally alter bedrock assumptions on which the U.S. international tax regime rests.

## THE LONG HISTORY OF HYBRIDS

Hybrids are not new to U.S. tax law. Regulations issued in 1960 established a four-factor test for determining whether an entity is a partnership or a corporation for U.S. tax purposes; these factors were drawn from a 1954 decision of the Court of Appeals for the Ninth Circuit.[3] The long-standing position of the IRS was (and is) that the classification of a foreign entity as a corporation, partnership, or branch must be determined under U.S. tax principles, not under foreign law.

The application of these principles is illustrated in a 1977 revenue ruling. Rev. Rul. 77–214[4] examined the treatment of a German Gesellschaft mit beschränkte Haftung ("GmbH"), a business entity that is governed by flexible provisions of German law. The ruling examined the legal relationships established by the corporate charter of the GmbH at issue and concluded that the entity was a corporation for U.S. tax purposes because it met the regulatory tests for corporate status.

The clear implication of the ruling is that the GmbH would have been a partnership for U.S. purposes had it failed those tests, even though its status as a corporation (Gesellschaft) under German law would be unchanged. (Rev. Rul. 93–4[5] subsequently modified the application of the four-factor test in this situation, but left unchanged the general premise that the GmbH could be either a corporation or a partnership for U.S. tax purposes.)

Many private letter rulings issued during the years before 1995 confirm that foreign hybrids were possible and even common. Authority also existed to support the proposition that a single-owner entity could be disregarded for tax purposes under the four-factor test.[6]

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[2] Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 1999 Budget Proposal, JCS–4–98, February 24, 1998, at 197.

[3] United States v. Kintner, 216 F.2d 418 (9th Cir. 1954).

[4] 1977–1 C.B. 408.

[5] 1993–1 C.B. 225.

[6] LTR 8533003 (GCM 39395) and LTR 8737100. See also Lombard Trustees, Ltd. v. Commissioner, 136 F.2d 22 (9th Cir. 1943) and Hynes v. Commissioner, 74 T.C. 1266, 1279–81 (1980).

## CHECK-THE-BOX: TAX SIMPLIFICATION, NOT TAX AVOIDANCE

As the corporate and partnership laws of the various U.S. states and of foreign countries evolved, the four-factor test grew less and less relevant. Partnerships and other unincorporated organizations were allowed to have characteristics traditionally associated only with corporations (for example, limited liability). For these reasons, Treasury ultimately concluded that an elective regime would add certainty to entity classifications and eliminate the need for artificial provisions in organizational documents that bore little relevance to the purpose of the four-factor test as it was originally conceived.

The genesis of the check-the-box regulations was Notice 95–14, which was issued on March 29, 1995. This notice invited public comments on hybrid transactions, an early indication that the government was fully aware of the potential effects of hybrids on U.S. tax. The notice explained that new entity classification regulations were being considered because of the continuing erosion of non-tax, legal distinctions between partnerships and corporations.

After review and consideration of the public comments submitted in response to this request, the IRS and Treasury issued a notice of proposed rulemaking on May 13, 1996. The proposed regulations adopted an elective entity classification regime in both the domestic and international context. Certain entities, both foreign and domestic, were deemed to be per se corporations; these were entities that in the government's view could never have qualified as partnerships or branches under the four-factor test. All other entities were eligible to elect their U.S. tax classification.

The IRS made a second request for public comments on the proposed regulations. After considering the comments received, both in writing and at a public hearing, Treasury issued final entity classification regulations on December 17, 1996, establishing the new simplified regime for classifying both foreign and domestic entities.

It is clear from all of these pronouncements that Treasury and the IRS were aware that the new regulations would facilitate the creation of hybrid entities. After thoughtful consideration of the issues raised by hybrids in the international context, the final regulations allowed taxpayers to choose hybrid treatment for any eligible entity. The preamble to the final regulations noted that "future monitoring of partnerships" might be appropriate, but otherwise was silent on hybrids.

There is a good reason why the check-the-box regulations did not create special rules for hybrid entities in the foreign context. Both the entity classification rules and the anti-deferral rules were highly complex prior to the issuance of the regulations. Addressing hybrid issues would have significantly increased complexity in both areas without a commensurate benefit to the government. Simplification was felt to be the more desirable goal. Congressional efforts to simplify the anti-deferral provisions have continued with the repeal of the tax on excess passive assets held offshore and the elimination of the overlap between the passive foreign investment company rules and the controlled foreign corporation rules.

In contrast, the notices and the legislation requested in the budget proposal would add tremendous complexity to the subpart F and foreign tax credit rules. In effect, hybrid arrangements would be subject to a special set of rules under those provisions, but would continue to be treated under old rules for all other purposes of the Code. Nothing in the pronouncements issued by the government to date justifies this heavy extra burden at a time when simplification of the Code is a top priority of both the legislative and administrative branches.

## NOTICE 98–11

Subpart F contains provisions that impose current U.S. income tax on United States persons who control a foreign corporation. If the subpart F requirements are met, the U.S. shareholders are taxed on their proportionate shares of the "subpart F" income earned by the controlled foreign corporation ("CFC"). Subpart F income is composed of many elements, but two principal categories are (1) foreign personal holding company income—passive income such as dividends, interest, rents, and royalties, and (2) foreign base company income—certain kinds of active income earned outside the CFC's country of incorporation. The subpart F provisions are intended to prevent U.S. taxpayers from deferring tax on "portable" income by moving it to a low-taxed foreign jurisdiction.

Other kinds of active business income are not taxed to the U.S. shareholder until the CFC actually distributes the earnings as a dividend. Such income is normally subject to tax in the foreign country where it is earned; the dividend to the U.S. shareholder carries with it a right to a credit for the foreign taxes paid. The United States collects any tax still payable on the dividend after the allowance of the credit. Thus, a lower foreign tax rate results in more money actually paid to the U.S. treasury.

Notice 98–11 addresses situations where a CFC reduces its foreign income tax liability by making tax-deductible payments (interest, rents, or royalties) to a related party in another country. The income received by the related party is subject to a low tax rate in its home country. If the related party is also a CFC, this passive income would normally be subpart F income currently taxed to the U.S. shareholder. However, if the recipient is treated as a branch of the paying CFC, it will be ignored for U.S. tax purposes, and the transaction (loan, license, or lease) will also be ignored. No subpart F income would result, because for U.S. tax purposes the paying CFC is still the owner of the funds. This result is consistent with the U.S. tax result with respect to the first CFC's income had it never entered into the structure to reduce foreign taxes.

Notice 98–11 requires that the disregarded entity be treated as a separate corporation when determining whether the payment is subpart F income. Under this approach, the transaction just described would create such income, subjecting the U.S. shareholder to immediate taxation. The notice applies similar treatment to a payment made by the CFC to a branch of a brother-sister CFC that (absent the notice) would be excluded from subpart F income by an exception for payments to CFCs organized in the same country as the paying CFC.

Notice 98–11 cites no authority for these conclusions other than "the policies and rules of subpart F." This is not surprising, because no authority appears to exist. Nevertheless, the notice adds that similar transactions involving partnerships and trusts may be subject to rules of this sort in separate regulations.

### NOTICE 98–11 OVERTURNS THE BASIC PREMISE THAT BRANCH TRANSACTIONS ARE IGNORED

The inherent problem with Notice 98–11 and the legislation requested in the budget proposal is that they seek to overturn the fundamental premise that transactions between a branch and its home office generally are ignored for U.S. income tax purposes. The check-the-box regulations unambiguously state that if an entity is disregarded, its activities will be treated in the same manner as those of a sole proprietorship, branch, or division of its owner. This long-standing premise has recently been reaffirmed in several related areas, including the new withholding tax regulations, the transfer pricing regulations, the global dealing regulations, notional principal contract rules, and interest allocation rules. There is no reason to disturb this principle, and every reason to retain it.

The U.S. tax system is founded on the concept of income—that is, an accretion in wealth. The Internal Revenue Code imposes tax on the income of "persons," a term that is clearly defined and that does not include a branch or division. When a single taxable entity transfers money from one part of the entity to another, no wealth is created and no income arises. As early as 1920, the United States Supreme Court[7] announced this principle in affirming the separate taxable identity of a corporation and its shareholders:

"Did we regard corporation and stockholders as altogether identical, there would be no income except as the corporation acquired it .... [I]f there were entire identity between [the shareholders] and the company they could not be regarded as receiving anything from it, any more than if one's money were to be removed from one pocket to another."

This reasoning applies fully to transactions between branches of a single corporation. Absent a limited exception for currency transactions, income is not created when money is moved from one branch to another.

There are other objections to the abandonment of this cardinal tenet of U.S. tax law. First, the proposed rule would be limited to determinations under subpart F. The treatment of such a payment under all other provisions of the Code would remain the same, raising the possibility of inconsistent tax treatment of the same transaction. Second, the proposed rule would run counter to decades of established precedent and practice. Years of uncertainty could ensue while the limits and effects of the proposed rule were established through examinations, rulings, and court decisions. Finally, the subpart F rules already contain a carefully crafted, limited branch rule enacted by Congress to deal with a narrowly perceived problem. The presence of this rule argues strongly that Congress did not intend to create any other branch rules. If a new branch rule is required, it is for Congress to create it.

[7] Eisner v. Macomber, 252 U.S. 189 (1920).

### HYBRID BRANCH TRANSACTIONS REDUCE FOREIGN TAXES ON OFFSHORE INCOME

The principal effect (and, in many cases, the principal purpose) of the transactions described in Notice 98–11, and others like them, is a reduction of foreign income taxes. Because such taxes are ordinarily creditable against U.S. income taxes, a reduction of foreign tax means an increase in U.S. taxes. Therefore, it has been the long-standing policy of the U.S. government to encourage taxpayers to reduce their foreign tax liability in order to reduce foreign tax credits and increase U.S. tax receipts.

For example, the foreign tax credit regulations affirmatively require taxpayers to interpret foreign tax law in a way that reduces foreign tax liability, and to exhaust available remedies for credits or refunds, in order to qualify for a foreign tax credit. In addition, the legislative history of the Tax Reform Act of 1986 ("TRA 86") confirms that Congress specifically encourages companies to make payments that are deductible under foreign law. Under TRA 86, interest, rent, and royalty payments qualify for the taxpayer-favorable foreign tax credit "look-through" rules applicable to dividends. Congress reasoned that since interest, rents, and royalties were generally deductible under foreign law, while dividends were not, these payments would reduce the local country tax liability. Consequently, less foreign tax would be available to reduce the taxpayer's ultimate U.S. tax liability.

In contrast to this sound and long-standing policy, Notice 98–11 penalizes taxpayers for tax planning strategies that allow significant reductions in foreign tax. The U.S. government should not be concerned over reductions in the tax base of a foreign country; indeed, as discussed above, it should welcome such reductions and the corresponding increases in U.S. tax payments. The Code should not appoint the IRS as the "tax police" to ensure that U.S. companies pay the highest possible tax to other countries.

### GOOD FAITH RELIANCE SHOULD NOT BE PENALIZED

As discussed above, the check-the-box regulations were adopted after a long period of deliberation, the receipt of public comments, and a clear acknowledgement of the issues presented by hybrids. The final regulations represent a considered policy decision that the benefits of simplification outweighed any possible difficulties presented by hybrids, and a confidence that abuses, if any, could be adequately dealt with.

Notice 98–11 upsets this balanced decision. If the Treasury were to issue far-reaching regulations limiting—or even preventing—the use of hybrid arrangements to reduce foreign taxes after the issuance of the final check-the-box regulations, taxpayers that relied on the regulations in good faith (and incurred substantial costs in often irreversible restructuring) would be severely penalized. This is unfair. Taxpayers acted in response to the regulations as they should have been expected to act. There is no way that taxpayers could have reasonably foreseen that "the policies of subpart F" could be invoked to override long-standing principles of law in situations where the chief benefit of a transaction is the reduction of foreign tax.

### CONGRESS, NOT THE TREASURY, SHOULD MAKE A DECISION OF THIS MAGNITUDE

The Constitution assigns to Congress the power to enact legislation. The Treasury's responsibility is to interpret, administer, and enforce these laws under statutorily prescribed procedures. The proposed regulations would make significant changes in fundamental principles of U.S. tax law. Changes of this magnitude are beyond the scope of administrative "interpretation." If Congress is concerned over the effect of hybrids on the policies of subpart F, it should speak to those concerns itself.

### JCT IS CONCERNED ABOUT THE ADMINISTRATION'S PROPOSAL TO GRANT TREASURY REGULATORY AUTHORITY

Congressional staff have already indicated that they share in the concerns we have presented. In its description of the revenue provisions of the Administration's proposal on hybrid entities, the JCT observed that a grant of broad regulatory authority to prescribe the tax consequences of hybrid transactions may not be appropriate. The JCT stated that the lack of definition of the scope of such rules could have a profound impact on business operations in the global market-place: "Granting broad authority, without further enumerating the reach of the authority, could create an environment of uncertainty that has the potential for stifling legitimate business transactions."

The JCT stated that additional information would be required in order to evaluate the scope and content of the regulations. Insufficient information also prevented the JCT from estimating the revenue to be raised by the Administration's proposal. Finally, the JCT stated that it was not clear how the Administration's proposal on hybrid arrangements would interact with Notice 98–11.

THESE IRS ACTIONS UNDERMINE THE SELF-ASSESSMENT SYSTEM

Fair and impartial administration of the tax law is the cornerstone of a self-assessment system. Taxpayers are required to follow, and therefore entitled to rely on, interpretive guidance published by the Internal Revenue Service and the Treasury Department. If the rules and regulations that give this guidance are not supported by statutory authority, or are not issued in a manner that allows for the execution of ordinary business transactions, then respect for these rules is eroded, and so is voluntary compliance.

For more than a decade, Congress has worked to improve and protect taxpayer's rights. The first Taxpayer Bill of Rights was passed by Congress in 1988. The bill provided taxpayers with rights and procedures that must be observed in dealing with the IRS. The Taxpayer Bill of Rights 2 followed in 1996, which established the Office of Taxpayer Advocate in order to ensure that taxpayer rights were receiving attention at the highest level. The Taxpayer Advocate reports directly to the Deputy Commissioner of the IRS.

Yet in 1997, the IRS Restructuring Commission still found "serious deficiencies in governance, management, performance measures, training, and culture" at the IRS.[8] The Commission recommended the appointment of an independent board of directors to oversee the IRS and ensure implementation of "the fundamental reforms necessary to make the IRS a respected, stable institution that everyday Americans find to be fair and efficient."[9] In subsequent hearings conducted by the Senate Finance Committee, Treasury Secretary Rubin agreed with the findings of the Commission and acknowledged the need for these reforms.[10]

Despite these continuing efforts to improve the fairness of the system, the IRS and Treasury have once again failed in their responsibility to administer our tax laws in an objective and equitable manner. As we have outlined, Notice 98–11 exceeds the authority granted to the IRS and Treasury by Congress, seeks to overturn fundamental U.S. tax principles, and proposes to do so without proper regard for established regulatory processes.

NOTICE 98–5 SUFFERS FROM THE SAME INFIRMITIES AS THOSE OF NOTICE 98–11

Notice 98–11 was issued shortly after Notice 98–5, which deals with the impact of hybrid arrangements on foreign tax credits. Although different provisions of the Code are involved, the two notices are similar in their overall lack of authority and their disregard of long-standing U.S. tax policies.

Notice 98–5 states that the IRS and Treasury will seek to deny U.S. credits for otherwise creditable foreign income taxes where "the expected economic profit is insubstantial compared to the foreign tax credits generated." The notice then gives five examples of arrangements where this result is believed to occur. However, the applicability of the notice beyond these five enumerated transactions is vague at best, and the notice purports to give the IRS extremely wide latitude in deciding on the amount of expected economic profit and how it compares to the foreign tax credits.

Because of this vagueness, Notice 98–5 provides little real guidance and generates enormous uncertainty. The notice could be read, for example, to disallow foreign tax credits simply because of differences between the computation of the tax base under U.S. law and foreign law. This would represent a significant departure from long-established U.S. tax principles.

Because the U.S. subjects to tax the worldwide income of its citizens and residents, the foreign tax credit is a vital mechanism for ensuring that American businesses do not pay double tax and remain competitive in the global marketplace. For this reason, Treasury should not be granted broad regulatory authority without a clear delineation of the scope and purpose of the regulations to be promulgated. Congress must ensure that Treasury regulations will be consistent with, and limited to, Congressional intent behind the statute. The Treasury and IRS already have at

[8] National Commission on Restructuring the Internal Revenue Service, A Vision for a New IRS, June 25, 1997, at 11.

[9] Id. at 1.

[10] Unofficial Transcript of Senate Finance Committee Hearing on IRS Restructuring on January 28, 1998, Tax Notes Today, 98 TNT 24–61, ¶ 196.

their disposal tools sufficient to combat foreign tax credit abuses, including the recently enacted economic ownership requirements, along with the judicially developed sham transaction doctrine and substance-over-form principles.

RELIEF REQUESTED

(1) Congress should reject the President's budget proposal to grant to the IRS broad regulatory authority to interfere in legitimate business transactions where the perceived abuse is the reduction of foreign taxes.

(2) Congress should enact legislation codifying the application of the final check-the-box regulations to single-member entities and clarifying that intra-company transactions do not generate income that is taxed to U.S. shareholders.

(3) Congress should enact a moratorium on the issuance of regulations under Notice 98–5, with a postponement of the effective date of that notice, until Treasury demonstrates to Congress the need for regulatory action and provides a specific regulatory proposal.

## Statement of INMC Mortgage Holdings, Inc.

INMC Mortgage Holdings, Inc. appreciates the opportunity to respond to the Chairman's request for testimony to the Committee on Ways and Means on the revenue-raising provisions of the Clinton Administration's FY 1999 budget plan. We are testifying to express our strong opposition to the Administration's proposal to restrict businesses indirectly conducted by real estate investment trusts (REITs), in particular with respect to the portion of the proposal dealing with preferred stock subsidiaries.

MORTGAGE CONDUIT BUSINESS

INMC Mortgage Holdings, Inc. ("INMC"), based in Pasadena, California, is the largest publicly traded mortgage REIT[1] in terms of stock market capitalization. INMC is a diversified lending company with a focus on residential mortgage products, and is active in residential and commercial construction lending, manufactured housing lending, and home improvement lending. INMC is a NYSE-traded company with $6 billion in assets and 900 employees.

As one of its most important business activities, INMC and its affiliate, IndyMac, Inc., operate as one of only a small number of private "mortgage conduits" in this country. While small in number, mortgage conduits play a vital financing role in America's residential housing market, essentially acting as the intermediary between the originator of a mortgage loan and the ultimate investor in mortgage-backed securities (MBSs). The conduit first purchases mortgage loans made by financial institutions, mortgage bankers, mortgage brokers, and other mortgage originators to homebuyers and others. When a conduit has acquired sufficient individual loans to serve as collateral for a loan pool, it creates an MBS or a series of MBSs, which then is sold to investors through underwriters and investment bankers. After securitization, the conduit acts as a servicer of the loans held as collateral for the MBSs, meaning that the conduit collects the principal and interest payments on the underlying mortgage loans and remits them to the trustee for the MBS holders.

Perhaps the best-known mortgage conduits are the government-owned Government National Mortgage Association (Ginnie Mae) and the government-sponsored Fannie Mae and Freddie Mac. These government sponsored enterprises (GSEs) act as conduits for loans meeting specified guidelines that pertain to loan amount, product type, and underwriting standards, known as "conforming" mortgage loans. Private conduits such as INMC play a similar role for "nonconforming" mortgage loans that do not meet GSE selection criteria. Mortgage loans purchased by INMC include nonconforming and jumbo residential loans, sub-prime loans, manufacturing housing loans, and other mortgage-related assets. Many of INMC's borrowers are low-income and minority consumers who are not eligible for programs currently offered by the GSEs or Ginnie Mae. In sum, INMC and its affiliate IndyMac, through their conduit activities, play a critical role in providing liquidity to our nation's housing markets.

[1] A mortgage REIT invests primarily in debt secured by mortgages on real estate assets. An equity REIT, by contrast, invests primarily in equity or ownership interests directly in real estate assets.

## INMC'S BUSINESS STRUCTURE

INMC's mortgage conduit business is conducted primarily through two entities: INMC itself (hereafter referred to as "IndyMac REIT") and its taxable affiliate, IndyMac, Inc. (hereafter referred to as "IndyMac Operating"). IndyMac REIT owns all of the preferred stock and 99 percent of the economic interest in IndyMac Operating, a C corporation. IndyMac Operating is thus a "preferred stock" affiliate of INMC that would be adversely impacted by one part of the Administration's REIT proposals.

IndyMac REIT is the arm of the conduit business that purchases mortgage loans. IndyMac Operating is the arm of INMC that securitizes and services the loans acquired by IndyMac REIT and others. In order to control the interest rate risks associated with managing a pipeline of loans held for sale, IndyMac Operating also conducts hedging activities. In addition, IndyMac Operating performs servicing for all loans and MBSs owned or issued by it. IndyMac Operating is liable for corporate income taxes on its net income, which is derived primarily from gains on the sale of mortgage loans and MBSs and servicing fee income.

Use of this "preferred stock" structure for conducting business is in part a product of the tax law. IndyMac REIT, by itself, effectively is unable to securitize its loans through the most efficient structure, a real estate mortgage investment conduit ("REMIC"). This is because the issuance of REMICs by a REIT in effect would be treated as a sale for tax purposes; such treatment in turn would expose the REIT to a 100-percent prohibited tax on "dealer activity." In like fashion, IndyMac Operating would be unable to deduct certain hedging losses related to its loans held for sale. Similarly, we note that the ability to service a loan is critical to owning a loan, and that IndyMac REIT would be subject to strict and unworkable limits on engaging in mortgage servicing activities. Such activities would generate nonqualifying fee income under the 95-percent REIT gross income test,[2] potentially disqualifying IndyMac REIT from its status as a REIT. It is critical to keep in mind that all net income derived by IndyMac Operating from its business activities is subject to two tiers of taxation at state and federal levels.

In business terms, INMC's use of the preferred stock structure aligns its "core competencies," which has allowed it to compete in the mortgage conduit business. This alignment makes available the benefits of centralized management, lowers costs, provides operating efficiencies, and allows INMC to respond to market changes, such as trends toward securitization. It is important to note that INMC's structure does not involve the type of "stapled REIT" arrangement that has given rise to other legislative proposals advanced by Treasury.

## IMPACT OF ADMINISTRATION PROPOSAL ON INMC

The Administration's FY 1999 budget includes a proposal aimed at eliminating use of the preferred stock subsidiary structure. Specifically, the proposal would amend section 856(c)(5)(B) of the Internal Revenue Code to prohibit REITs from holding stock possessing more than 10 percent of the vote or value of all classes of stock of a corporation.

The Administration's FY 1999 budget proposal would force IndyMac REIT to reduce, to below 10 percent of value, its ownership of IndyMac Operating stock. This effectively would force INMC to end IndyMac REIT's preferred stock affiliation with IndyMac Operating.

The proposal therefore would force INMC to consider less efficient structures, such as spinning off IndyMac Operating as a wholly separate entity. Conducting a mortgage conduit business through two unrelated companies would eliminate the benefits and efficiencies of centralized management. This split also potentially would lead to conflicts, as one company would be responsible for servicing loans on behalf of an unrelated MBS trustee that may have different interests. The result would be lower returns for INMC's investors and higher borrowing costs for the homeowners for whom INMC's mortgage conduit business has meant lower mortgage interest rates.

The Treasury proposal also would jeopardize INMC's ability to compete in the mortgage business, which has hinged on its ability to align the two arms of its mortgage conduit business. In all likelihood, mortgage originators and other parties transacting in the mortgage conduit business would curtail significantly their business with INMC and other mortgage REITs. Moreover, partnerships would continue to be able to perform these activities and be subject to only one level of tax, giving

[2] The 95-percent test generally limits REITS to receiving income that qualifies as rents from real property and, to a lesser degree, portfolio income.

them a significant competitive advantage. If the proposal were to be adopted, INMC might not be able to serve those borrowers ineligible for programs offered by the GSEs or Ginnie Mae.

We also should note that the "grandfather relief" proposed by Treasury would not apply to INMC.[3] Specifically, INMC would not be able to meet the requirement that IndyMac Operating could not acquire "substantial new assets" after the specified date. While IndyMac Operating is not an acquirer of companies or businesses, its securitization of an ever-rotating pool of loans would appear to violate this test. If the proposal were to be adopted, one alternative grandfather test might involve a cap on total assets.

### TREASURY'S FLAWED RATIONALE

Treasury's "Green Book" description of the Administration's FY 1999 budget states its reasoning behind the proposal. Treasury argues that a preferred stock subsidiary of a REIT often is significantly leveraged with debt held by the REIT; this generates interest deductions intended to eliminate, or significantly reduce, the taxable income of the affiliate corporation. Treasury also argues that the operating income of the corporation effectively is "transmuted" into interest paid to the REIT, and thus is not subject to corporate-level tax.

INMC takes exception to these arguments. First, we believe the income-shifting argument is significantly overstated. The REIT rules strictly regulate the types and amount of income that may be earned by a REIT. INMC and others in the REIT industry are strongly discouraged from taking aggressive tax positions, given the severity of potential tax penalties, including loss of REIT status and the 100-percent prohibited transactions tax. Moreover, a recent Price Waterhouse LLP study found no evidence of transfer pricing abuse in situations where a REIT is "paired" with a management company, a situation similar to the combined activities of IndyMac REIT and IndyMac Operating. We believe Treasury should offer this reason for a legislative change only if it can document evidence, rather than perception, of abuse.

Second, we reject Treasury's inference that preferred stock subsidiaries like IndyMac Operating are in existence primarily to be loaded up with debt. IndyMac Operating had pre-tax income of $32.7 million and $31.6 million in 1997 and 1996, respectively; tax liability of $13.9 million and $13.5 million in 1997 and 1996, respectively; and net income of $18.8 million and $18.1 million in 1997 and 1996, respectively. This aggregated to a return on equity of 34.4 percent and 36.4 percent in 1997 and 1996, respectively.

Moreover, IndyMac Operating is careful to use market-based rates for intercompany debt, and the vast majority of financing for IndyMac Operating comes from unrelated third-party lenders. INMC does not engage in earnings stripping because to do so would jeopardize INMC's status as a REIT.

### POLICY OBJECTIVES UNDERLYING REITS

The Administration proposal is fundamentally at odds with Congressional intent in enacting the REIT rules and updating them to respond to changing market realities.

Congress enacted the REIT rules in 1960 to allow small investors the same access to real estate markets available to larger investors, just as regulated investment companies (mutual funds) allow small investors greater access to equity markets. Benefits of the REIT structure, as envisioned by Congress, included diversification of investments and thus minimization of risk, expert advice on investments, and means for individuals on a collective basis to finance larger projects.

INMC's alignment of a REIT with a related active business is entirely consistent with these original policy goals. State-of-the-art mortgage lending requires the use of all the tools and techniques available in the financial marketplace, including the use of hedging, securitization, and investment in derivative mortgage instruments such as mortgage servicing rights. Without access to these tools and techniques, a mortgage entity will not be able to maximize profits to its investors and will be exposed to a level of market risks to which other traditional and non-traditional lenders are not exposed. The result would be an entity that is inefficient in the marketplace and that ultimately will not be able to compete.

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[3] The proposal would be effective with respect to stock acquired on or after the date of first committee action. Stock acquired before such date would become subject to the proposal when the corporation in which stock is owned engages in a trade or business in which it does not engage on the date of first committee action or if the corporation acquires substantial new assets on or after such date.

Mortgage REITS also have helped to fill a significant void in the mortgage investment industry that GSEs have been unable to fill. The benefits of our business to American homeowners at all income levels and with a wider variety of credit histories should not be overlooked.

RECOMMENDATIONS

As an initial matter, INMC respectfully urges the Congress to reject the Administration proposal to restrict businesses indirectly conducted by REITs. The proposal would penalize the investors whom the REIT provisions originally were enacted to benefit. The Administration prescribes an overly broad "remedy"—effectively banning the alignment of a REIT with a related active business—to address unfounded allegations of abuse relating to debt and income shifting. Moreover, the revenues estimated to be raised by the proposal (a total of $19 million over the FY 1998–2003 period) are relatively small when judged against its harsh impact on our industry and the availability of financing to segments of the housing industry not currently served by GSEs.

It seems to us that a more proper point of inquiry for the Congress, taking into account the original pro-shareholder objectives underlying enactment of the REIT provisions, would be to consider ways to facilitate the ability of REITs to compete. Indeed, the Congress has amended the REIT statute at least nine times since 1960—most recently in 1997—to reflect the dramatic changes that have taken place in the real estate marketplace.

INMC strongly believes the REIT rules as they relate to our industry should encourage, rather than discourage, the alignment of a mortgage REIT with the core competencies of servicing and securitizing mortgage loans. We are prepared to work with Congress to develop solutions in this regard.

## Statement of the Service Bureau Consortium and the Interstate Conference of Employment Security Agencies

The Interstate Conference of Employment Security Agencies (ICESA) is the national organization of state administrators of unemployment insurance, employment and training services, and labor market information programs. The Service Bureau Consortium (SBC) represents businesses providing payroll processing and employment tax services directly to employers. SBC members serve more than 600,000 employers and are responsible for more than one-third of the private sector payroll. Together, these organizations represent both those who collect UI taxes and those who process the tax payments.

SBC and ICESA oppose the Administration's proposals to change the frequency of collections under the Unemployment Tax Act ("FUTA") and believe that any restructuring of the FUTA/State Unemployment Insurance ("SUI") tax rules should only be considered in the context of broad-based UI programmatic reforms. Furthermore, we believe any reform of the UI system should include a streamlining of the FUTA/SUI collection system, thereby creating greater efficiencies and reduced costs for the federal and state governments and for employers.

We are deeply concerned that the FUTA proposals contained in the Administration's FY 1999 budget would create substantial new burdens for both taxpayers and state government administrators.

THE ADMINISTRATION'S FY 1999 UI PROPOSALS

The Administration's FY 1999 budget would accelerate, from quarterly to monthly, the collection of most federal and state UI taxes beginning in the year 2004.

Accelerating the collection of existing federal and state UI taxes is a device that generates a *one-time* artificial revenue increase for budget-scoring purposes and real, *every year* increases in both compliance costs for employers and collection costs for FUTA and SUI tax administrators. The Administration's proposal is fundamentally inconsistent with every reform proposal that seeks to streamline the operation of the UI system and with its own initiatives to reduce paperwork and regulatory burdens.

The proposal would increase federal revenues in FY 2004, as taxes scheduled to be collected in FY 2005 are accelerated into the previous year.[1] *No new revenues*

[1] Ironically, the amount of revenue recorded through this one-time accounting speed-up results from yet another budgeting device. State UI tax revenues are included as assets of the federal

would be collected by the federal or state governments by virtue of this proposal—the federal government would simply record, in FY 2004, revenues that would otherwise be received a year later.

This proposal is even more objectionable than other tax speed-up gimmicks considered in the past. For example, proposals that might move an excise tax deposit date forward by one month into an earlier fiscal year make little policy sense, but also do not create major additional administrative burdens. This particular proposal would result directly in significant *and continuing* costs to taxpayers and to the federal and state governments. By tripling the number of required UI tax collection filings from 8 to 24 per affected employer each year, the proposal would substantially raise costs to employers and both federal and state UI tax administrators. Tripling the required number of deposits can only dramatically escalate the cost to employers inherent in the current separate FUTA/SUI quarterly collection practices—now estimated to cost employers up to $500 million a year.

Furthermore, the one-time, budget score-keeping gain will be far more than offset by the real, *every year* administrative costs of additional FUTA tax collection to the IRS and SUI tax collection to the states. Monthly submission requirements can only increase the $100 million the IRS now receives annually from the UI trust funds to process and verify the quarterly FUTA deposits. In addition, since the federal government is required to reimburse states for their UI administrative costs, reimbursement of states for the added costs of monthly SUI collection is another hidden federal outlay cost in this ill-conceived proposal.[2] To the extent the federal government does not reimburse the states for these higher SUI collection costs, the states will experience yet another form of unfunded mandate.

The Administration implicitly recognizes that the added federal and state deposit requirements would be burdensome, at least for small business, since the proposal includes an exemption for certain employers with limited FUTA liability. Many smaller businesses that add or replace employees or hire seasonal workers would not qualify for the exemption since new FUTA liability accrues with each new hire, including replacement employees. Further, this new exemption would add still another distinction to the many already in the tax code as to what constitutes a "small" business. This deposit acceleration rule makes no sense for businesses large or small, and an exception for small business does nothing to improve this fundamentally flawed concept.

## CONCLUSION

UI reform should focus on simplifying the system, reducing the burden of our employers and reducing the costs of administration to federal and state governments. Adopting the revenue raising provisions in the Administration's FY 1999 budget proposal would take the system in exactly the opposite direction, creating even greater burdens than the current system.

We urge the Committee to reject the speed-up in collection of FUTA and SUI taxes proposed in the Administration's budget. Any consideration of tax collection issues should take place only in the context of system-wide reform. We believe that such consideration will demonstrate that FUTA/SUI tax collection should be simplified, not further complicated as the Administration has proposed.

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government for budget-scoring purposes, notwithstanding the fact that the federal government does not mandate the rate of this tax, collect it, or even have the right to use the proceeds. All state monies in these Trust Fund Accounts are automatically transferred back to the states to pay UI benefit obligations as they occur. In the interim, they cannot be used by the federal government for any other purpose.

[2] The Administration's budget does not appear to factor in such increased federal and state collection costs as an outlay offset to the increased FUTA revenues projected.

**Statement of Investment Company Institute**

The Investment Company Institute (the "Institute")[1] submits for the Committee's consideration the following comments regarding proposals to (1) exempt from withholding tax all distributions made to foreign investors in certain qualified bond funds, (2) enhance retirement security, (3) modify section 1374 of the Internal Revenue Code[2] to require current gain recognition on the conversion of a large C corporation to an S corporation, and (4) increase the penalties under section 6721 for failure to file correct information returns.

I. WITHHOLDING TAX EXEMPTION FOR CERTAIN BOND FUND DISTRIBUTIONS

*Background*

Individuals around the world increasingly are turning to mutual funds to meet their diverse investment needs. Worldwide mutual fund assets have increased from $2.4 trillion at the end of 1990 to $7.2 trillion on September 30, 1997. This growth in mutual fund assets is expected to continue as the middle class continues to expand around the world and baby boomers enter their peak savings years.

U.S. mutual funds offer numerous advantages that could be attractive to foreign investors. The expertise of the industry's portfolio managers and analysts, for example, could provide superior fund performance, particularly with respect to U.S. capital markets. Moreover, the U.S. securities laws provide strong shareholder safeguards that foster investor confidence in our funds.

While the U.S. fund industry is the world's largest, with over half of the world's mutual fund assets, foreign investment in U.S. funds is low. Today, less than one percent of all U.S. fund assets are held by non-U.S. investors.

One significant disincentive to foreign investment in U.S. funds is the manner in which the Code's withholding tax rules apply to distributions to non-U.S. shareholders from U.S. funds (treated for federal tax purposes as "regulated investment companies" or "RICs"). Under U.S. law, foreign investors in U.S. funds receive less favorable U.S. withholding tax treatment than they would receive if they made comparable investments directly or through foreign funds. This withholding tax disparity arises because a U.S. fund's income, without regard to its source, generally is distributed as a "dividend" subject to withholding tax.[3] Consequently, foreign investors in U.S. funds are subject to U.S. withholding tax on distributions attributable to two types of income—interest income (on "portfolio interest" obligations and certain other debt instruments) and short-term capital gains—that would be exempt from U.S. withholding tax if received directly or through a foreign fund.

A U.S. fund may "flow through" the character of the income it receives only pursuant to special "designation" rules in the Code. One such character preservation rule permits a U.S. fund to designate distributions of long-term gains to its shareholders (both U.S. and foreign) as "capital gain dividends." As capital gains are exempt from U.S. withholding tax, foreign investors in U.S. funds are not placed at a U.S. tax disadvantage with respect to distributions of funds' long-term gains.

Legislation introduced in every Congress since 1991 would permit all U.S. funds also to preserve, for withholding tax purposes, the character of interest income and short-term gains that would be exempt from U.S. withholding tax if received by foreign investors directly or through a foreign fund. The Institute strongly supports these "investment competitiveness" bills.

*Proposal*

Under the President's Fiscal Year 1999 budget proposal, distributions to foreign investors by a U.S. fund that invests substantially all of its assets in U.S. debt securities or cash generally would be treated as interest exempt from U.S. withholding tax. A fund's distributions would remain eligible for this withholding tax exemption if the fund invests some of its assets in foreign debt instruments that are free from foreign tax pursuant to the domestic laws of the relevant foreign countries. The taxation of U.S. investors in U.S. funds would not be affected by the proposal.

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[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 6,860 open-end investment companies ("mutual funds"), 441 closed-end investment companies and 10 sponsors of unit investment trusts. Its mutual fund members have assets of about $4.419 trillion, accounting for approximately 95% of total industry assets, and have over 62 million individual shareholders.

[2] All references to "sections" are to sections of the Internal Revenue Code.

[3] Dividends paid to foreign investors are subject to U.S. withholding tax at a 30 percent rate, although that rate may be reduced, generally to 15 percent, by income tax treaty.

*Recommendation*

The Institute urges enactment of this proposal as an important first step toward eliminating all U.S. tax incentives for foreign investors to prefer foreign funds over U.S. funds. The imposition of U.S. withholding tax on distributions by U.S. funds, where the same income would be exempt from U.S. tax if the foreigners invested directly or through foreign funds, serves as a very powerful disincentive to foreign investment in U.S. funds. By providing comparable withholding tax treatment for our bond funds, the proposal would enhance the competitive position of U.S. fund managers and their U.S.-based work force.

As noted above, the Administration's proposal would exempt from U.S. withholding tax distributions by a U.S. fund that also holds some foreign bonds that are free from foreign tax under the laws of the relevant foreign countries. This is in recognition of the fact that U.S.-managed bond funds may hold some foreign bonds. These can include "Yankee Bonds," which are U.S. dollar-denominated bonds issued by foreign companies that are registered under the U.S. securities laws for sale to U.S. investors, and other U.S. dollar-denominated bonds that may be held by U.S. investors (e.g., "Eurobonds"). The Institute urges appropriate standards ensuring that U.S. funds seeking foreign investors may continue to hold them.

The Institute supports drawing a distinction between a foreign bond (such as a Yankee Bond or a Eurobond) that is exempt from foreign withholding tax under the domestic law of the relevant foreign country and one that is exempt only pursuant to an income tax treaty with the U.S. By treating investments in foreign bonds that are exempt from withholding tax pursuant to treaty as "nonqualifying" for purposes of the "substantially all" test, the proposal prevents foreign investors from improperly taking advantage of the U.S. treaty network.

## II. *Retirement Security Initiatives*

The U.S. mutual fund industry serves the needs of American households saving for their retirement and other long-term financial goals. By permitting millions of individuals to pool their savings in a diversified fund that is professionally managed, mutual funds provide an important financial management role for middle-income Americans.[4] Mutual funds also serve as the investment medium for employer-sponsored retirement programs, including small employer savings vehicles like the new Savings Incentive Match Plan for Employees ("SIMPLE") and section 401(k) plans, and for individual savings programs such as the traditional and Roth IRAs. As of December 31, 1996, mutual funds held over $1.24 trillion in retirement assets.[5]

The Institute has long supported legislative efforts to enhance retirement savings opportunities for Americans. It strongly advocates legislation to increase small employer retirement plan coverage and make retirement savings more portable, thus enabling Americans to more easily manage their retirement savings. Our prescriptions for attaining these goals, however, differ in some respects from the Administration's.

### *A. Small Employer Retirement Plan Coverage*

*Background*.—Retirement plan coverage is a matter of serious public concern. Coverage rates remain especially low among small employers. Less than one-half of employers with 25 to 100 employees sponsored retirement plans. More starkly, under 20 percent of employers with fewer than 25 employees offer their employees a retirement plan.[6] The enactment of legislation creating SIMPLE plans was a major first step toward improving coverage, but more remains to be done.

*Recommendations*.—Congress should (1) improve the SIMPLE plan program for small employers by raising the salary deferral limitation, (2) eliminate or modify regulations, such as the "top-heavy" rule, that continue to retard small employer plan formation and (3) assure that new small employer plan initiatives provide effective incentives for plan establishment and do not undermine currently successful programs.

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[4] An estimated 37 million households, representing 37% of all U.S. households, owned mutual funds in 1996. *See* Brian Reid, "Mutual Fund Developments in 1996," Perspective, Vol. 3, No. 1 (Investment Company Institute, March 1997).

[5] Reid and Crumrine, Retirement Plan Holdings of Mutual Funds, 1996. (Investment Company Institute, 1997).

[6] In 1993, the most recent year for which data is available, only 19 percent of employers with fewer than 25 employees sponsored a retirement plan. EBRI Databook on Employee Benefits. Employee Benefit Research Institute, 1997.

1. *Raise the SIMPLE Plan Deferral Limitation*.—In 1996, Congress created the successful SIMPLE program. The SIMPLE is a simplified defined contribution plan available to small employers with fewer than 100 employees. In just the first seven months of its availability, an Institute survey of its largest members found that no less than 18,250 SIMPLE plans had been established, covering over 95,000 employees. Virtually all (97 percent) SIMPLE plan formation is among the smallest of employers—those with fewer than 25 employees. Indeed, employers with 10 or fewer employees established about 87 percent of these plans. For the first time, significant numbers of small employers are able to offer and maintain a retirement plan for their employees.

Presently, however, an employee working for an employer offering the SIMPLE may save only up to $6,000 annually in his or her SIMPLE account. Yet, an employee in a 401(k) plan, typically sponsored by a mid-size or larger employer, is permitted to contribute up to $10,000. Congress can readily address this inequity by amending the SIMPLE program to permit participating employees to defer up to $10,000 of their salary into the plan, that is, up to the limit set forth at section 402(g) of the Internal Revenue Code. This change would enhance the ability of many individuals to save for retirement and, yet, would impose no additional costs on small employers sponsoring SIMPLEs.

2. *Reduce Unnecessary, Costly Regulations, Such as The Top-Heavy Rule, That Retard Small Employer Plan Formation*.—Congress could raise the level of small employer retirement plan formation if it reduced the cost of plan formation and maintenance. One way to reduce these costs is for the federal government to subsidize them. The Administration has proposed a "start-up tax credit" for small employers that establish a retirement plan in 1999. Such a tax incentive may induce certain small employers to establish retirement plans.

Another approach would be to seek the actual reduction of on-going plan costs attributed to regulation. For example, repeal or modification of the "top-heavy" rule[7] may lead to more long-term plan formation than a one-time tax credit program. A 1996 U. S. Chamber of Commerce survey showed that the top-heavy rule is the most significant regulatory impediment to small businesses establishing a retirement plan.[8]

Finally, Congress certainly should avoid discouraging plan formation by adding to the cost of retirement plans. Thus, the Institute strongly urges that Congress *not* enact the Administration's recommendation that a new mandatory employer contribution be required of employers permitted to use design-based safe harbor formulas in their 401(k) plans beginning in 1999.

3. *New Programs For Small Employers Should Provide Effective Incentives For Plan Establishment and Not Undermine Currently Successful Programs*.—The Administration has also proposed enhancing the "payroll deduction IRA" program and creating a new simplified defined benefit plan program for small employers. In considering these proposals, it is important to assure that incentives are appropriately designed to induce program participation and that the programs do not undermine current retirement plan options.

For instance, the Administration would create an additional incentive to use the payroll deduction IRA program by excluding payroll deduction contributions from an employee's income. Accordingly, they would not be reported on the employee's Form W–2. As the success of the 401(k) and SIMPLE programs demonstrate, payroll deduction provides an effective, disciplined way for individuals to save, and its encouragement is a laudable policy goal. However, simplifying tax reporting may not add sufficient incentive for employers to establish a payroll deduction IRA program. More importantly, the interaction of an expanded payroll deduction IRA program with the new and successful SIMPLE program should be carefully considered. As noted above, the SIMPLE plan program has been extremely attractive to the smallest employers, exactly those for whom a payroll deduction IRA program is designed. Any new program expansion should not undermine already existing, successful small employer programs. Because the maximum IRA contribution amount is $2,000

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[7] Section 416 of the Internal Revenue Code. The top-heavy rule looks at the total pool of assets in a plan to determine if too high a percentage (more than 60 percent) of those assets represent benefits for "key" employees. If so, the employer is required to (1) increase the benefits paid to non-key employees, and (2) accelerate the plan's vesting schedule. Small businesses are particularly effected by this costly rule, because "key" employees include individuals with an ownership interest in the company. Small businesses are more likely to have concentrated ownership and individuals with ownership interests working at the company and in supervisory or officer positions, each of which exacerbates the impact of the rule.

[8] Federal Regulation and Its Effect on Business—A Survey of Business by the U.S. Chamber of Commerce About Federal Labor, Employee Benefits, Environmental and Natural Resource Regulations, U.S. Chamber of Commerce, June 25, 1996.

(an amount not increased since 1981), it may not be appropriate to induce small employers to use that program rather than the popular SIMPLE program, which would permit employees a larger plan contribution. Similar considerations should be made with regard to any simplified defined benefit program.

*B. Retirement Account Portability*

*Background*.—Because average job tenure at any one job is under 5 years,[9] individuals are likely to have at least several employers over the course of their careers. As a result, the portability of retirement plan assets is an important policy goal. The Administration advocates an accelerated vesting schedule for 401(k) plan matching contributions to address this issue. Consideration should be given to a broader approach to portability that would enhance the ability of all individuals to move their account balances from employer to employer when they change jobs.

Under current law, an individual moving from one private employer to another, where both employers provide section 401(k) plan coverage, generally may roll over his or her vested account balance to the new employer. Where an individual moves from a private employer to a university or hospital or to the government sector, however, such account portability is *not* permitted. The problem arises because each type of employer has its own separate type of tax-qualified individual account program. Neither the university's section 403(b) program nor the governmental employer's "457 plan" program may accept 401(k) plan money, and vice versa. Moreover, with the exception of "conduit IRAs," moving IRA assets into an employer-sponsored plan is prohibited.

*Recommendation*.—Legislation to permit portability amongst these retirement plans would enable individuals to bring retirement savings with them when they change jobs, consolidate accounts and more readily manage retirement assets. Congress should amend the tax laws pertaining to all individual account-type retirement plans to permit individuals to roll over retirement account balances as they move from employer to employer, regardless of the nature of the employer.

*C. Variable Annuities*

*Background*.—The Administration has proposed imposing new taxes on the owners of variable annuity contracts. Proposals include taxing owners upon the exchange of one contract for another and in the event of a reallocation of contract savings from one investment option to another under the variable annuity contract.

*Recommendation*.—The Institute opposes these proposals, because they would tax many individuals who save for retirement through variable annuities.

## III. Conversions of Large C Corporations to S Corporations

*Background*

Section 1374 generally provides that when a C corporation converts to an S corporation, the S corporation will be subject to corporate level taxation on the net built-in gain on any asset that is held at the time of the conversion and sold within 10 years. In Notice 88–19, 1988–1 C.B. 486, the IRS announced that regulations implementing repeal of the so-called *General Utilities* doctrine would be promulgated under section 337(d) to provide that section 1374 principles, including section 1374's "10-year rule" for the recognition of built-in gains, would be applied to C corporations that convert to regulated investment company ("RIC") or real estate investment trust ("REIT") status.

Notice 88–19 was supplemented by Notice 88–96, 1988–2 C.B. 420, which states that the regulations to be promulgated under section 337(d) will provide a safe harbor from the recognition of built-in gain in situations in which a RIC fails to qualify under Subchapter M for one taxable year and subsequently requalifies as a RIC. Specifically, Notice 88–96 provides a safe harbor for a corporation that (1) immediately prior to qualifying as a RIC was taxed as a C corporation for not more than one taxable year, and (2) immediately prior to being taxed as a C corporation was taxed as a RIC for at least one taxable year. The safe harbor does not apply to assets acquired by a corporation during the C corporation year in a transaction that results in its basis in the assets being determined by reference to a corporate transferor's basis.

[9] The Changing World of Work and Employee Benefits, Employee Benefit Research Institute, Issue Brief No. 172 (April 1996).

*Proposal*

The President's Fiscal Year 1999 budget proposes to repeal section 1374 for large corporations. For this purpose, a corporation is a large corporation if its stock is valued at more than five million dollars at the time of the conversion to an S corporation. Thus, a conversion of a large C corporation to an S corporation would result in gain recognition both to the converting corporation and its shareholders. The proposal further provides that Notice 88–19 would be revised to provide that the conversion of a large C corporation to a RIC or REIT would result in the immediate recognition of the corporation's net built-in gain. Thus, the Notice, if revised as proposed, would no longer permit a large corporation that converts to a RIC or REIT to elect to apply rules similar to the 10-year built-in gain recognition rules of section 1374.

*Recommendation*

Because the safe harbor set forth in Notice 88–96 is not based upon the 10-year built-in gain rules of section 1374, the repeal of section 1374 for a large C corporation should have no effect on Notice 88–96. The safe harbor is based on the recognition that the imposition of a significant tax burden on a RIC that requalifies under Subchapter M after failing to qualify for a single year would be inappropriate. Moreover, the imposition of tax in such a case would fall directly on the RIC's shareholders, who are typically middle-class investors.

The Institute understands from discussions with the Treasury Department that the proposed revision to section 1374 and the related change to Notice 88–19 are not intended to impact the safe harbor provided by Notice 88–96.

Should the Congress adopt this proposal, the Institute recommends that the legislative history include a statement, such as the following, making it clear that the proposed revision to section 1374 and the related change to Notice 88–19 would not impact the safe harbor set forth in Notice 88–96 for RICs that fail to qualify for one taxable year:

This provision is not intended to affect Notice 88–96, 1988–2 C.B. 420, which provides that regulations to be promulgated under section 337(d) will provide a safe harbor from the built-in gain recognition rules announced in Notice 88–19, 1988–1 C.B. 486, for situations in which a RIC temporarily fails to qualify under Subchapter M. Thus, it is intended that the regulations to be promulgated under section 337(d) will contain the safe harbor described in Notice 88–96.

## IV. Increased Penalties for Failure to File Correct Information Returns

*Background*

Current law imposes penalties on payers, including RICs, that fail to file with the Internal Revenue Service ("IRS") correct information returns showing, among other things, payments of dividends and gross proceeds to shareholders. Specifically, section 6721 imposes on each payer a penalty of $50 for each return with respect to which a failure occurs, with a maximum penalty of $250,000.[10] The $50 penalty is reduced to $15 per return for any failure that is corrected within 30 days of the required filing date and to $30 per return for any failure corrected by August 1 of the calendar year in which the required filing date occurs.

*Proposal*

The President's Fiscal Year 1999 budget contains a proposal which would increase the $50-per-return penalty for failure to file correct information returns to the greater of $50 per return or five percent of the aggregate amount required to be reported correctly but not so reported. The increased penalty would not apply if the total amount reported for the calendar year was at least 97 percent of the amount required to be reported.

*Recommendation*

The Institute opposes the proposal to increase the penalty for failure to file correct information returns. Information reporting compliance is a matter of serious concern to RICs. Significant effort is devoted to providing the IRS and RIC shareholders with timely, accurate information returns and statements. As a result, a high level of information reporting compliance is maintained within the industry.

[10] Failures attributable to intentional disregard of the filing requirement are generally subject to a $100 per failure penalty that is not eligible for the $250,000 maximum.

The Internal Revenue Code's information reporting penalty structure was comprehensively revised by Congress in 1989 to encourage voluntary compliance. Information reporting penalties are not designed to raise revenues.[11] The current penalty structure provides adequate, indeed very powerful, incentives for RICs to promptly correct any errors made.

[11] In the Conference Report to the 1989 changes, Congress recommended to IRS that they "develop a policy statement emphasizing that civil tax penalties exist for the purpose of encouraging voluntary compliance." H.R. Conf. Rep. No. 386, 101st Cong., 1st Sess. 661 (1989).

## Statement of Joint Venture's Council on Tax and Fiscal Policy

## Reasons Why the Export Source Rule Should Not Be Replaced with an Activity-Based Rule [1]

### EXECUTIVE SUMMARY

High-technology industries comprise integrated industries with numerous companies occupying critical niches. Product cycles of 1–5 years are not uncommon and successful companies at each stage of the high-tech food chain must adapt and constantly improve their product lines. As these cycles repeat and new products and markets are created, residual markets from prior product cycles remain and as a result, the absolute market size and opportunity increases.

High-tech industries are heavily export oriented. Recent statistics show that Silicon Valley's exports grew 9 percent in 1996 to $39.7 billion. For many Silicon Valley companies, exports exceed 50 percent of total sales. Much of this exported product is manufactured in the United States and because of the nature of high-tech industries and their product cycles, a tremendous amount of research and development accompanies the manufacturing function. The linkage between research and manufacturing is very strong within high-tech industries.

The export source rule helps to mitigate the double taxation faced by many U.S. exporters when income is taxed both in the United States and in a foreign country, and as a result, can have a direct effect on a high-tech company's global tax burden. The export source rule only applies when goods are manufactured in the United States and exported. In high tech industries, significant U.S. research and research related jobs accompany the U.S. manufacturing function. Repeal of the export source rule would place upward pressure on the after tax cost of performing the manufacturing and related research activity in the United States.

Capital investment decision-making is influenced by both tax and non-tax factors. However, as global infrastructure and education levels improve, non-tax factors become increasingly less important in the capital investment decision-making and, therefore, U.S. tax laws that increase the after-tax cost of doing business could have a profound impact on location of investment. This will in turn have a direct impact on exports and export-related jobs not only for companies that respond quickly to after-tax returns, but also supplier companies that support the U.S. manufacturing and research activities. The various sectors within high-tech industries tend to be very closely linked and interdependent so that investment decisions by one sector will have a multiplier effect on where future geographic income will be earned.

U.S. high-tech industries are innovative, highly profitable, drive academic institution curriculum and excellence, produce high-paying jobs, produce a tremendous volume of exports, and serve as a model to the world. Repeal of the export source rule would serve to discourage these U.S.-based activities.

### MARKETING AND SALES, NOT TAX, DRIVES MULTINATIONAL CORPORATE STRUCTURES

A Silicon Valley high-tech start up company begins with an innovative idea. This idea may or may not have large market potential in the early life cycle of the company. Those companies destined to become successful will either have a product that is ready for the current market[s] or the product idea will create a new market. High-tech products change every 1–5 years because industry innovation and global markets are constantly evolving. Successful companies at each stage of the high-tech

[1] These comments were prepared by Tax Policy Group member Bill Barrett, Director: Tax, Export & Customs, Applied Materials, Inc. These comments are an updated version of comments on this proposal that were submitted to the Senate Finance Committee in April 1997.

food chain must adapt and constantly improve their product lines. High-tech companies that do not adapt or evolve their product lines do not survive.

High-technology represents integrated industries with numerous companies occupying critical niches. For example, semiconductor equipment companies supply the semiconductor chip companies and the chipmakers in turn provide the means for computers to perform complex software functions ranging from number crunching to multimedia. The explosion of the Internet and networking companies that link computers has been a more recent evolution in high-tech industries. Computer software companies have been both pushing the semiconductor industry as well as adapting new software applications to existing computer capability. At each component stage, companies must keep pace with evolution and product cycles to survive. As these cycles repeat and new products and markets are created, residual markets from prior product cycles remain and as a result, the absolute market size and opportunity increases.

The profile of a high-tech multinational company is no different from the above description, but for the fact that it either competes in or develops markets in multiple countries. To be successful in countries outside the U.S., the multinational must understand different markets and adapt its corporate structure to accommodate those markets. A not uncommon profile as product lines evolve and/or the multinational adapts to foreign markets, is that specific segments of manufacturing may be located offshore.[2] These segments may be older product lines or components of a product that are produced more efficiently offshore. In most cases, newer product lines, and the requisite research and development remain in the U.S. and close to development centers.

Silicon Valley high-tech companies do not structure their global operations solely on the basis of local country tax rates. For example, as high-tech product lines mature, investment in alternate manufacturing sites is a natural process of growth and diversification of risk. However, this statement should not be interpreted to mean tax rates do not play a significant role. An increase in U.S. tax increases the cost of business in the U.S. and if a company is to maintain an after-tax shareholder return, it must evaluate lower cost site locations. Popular rhetoric often characterizes U.S. industries as intent on the wholesale migration of manufacturing to offshore locations with the sole purpose of minimizing corporate income tax when in reality, companies are trying to remain competitive in a global market and taxes represent only one, albeit a significant, cost of doing business.

An analysis of a new manufacturing location will involve a comparison of factors, such as the following:

- Labor skills, consistent with the demands of product technical requirements.
- Labor productivity.
- Cost of labor.
- Cost of land and construction costs.
- Financial and physical infrastructure (e.g., highway and airport).
- Proximity to customers and the market.
- Protection of intellectual property.
- Tax rates.

In reviewing this list, the superordinate goal of generating additional sales revenue and global market share may be overlooked. Any successful high-tech company is in the business of selling product and increasing financial return to its investors and when tax rates reduce potential return, they play an increased role in the decision-making process. A company that makes sensible investment decisions based on after-tax returns that improve the ability to competitively price product stands a good chance to improve its market share.

### THERE ARE FUNDAMENTAL FLAWS IN THE ADMINISTRATION'S EXPORT SOURCE PROPOSAL

President Clinton's FY 1999 budget proposal contains a provision that would eliminate the export source rule, which allows 50 percent of the income from the sale of goods manufactured in the U.S. and exported to be considered "foreign source

[2] A successful company locates offshore to increase its global sales revenue and market share. Often, this raison d'être is lost in political rhetoric. If a company is less competitive in the global marketplace (i.e., does not increase its global market share) because of higher tax rates, that company will naturally evaluate where it places manufacturing and R&D capability. Similarly, import tariffs will influence global investment patterns. For example, the European Union in 1992 effectively placed a European manufacturing content requirement through imposition of duties on non-European manufactured semiconductors. United States and Asian semiconductor manufacturers now dominate the European semiconductor industry, which illustrates how investment decisions can be altered to reduce government imposed costs of doing business.

income." The proposal would instead source income from export sales under an "activity based" standard—effectively eliminating the export source rule. "Activity based" sourcing is not defined in the proposal, but might be patterned after a current income tax regulation example.[3] For U.S. exporters with excess foreign tax credits, the export source rule alleviates double taxation, and thereby operates as an export incentive for U.S. multinationals. The foreign source income rule *only* applies if companies manufacture goods in the U.S. and export them. In the case of high-tech companies this usually means the company is also performing substantial R&D in the U.S.

The Administration makes the following argument in support of repeal:

The existing 50/50 rule provides a benefit to U.S. exporters that also operate in high-tax foreign countries. Thus, U.S. multinational exporters have a competitive advantage over U.S. exporters that conduct all their business activities in the United States.[4]

There are at least three flaws in this argument. *First*, companies without foreign operations do not face the double taxation the export source rule is designed to alleviate. Thus, the rule does not create a competitive advantage; instead, it levels the playing field. Double taxation increases the cost of doing business offshore and therefore, the multinational with foreign operations becomes less competitive without benefit of the foreign source income rule. *Second*, a company without foreign operations may be a start-up that has not entered global markets. This new company cannot be compared to a large and well-established multinational. As the new company grows into global markets, it too will benefit from the export source rule. *Finally*, the argument in favor of eliminating the foreign source income rule fails to take into account additional [non-tax] expenses that will be incurred by the multinational with foreign operations. Selling, marketing, administrative expenses associated with a foreign location, and product adaptation to local market, all must be incurred to support the local market. The conclusion is inescapable that establishing foreign operations will produce additional operating costs. Although operating costs will increase with foreign operations, the reality is that a U.S. manufacturing company cannot compete for global market share without establishing offshore operations. The resulting increased global market share increases high—paying R&D and manufacturing jobs in the U.S.

### Tax Treaties are No Substitute for the Export Source Rule

The Administration has stated that the United States income tax treaty network protects export sales income from tax in the foreign country where the goods are sold and thus, protects companies from double taxation. Treasury argues that the export source rule is no longer necessary as a result of this treaty protection.

The tax treaty network is not a substitute for the export source rule, but even if it was, the treaty network is far from complete. The U.S. treaty network is limited to 56 countries, leaving many more countries (approximately 170) without treaties with the U.S. Moreover, many of the countries without treaties are developing countries, which are frequently high-growth markets for American exporters. For example, the U.S. has no treaty with any Central or South American country.

With or without a tax treaty, under most foreign countries' tax laws, the mere act of selling goods into the country, absent other factors such as having a sales or distribution office, does not subject the United States exporter to income tax in the foreign country. Thus, export sales are not the primary cause of the excess foreign tax credit problem that many companies face in trying to compete overseas.

The real reason most multinational companies face double taxation is that U.S. tax provisions unfairly restrict their ability to credit foreign taxes paid on these overseas operations against their U.S. taxes. Requirements to allocate a portion of the costs of U.S. borrowing and research activities against foreign source income (even though such allocated costs are not deductible in any foreign country), cause many companies to have excess foreign tax credits, thereby subjecting them to double tax, i.e., taxation by both the U.S. and the foreign jurisdiction.

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[3] Treas. Reg. Sec. 1.863–3(b)(2) Ex. 1. The Tax Court in both Phillips Petroleum Co., 97 T.C. 30 (1991) and Intel Corp., 100 T.C. 616 (1993), found that the fact pattern in the regulations example did not apply to the facts of these cases. The facts in these cases are typical of most exporters and therefore, under current law "activity based" sourcing as described in Example 1 would rarely produce any foreign source income. The result, using an "activity based" model, would be zero percent foreign source income on exported U.S. manufactured product, which increases the global tax burden on this income.

[4] General Explanations of the Administration's Revenue Proposals, February 1998, page103; http://www.ustreas.gov/press/releases/grnbk98.htm.

As previously explained, the export source rule alleviates double taxation by allowing companies who manufacture goods in the United States for export abroad to treat 50 percent of the income as "foreign source," thereby increasing their ability to utilize their foreign tax credits. Thus, the rule encourages these companies (facing double taxation as described above) to produce goods in the U.S. for export abroad.

As an effective World Trade Organization-consistent export incentive, the export source rule is needed now more than ever to support quality, high-paying jobs in U.S. export industries.[5] Exports have provided the spark for much of the growth in the U.S. economy over the past decade. Again, the existence of tax treaties does nothing to change the importance of this rule to the U.S. economy.

The decision to allow 50 percent of the income from export sales to be treated as "foreign source" was in part a decision based upon administrative convenience to minimize disputes over exactly which portion of the income should be treated "foreign" and which should be "domestic." The rule still serves this purpose, and neither the tax treaty network nor the Administration's proposal to adopt an "activities-based" test for determining which portion of the income is "foreign" and which is "domestic" addresses this problem. Moreover, adopting an "activities-based" rule would create endless factual disputes similar to those under the Section 482 transfer pricing regime.

Tax treaties are critically important in advancing the international competitiveness of U.S. companies' global operations and trade. In order to export effectively in the global marketplace, most companies must eventually have substantial operations abroad in order to market, service or distribute their goods. Tax treaties make it feasible in many cases for business to invest overseas and compete in foreign markets. Foreign investments by U.S.-based multinationals generate substantial exports from the United States. These foreign operations create a demand for U.S. manufactured components, service parts, technology, etc., while also providing returns on capital in the form of dividends, interest and royalties.

Tax treaties are not a substitute for the export source rule. They do not provide an incentive to produce goods in the United States. Nor do they address the most significant underlying cause of double taxation—arbitrary allocation rules—or provide administrative simplicity in allocating income from exports.

### CAPITAL EXPORT NEUTRALITY MODEL AS A GUIDE FOR TAX SIMPLIFICATION

In an ideal income tax system, income tax would not influence how a company structures transactions or where the company decides to build a manufacturing plant. Investment decisions would be influenced by other economic factors such as those listed above. To eliminate income tax from the investment location decision it would be necessary to structure the system such that the global tax rate on income earned anywhere in the world is no different than the domestic rate of tax. A system patterned after the "capital export neutrality" (CEN) concept would achieve this result.[6]

The CEN concept holds that an item of income, regardless of where it is earned, will not suffer a global rate of tax higher than the U.S. tax rate. Dividends received from both high and low tax countries suffer a double rate of tax first in the country in which the income was earned and second in the United States when received. The credit for foreign tax paid is designed to mitigate this double taxation. The export source rule operates to increase the credit for foreign taxes paid which in turn operates to more closely align the United States tax system with the concept of CEN. With sufficient foreign source income, the global rate of income tax on income earned in high tax countries approaches 35 percent.

A classical tax system that diverges from the CEN concept will increase the importance of income tax in plant location decision-making. If the foreign source in-

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[5] Studies have shown that average exporting plants have higher blue-collar and white-collar wages, and that average workers at exporting plants have higher benefits. J. David Richardson and Karin Rindal, Why Exports Matter: More!, The Institute for International Economics and The Manufacturing Institute, February 1996, page 11.

[6] CEN is also referred to as a classical tax system. In addition to the United States, Japan and the United Kingdom loosely base their tax systems on this concept. An alternative concept is "capital import neutrality" (CIN). Under CIN, the global rate of tax on foreign income does not exceed the foreign tax rate. In other words, under CIN income earned outside the home country is not taxed in the home country when received as a dividend or when the foreign operation is sold. "Territorial" based tax systems are patterned after the CIN concept. The Netherlands and France apply the "territorial" concept. Germany, Canada, and Australia apply the concept pursuant to income tax treaty with certain trading partners. For a detailed description of these principles, see Factors Affecting The International Competitiveness Of the United States, prepared by the Joint Committee on Taxation (JCS–6–91), Part 2. III.

come rule is repealed, the double taxation of U.S. multinationals that export from the United States will increase and for many high-tech companies this increase in taxes, and corresponding reduction in return to shareholders, will alter plant investment decisions. Many companies will be forced to invest offshore rather than build new plants in the U.S. to remain competitive and maintain shareholder rate of return. Foreign investment decisions will have a ripple effect within high-tech industries because they are so closely interrelated. For example, a natural consequence of additional offshore investment by a semiconductor manufacturer will be that equipment suppliers will increase their offshore presence to meet the demands of their customers. This dynamic will be repeated in other industry segments creating a foreign investment multiplier effect.

THE PROPOSAL WOULD TEND TO ENCOURAGE MANUFACTURING OUTSIDE OF THE U.S.

The elimination or scale back of the foreign source income rule will have a negative tax impact on U.S. multinationals that export U.S. manufactured product. For many companies this will result in a tax disincentive to manufacture in the U.S. vis-à-vis other countries with lower tax rates and is contrary to a "capital export neutrality" model, which holds that income tax should play a minor role in plant location decision-making. Repeal of the foreign source income rule would elevate the importance of taxes in offshore plant location decision-making and is contrary to tax simplification within a "capital export neutral" model.[7]

SUMMARY

United States high-tech industries are innovative, highly profitable, drive academic institution curriculum and excellence, produce high-paying jobs, produce a tremendous volume of exports, and serve as a model to the world.[8] U.S. government policies that discourage these U.S.-based activities risk impeding very desirable attributes and drivers in the U.S. economy. Government policies that encourage these attributes will obviously promote these attributes. Therefore, the Administration's export sourcing proposal should not be enacted.

## Statement of M Financial Holdings Incorporated

OVERVIEW

The President's budget proposal calls for unwarranted tax increases on American life insurance policyholders and products that would discourage long-term investment and saving. Several provisions of the budget would prevent life insurance products from continuing to provide effective solutions to long-term benefit, savings, and retirement security needs. This unfortunate proposal drastically undermines the government's decades-long policy of encouraging individuals and businesses to provide for their own and their employees' financial security. At a time when long-term financial planning is encouraged of all Americans, the President's budget takes away several key methods of providing for that financial security. In many cases, the proposals result in a retroactive tax increase on middle-class working Americans.

The provisions in the 1999 Administration budget that particularly concern us include the following:

[7] As income earned offshore increases as a result of additional foreign plant investment, history suggests complicated tax laws will be introduced in an attempt to tax this income before it is remitted back to the U.S., contrary to efforts towards a more simplified income tax mode. PFIC and subpart F, as it relates to operating income earned from related party sales, are examples of this type of legislation.

[8] Studies have documented the impact exports have in job creation. Hufbauer and DeRosa project that in 1999, exports will increase $30.8 billion and $2.3 billion of additional wage income. In addition, the effect of the rule and the exports it generates will support 360,000 workers in export-related jobs, which also tend to be higher paying jobs (Costs and Benefits of the Export Source Rule, 1998–2002, Gary Hufbauer and Dean DeRosa, February 19, 1997). In Silicon Valley, it is estimated that over 200,000 jobs were added since 1992. Also, in 1997 the average real wage, after accounting for inflation, grew about 2.2 percent compared to a wage increase of 1.2 percent at the national level (Joint Venture's Index of Silicon Valley, 1998, prepared by Joint Venture: Silicon Valley Network). The Joint Venture study also reported that in 1996, Silicon Valley exports grew 9 percent to $39.7 billion, while California exports grew 4 percent and U.S. exports grew 6 percent.

• COLI Proposal—Increased taxation on companies that own life insurance policies on their officers and employees. This tax increase could significantly reduce the level of funding for employee-related benefits, undermining employee security associated with these benefits and the financial protection of families and businesses. The proposal particularly hurts small businesses who rely on life insurance policies to provide benefits and incentives to their employees.

• Investment in Contract Proposal—Elimination of annual cost of insurance and expense charges from the insurance owner's basis in the contract. This proposal contradicts the well-established tax principle that a return of invested funds is not taxed. Furthermore, it reduces the effectiveness of the savings element of the policies.

• Variable Life Insurance and Annuities Proposal—Taxation of gains in variable policies at the time values are moved among investment options within one policy or transferred between similar policies. This tax increase effectively eliminates the use of these products as long-term retirement investments, thereby making it harder for millions of Americans to save for retirement

• Crummey Proposal—Elimination of the Crummey provisions to obtain the gift tax annual exclusion. This tax increase would reduce the availability of life insurance proceeds to provide funds to pay future estate taxes on many closely held business interests.

These proposals will reduce the financial protection being provided to millions of Americans and thousands of businesses of all sizes. The provisions would adversely affect the economic viability of existing life insurance policies and severely limit new insurance policy purchases, thus reducing overall savings. Furthermore, the proposals would reduce private retirement savings by increasing the administrative and tax expense associated with owning these products. Taken together, the proposals also could cause thousands of employees to lose their jobs. Particularly hard hit would be U.S. small businesses.

Given the uncertain economic impact, it is reasonable to expect that these Budget proposals may have a negative effect on general revenue. These proposals also seem to disproportionately isolate and disadvantage insurance businesses. The reduced purchase of insurance as a result of these proposals would produce a corresponding reduction in certain federal and state tax revenue. By example, in 1996, approximately $1.8 billion in revenue was paid by the insurance industry in state premium taxes on life insurance. Additionally, approximately $1 billion was generated at the federal level just from the "DAC" tax on life insurance premiums. The current level of revenue generated at both the state and federal level would be threatened by this set of proposals.

## M Financial Group

M Financial Group is a marketing and reinsurance organization comprised of over 100 independently owned firms, located across the country, that focus on providing financial security and solutions to the estate and benefit planning needs of individuals and businesses.

Collectively, these firms manage life insurance policies in force for their clients representing over $1 billion of annual life insurance premiums, over $10 billion of policyholder account values, and over $40 billion of total death benefit protection.

These policies provide benefits for a variety of needs that enhance individual

• Allowing businesses an effective vehicle to fund benefit liabilities for employee retirement income payments, salary continuance for employees' spouses, and other post-retirement benefits.

• Providing for financial liquidity to families at time of death to pay estate taxes. Many families' assets are in illiquid forms such as family owned real estate or small businesses. Life insurance helps families meet their estate tax and business continuity needs without having to sell the underlying asset. Life insurance provides a liquid source of funds to meet the liability without disrupting families and small businesses, allowing them to continue into the next generation and continue to provide jobs to their employees.

• Providing businesses with a financial means to continue operation upon death of a key executive, allowing the business to continue operations while replacing the key individual.

• Providing individuals with the ability to provide survivors with death benefit protection while supplementing retirement savings.

Life insurance is a particularly effective and efficient vehicle to defray the costs of these benefits and provide individuals and employers with a future income stream to offset various unpredictable future needs, such as untimely death or long-

term medical needs. The impact of the proposal on the ability to use life insurance on all of these areas is devastating.

In addition, the proposed retroactive application of several provisions to policies already purchased and owned by millions of Americans makes effective tax-planning virtually impossible. A precedent of retroactive application of tax increases to existing contracts is inherently unfair and reduces the potential for tax law to provide effective long-term incentives for establishing any private savings programs. Moreover, retroactive tax increases reduce compliance with our Federal Tax system at a time when the system is already under broad attack. We applaud the strong opposition to retroactivity, as expressed recently by Chairman Archer, who made the following statement related to the Administration's FY 1999 Budget:

"I do not intend to put my name on anything that is retroactive."

The balance of this document provides specific background on the impact of these proposals on certain uses of life insurance that help provide financial security to millions of Americans.

PROPOSAL: REPEAL OF THE EXCEPTION FOR EMPLOYEES, OFFICERS, AND DIRECTORS UNDER THE CORPORATE OWNED LIFE INSURANCE (COLI) PRORATION RULES.[1]

*Background:*

COLI policies have long been used as a tool by businesses to provide employee and retirement benefits. COLI helps promote the long-term financial security of employees, provide employees an incentive to save for their own retirement, and help corporations effectively manage financial consequences of the untimely death of a key employee.

The need to use COLI to provide employee and retirement benefits arises from prior legislative initiatives such as ERISA, TEFRA, and DEFRA, which have limited a company's use of pension arrangements. Over time, these limitations have made the use of traditional pension arrangements more complex and less effective. Hit most hard are middle-level executives, as defined by the Department of Labor. The popularity of non-qualified plans has increased commensurate with the compression on qualified plans and corporate desire to provide the restoration of such benefits.

In the interest of enabling employees with a means to provide themselves and their families with long-term financial security benefits, corporations have created non-qualified plans to provide long-term benefits. The use of these plans is an effective vehicle for increasing the personal savings rate at a time when Americans are living longer and there is more uncertainty of the ability of other social programs to support these benefits. These plans have long-term emerging liabilities and actuarial risk, which are well suited to funding with life insurance. This use of COLI serves a valid social and economic purpose in financing these plans. Some examples of the many employee and retirement benefit beneficial programs and other business needs funded by COLI are:

- Supplements retirement income and survivor benefits beyond those available under qualified plan limits. These benefits promote the financial security of millions of Americans.
- The ability for employees to contribute after-tax dollars to enhance their retirement and survivor benefits.
- The ability for businesses to provide benefits needed to attract and retain key employees.
- Supports the ability, particularly for small businesses, to withstand the significant financial loss resultant from the premature death of a key employee.
- Provides business continuity in circumstances that could otherwise result in failure and significant economic hardship for all employees.

To accomplish these purposes, many corporations use COLI as a tool to effectively manage the liabilities related to employee and retirement benefits. Defraying the

[1] The written statement addresses the negative impact of the Administration's Proposal on traditional COLI plans, and does not address Bank-Owned Life Insurance (BOLI). We are aware that in addition to the use of traditional COLI plans, there has also developed a use of life insurance products as pure financial vehicles, used to take advantage of tax deferred investment or tax arbitraged nature of the products. Congress has been concerned about the use of COLI as a "pure" investment vehicle without the appropriate insurance elements and has in the past enacted legislation to limit the attractiveness of such uses. Of particular concern today is the use of COLI by financial institutions that borrow funds at low cost and invest the funds in tax deferred investments, thus creating additional tax leverage due to the deductibility of the borrowing costs while the offsetting investment is tax deferred. These plans are commonly referred to as BOLI.

costs of these liabilities with after-tax dollars in COLI policies is consistent with Federal retirement savings incentives and is good public policy.

*Effect of Proposal:*

The changes to COLI increase current taxes for all businesses that own or are beneficiaries of a life insurance policy. This proposal would seriously curtail the availability of the benefits these policies fund, reduce personal savings, and increase the risk of business failure from loss of a key employee. Most hard hit by the proposal is small businesses and their employees.

The proposed changes to IRC § 264 increase taxes by disallowing a portion of the company's interest deduction for unrelated debt. This proposal would affect all business uses of life insurance, not just abusive uses. To preserve the motivation and opportunity for private saving, it is important to preserve the ability for businesses to purchase life insurance to provide an array of benefits to their employees. At a time when Congress is increasing incentives for employee-based savings through the expansion of Roth IRAs and other provisions, it is contradictory to tax the use of life insurance to fund the same benefits.

Current law already limits potential abuses in COLI applications used to defray the costs of the types of liabilities previously mentioned: Qualified plan limits restrict the amount of insurance that can be purchased by an employer on a currently deductible basis. IRC § 7702 and IRC § 7702A require corporate-owned policies to provide a reasonable amount of true death benefit protection. IRC § 264 prevents leverage arbitrage from tax deductible borrowing against a corporate-owned life insurance policy. All these provisions combine to provide reasonable protection that the COLI may be used to defray the costs of real benefit liabilities in a manner consistent with tax policy.

Unfortunately, the effect of the COLI proposal in the Administration's Budget would be to limit wholly appropriate business uses of life insurance—such as assuring that employees receive the retirement benefits they have been promised and are counting on getting—by making the cost of insurance products economically unfeasible. The proposal would unnecessarily deny the benefits of COLI to millions of Americans.

Moreover, the Administration's rationale for the COLI proposal is fundamentally flawed and unjustified. The Administration believes that allowing a taxpayer a deduction for interest incurred on indebtedness in the operation of a business is wrong if the business owns life insurance on its employees, even if the business indebtedness is completely unrelated to the insurance. This belief flies in the face of fundamental principals of tax law, which allow for ordinary and necessary business expenses.

Under recent changes in current law, interest on indebtedness directly related or "traced" to corporate owned life insurance is already subject to disallowance. The new COLI proposal would go well beyond current law and deny deductions for interest that is completely unrelated to the insurance. This is not only unjustified, but is overbroad and creates inequities between businesses that rely on debt financing and those that are equity financed.

In cases where a business provides insurance-financed benefit programs such as broad-based health coverage for retirees, non-qualified pensions, or savings benefits, a "tax" would now be imposed if the business had any indebtedness on its books. This resulting "tax" will most likely cause the business to rethink and scale back its benefit programs, causing harm to the long-term health and security of its employees. Across the country, this would have a devastating impact on many small and mid-sized businesses who rely on insurance to fund such programs.

By indirectly "taxing" retirement and benefit programs, the COLI proposal moves in the complete opposite direction of recent efforts by the Administration and Congress to provide incentives to increase U.S. savings (e.g. expansion of IRAs, Roth IRAs, SIMPLE IRAs). The COLI proposal undermines these initiatives and is contradictory to the goals of the Administration and Congress.

Finally, the effective date of the COLI proposal would create a retroactive tax increase on millions of businesses and middle-class working Americans by denying an interest deduction on policies that have been in place for years. Businesses that relied on existing tax laws would be penalized and employees who relied on benefits funded by existing insurance policies would be unconscionable harmed.

While we understand the concern in Congress regarding perceived abusive transactions, we believe the Administration's proposal is overbroad, unjustified and inconsistent with Congressional incentives to encourage retirement savings and employee benefits. Accordingly, the COLI proposal should be rejected out of hand.

PROPOSAL: REDUCE THE LIFE INSURANCE AND ANNUITY POLICY OWNER'S "INVESTMENT IN THE CONTRACT" (BASIS) FOR MORTALITY AND EXPENSE CHARGES.

*Background:*

Cash value life insurance and deferred annuities allow individuals to provide for future financial security for themselves and their dependents through benefits paid to survivors at death or lifetime income benefits paid during retirement. Premiums paid for these benefits are usually made with after-tax dollars. The public policy reason for encouraging such insurance purchases is directly linked to the social value the benefits provided, both in terms of quality of life for surviving beneficiaries and additional retirement income available to further reduce demands that may fall on publicly funded social insurance programs. For this reason, the "inside build-up" of life insurance and annuity policy cash values has served a beneficial and socially justified purpose.

*Effect of Proposal:*

This proposal would reduce the effectiveness of life insurance and annuity policies as long-term financial security vehicles. The proposal would reduce retirement savings by reducing a policy owner's basis each year by internal mortality and expense charges for cash value life insurance and deferred annuity contracts for the purpose of calculating investment in the contract under IRC § 72.

This proposal is contrary to the notion of not paying tax on the amount invested in an asset. Policyholders pay premiums with after-tax dollars, and they should not be subject to a second tax on the return of their investment amount. The long-term cumulative effect of the proposed reduction in policyholder basis is the reduction of cash values available to Americans upon retirement.

The proposal actually operates to the detriment of responsible Americans who hold their annuity investments until retirement. The proposal would add back reductions to the policyholder's basis only if the contract is annuitized for life at the guaranteed rate in the contract, even if the guaranteed rate is less favorable than other rates then available. The logic of requiring retiring individuals to receive less than the amount they otherwise could receive is far from clear.

It is reasonable to consider taxing gains from contracts that are surrendered without ever providing the intended death and retirement benefits, but current law already accomplishes that purpose. Not only is ordinary income tax paid on the total difference between cash value and premium paid when a policy is surrendered, but there are several situations where a penalty tax also applies to such transactions. Those situations include all surrenders of deferred annuity policies or life insurance Modified Endowment Contracts before the policy owner reaches age 59½. Thus, current law already taxes and provides tax penalties on cumulative gains that are withdrawn without being used for the intended long-term financial security benefits of insurance.

The existing penalty taxes for withdrawals from Modified Endowment and annuity contracts apply only to withdrawals before the insured reaches age 59½. That age limit recognizes the multiple financial needs that can arise in the retirement years and increases the availability of life insurance and annuity values to address life changes at that time. The proposed basis changes would penalize life insurance and annuity owners who need to make withdrawals from their policies for other financial security reasons, such as the payment of nursing home costs, at any age.

The proposal would also introduce a high degree of additional and unnecessary complexity to supporting tax regulations and to the record-keeping and reporting requirements of insurers and individual policyholders. The impact of this complexity would ultimately be borne by the individual taxpayers, through the added costs and time involved in preparing their own returns and higher insurance company administrative costs passed through to policy owners, thus reducing the amount of their retirement savings.

PROPOSAL: TAX CERTAIN EXCHANGES OF INSURANCE CONTRACTS AND REALLOCATIONS OF ASSETS WITHIN VARIABLE INSURANCE CONTRACTS

*Background:*

As described previously in the discussion of proposed reductions in basis, tax law has encouraged individuals to provide for the financial needs of their survivors and their retirement years through purchase of life insurance and annuity contracts. To accomplish this result, cash value is allowed to accumulate in life insurance and annuity policies without being subject to current income taxation.

Furthermore, public policy has recognized that there are a number of different types of insurance contracts available in the market, and that it may sometimes be

in the consumer's best interest to exchange one policy for another. For that reason IRC § 1035 has long permitted transfers of value from one annuity or life insurance contract to another without taxation on the growth in cash values up to that time.

During the last decade, there has been increasing use of variable life insurance and variable annuity policies. These contracts provide the same basic financial security features of more traditional contracts, but they allow individuals greater flexibility in the general investment strategy of the assets backing policy cash values through access to equity returns. This opportunity generally allows individuals to lower the overall cost of their benefits, while enhancing long-term security. For example, a relatively young individual wishing permanent death benefit protection and the opportunity to save for retirement income may choose a variable product that allows allocation of current cash values to an equity-based fund. This fund may have the potential of providing higher long-term returns than the traditional fixed income investments of an insurer's general account. As retirement age approaches, that individual might wish to reallocate the cash values to a fund with less risk than equities, minimizing the volatility risk when the benefits are needed most.

*Effect of Proposal:*

This proposal would penalize individuals who seek to use life insurance and annuity contracts to save for retirement. Specifically, the proposal has two parts. First, it eliminates IRC § 1035-exchange treatment for transfers between any contract and a variable contract. Therefore all variable policy exchanges would be subject to tax on any gain in the contract. Secondly, it treats each separate account of a variable contract as a separate contract, so any transfer between accounts within a variable contract would be a taxable event.

The elimination of § 1035 exchange treatment would discourage individuals from changing from one policy to another with more attractive features or cost. The ability to make such exchanges without current tax impact is one factor that encourages insurers to offer policyholders increasingly favorable terms to keep their products competitive. Thus, this change would harm policyholders by reducing the natural marketplace incentive to maximize policy performance.

The second part of the proposal—taxing interim gains at the time funds are moved between separate account options within a single variable policy—also creates an unwarranted and inconsistent penalty to the individual who wishes to use his contractual rights most efficiently. Given the public policy of encouraging the use of life insurance and annuity contracts to facilitate the ability of individuals to provide for their own financial security, there is no reason to apply taxes to interim gains upon internal asset reallocations. Annuity and life insurance contracts already contain restrictions on transfers and liquidity. Policy owners may not withdraw funds from their account values without reducing or eliminating the long-term death or retirement income benefits that will be provided. As long as funds remain inside a policy that will provide those benefits, the gains should not be taxed.

This proposal would also increase the cost of variable products due to significantly more complexity in administration and record keeping for insurers and for buyers of variable products who reallocate assets among sub-accounts. These costs would be passed along to policy owners. Many details would need to be clarified through further complex regulations.

PROPOSAL: REPEAL THE SO-CALLED "CRUMMEY RULE" FOR GIFTS AFTER 1998.

*Background:*

As Congress intended, the $10,000 gift tax annual exclusion is widely used and encouraged to provide a mechanism for relatively small gifts to be made to individuals, primarily family members, without gift or estate tax consequences.

The "Crummey Rule" has, since 1968, been a widely used approach to appropriately utilize the gift tax annual exclusion. This long-established and well-recognized rule relies on the legal power of the beneficiaries of the Crummey power to withdraw amounts contributed to the trust for their benefit. It is primarily used to make gifts to family members and, more particularly minor children and grandchildren, while at the same time, providing them the protections of a trust to help safeguard their interests.

Frequently, the trust is used to purchase life insurance in order to provide family members liquidity for estate taxes without use of the insured's unified credit. This helps avoid unnecessary liquidation at the insured's death of important family assets such as a business and the displacement of employees, which would result therefrom.

*Effect of Proposal:*

The proposal substantially hurts families wanting to make appropriate use of the annual gift tax exclusion in order to make gifts in trust which protect family members, provide liquidity, and safeguard important family assets. The proposal would apply to all future gifts, including those which would be made to previously existing trusts. In a large percentage of those situations, life insurance has been utilized and those plans would be substantially disrupted or discontinued. This would frustrate the taxpayer's reasonable expectations of having irrevocably gifted their policies and having the law in effect at the time continue to apply.

## Statement of Management Compensation Group

### I. *Introduction*

We appreciate the opportunity to submit this statement for the record of the Committee's hearing on the revenue proposals included in the President's FY 1999 Budget. We are Management Compensation Group, a group of independently owned firms located across the country, dedicated to assisting businesses to provide retirement, health and other benefits to their employees. We help small, medium and larger businesses finance benefit plans through the purchase of corporate-owned life insurance ("COLI"). The use of COLI serves a valid social and economic purpose in financing these benefit plans.

We strenuously OBJECT to the President's proposal to apply the proration rule adopted in the Taxpayer Relief Act of 1997 (P.L. 105–34) to virtually all COLI, by eliminating exceptions to the rule for employees, officers and directors (the "COLI proposal"). In this statement, we will provide background on the legitimate business uses of COLI, and the history of tax issues associated with COLI. We will then discuss the President's COLI proposal and explain why we think it should be rejected outright by Congress.

### II. *Background*

*1) Permanent Life Insurance For Business*

The use of permanent life insurance in a business setting first arose as a means to protect against the premature death of key employees. The savings element in permanent life insurance also allowed for the accumulation of value for use in the buyback of stock or to protect against business interruption.

As businesses saw a need to fund for pension and other benefit liabilities that fell outside of their qualified plans, COLI in its current use evolved. The combination of predictable premiums, long-term asset accumulation and protection against death benefit liabilities makes COLI an ideal funding vehicle for these programs.

In these arrangements, businesses purchase COLI in an amount necessary to match the emerging liabilities for benefits outside of qualified plans. The COLI asset is typically placed in a trust, and specific arrangements are made to eliminate excess assets from building up within the trust. While such assets remain available to creditors should bankruptcy occur, they are otherwise pledged and held in trust for the sole purpose of extinguishing corporate liability associated with the benefit plans.

Funds used to purchase COLI are paid with after-tax dollars. The tax-deferred growth of these funds only serves to help the plans keep pace with the emerging liability. The company foregoes a current deduction, unlike qualified pension plans, and provides a dedicated buffer for future pension payments. Funding under these plans is typically limited to those eligible for participation in these programs.

*2) History Of Tax Changes Related To COLI*

In the past, Congress has been concerned about the use of COLI as a pure investment vehicle without appropriate insurance elements. As a consequence, it has acted to restrict COLI and certain investment-oriented insurance products, while protecting the tax-deferred nature of permanent life insurance.

The 1954 Code contained a provision limiting interest deductions on loans taken out directly or otherwise to purchase insurance (Code section 264). Since then, Congress has strengthened this provision several times. Most recently, in the Taxpayer Relief Act of 1997 (the "1997 Act"), Congress eliminated a broad range of exceptions and generally disallowed any interest on indebtedness "with respect to" the owner-

ship of a life insurance contract. This disallowed any direct and "traceable" interest. A limited exception for "key person" policies under $50,000 remained in place.

The 1997 Act also added a new "proration" rule which denied interest deductions on indebtedness "unrelated" to the ownership of insurance policies. An exception to the proration rule was provided for insurance purchased on lives of employees, officers, directors, and 20 percent owners (Code section 264(f)). This exception is the subject of the President's COLI proposal.[1]

## III. *The President's COLI Proposal*

Under current law, businesses are generally allowed a tax deduction for interest on indebtedness incurred in their trade or business. Businesses often own life insurance policies on the lives of their employees, officers and directors. These policies meet a number of business needs, including: (1) providing financial liquidity; (2) allowing businesses to fund employee and retirement benefits; (3) providing continuation of business operations upon the death of a key executive; and (4) providing survivors with death benefit protections.

Recent changes to the tax laws deny an interest deduction on any indebtedness WITH RESPECT TO life insurance policies. Therefore, any interest which is directly related or "traceable" to a life insurance policy is already denied under current law. If there is no relationship between the indebtedness and a corporate-owned life insurance policy on an employee, officer or director, then there is no denial of interest.

The President's FY 1999 Budget plan contains a proposal which would change the current COLI rules, resulting in the denial of interest deductions on indebtedness incurred by a business completely UNRELATED to the ownership of insurance on an employee, officer or director. The Administration believes this would prevent unwarranted tax arbitrage benefits. This proposal would have a devastating impact on businesses and employees throughout the country.

## IV. *Discussion*

The President's COLI proposal is seriously flawed, inequitable, overly broad, and unjustified. It must be REJECTED by Congress.

### *1) "Tax Arbitrage" Is A Smoke-Screen*

While the Administration suggests that traditional COLI provides unwarranted tax arbitrage, the argument is not persuasive and is nothing but a smoke screen to mask its attempt to tax inside build up of life insurance—a proposal that has been resoundingly rejected in the past.

There are legitimate tax policy reasons for allowing ordinary and necessary tax deductions for businesses that incur indebtedness and pay interest expenses. Similarly, there is a valid tax policy reason for allowing businesses to own permanent life insurance and for allowing the growth of these policies to be tax-deferred.

To arbitrarily tie these two fundamental tax concepts together as a means of raising revenue is disingenuous. If denying a deduction for an expense completely unrelated to an item of income were acceptable, we would have complete chaos in the tax code.

An example of how ill-conceived this policy would be is the case of a taxpayer who earns tax-deferred income in a ROTH IRA and also makes tax deductible mortgage interest payments. If the taxpayer's mortgage interest deduction were denied on the theory that he/she has "tax arbitrage" from unrelated tax-deferred earnings in the ROTH IRA, the entire tax code would have to be reviewed and the deductibility of deductions would always be in question. The purpose of the tax deferral, in this case to increase the ability of Americans to save for retirement and the interest deduction, to promote home ownership, are completely unrelated. There is no connection between the ROTH IRA and the mortgage indebtedness just as there is no connection here between the business indebtedness and the COLI policy. In the business setting, the analogy would be to deny an interest deduction on the purchase of office equipment solely because a business purchased key man life insurance.

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[1] Other changes impacting insurance products occurred over the years. Certain investment-oriented insurance products called "modified endowments" were restricted by Congress in 1988. This class of policies loses many or some of the favorable treatment available to other contracts under Code section 72. Congress in 1990 imposed another limitation on insurance policies with the enactment of the deferred acquisition cost provision (Code section 848)(the "DAC tax"). This provision limits the ability of insurance companies to deduct immediately the costs incurred in issuing a policy. The economic effect of the DAC provision has been to impose a federal premium tax.

Importantly, current law has safe guards for interest that is related or "traceable" to the ownership of life insurance, denying such interest deduction in such cases. The President's proposal attempts to disallow deductions for unrelated interest. The Administration apparently believes that allowing a taxpayer a deduction for interest incurred on indebtedness in the operation of a business is wrong if the business owns life insurance on its employees, officers, or directors, even if the business indebtedness is completely unrelated to the insurance. This belief is contrary to fundamental principals of tax policy as well as the social objectives such deductions are meant to achieve.

*2) The COLI Proposal is Inequitable*

By denying interest deductions on businesses that own life insurance, the President's COLI proposal creates unjustified inequities between businesses that rely on debt financing and those that are equity-financed. Under the proposal, two taxpayers in the same industry would be treated differently for tax purposes depending on whether they incurred debt in the operation of their business or whether they relied on equity investments.

In addition, businesses in different industries would be treated differently as a result of the proposal. Many capital intensive industries rely heavily on debt and would be disproportionately disadvantaged because the proposal would deny their interest deductions. This would occur even though the debt-financed businesses would own the same amount of life insurance and provide the same amount of employee and retirement benefits as their equity-financed competitors.

*3) Back Door Tax Increase on Cash Value and Unrealized Appreciation in Business Assets*

The President's FY 1999 budget proposal would apply the 1997 proration rules to all COLI and BOLI. Effectively, this would result in a backdoor taxation of cash values on all business life insurance.

As stated above, permanent life insurance has traditionally been a tax-favored investment for good social and tax policy reasons. The essential element of the insurance—to protect against the premature death of a key employee—and the use of the "cash value" savings element—to protect against business interruption or to fund pension and retirement benefits—have long been recognized as worthy goals.

By denying an interest deduction to businesses that own such policies and tying the denial to the "pro-rated" amount of "unborrowed cash value," the Administration is indirectly "taxing" the cash value on permanent insurance owned by a taxpayer. Traditional concepts of fairness should prevent the Administration to do indirectly what they choose not to do directly.

Moreover, this indirect tax increase on the cash value of a life insurance policy results in a tax on the "unrealized appreciation" in a taxpayer's asset. This result would be similar to taxing a homeowner each year on the appreciation of his/her home.

Fundamental concepts of tax policy dictate that taxes generally should be incurred on the "recognition" of a taxable event, such as a sale or exchange of property. To now impose a tax on "unrealized appreciation" would not only violate traditional concepts of tax policy, but could result in huge administrative burdens on taxpayers and the government if followed in other areas of the law.

*4) Unjustified Elimination of Funding for Employee and Retirement Benefits*

The President's COLI proposal would increase current taxes on all businesses that own or are the beneficiaries of a permanent life insurance policy. It would seriously curtail the availability of the benefits these policies fund and increase the risk of business failure from loss of a key employee. While there is a clear relationship between the providing of insurance and the funding of benefits, there is no relationship between interest on business indebtedness and unrelated insurance used to fund benefits.

Current rules already limit potential abuses in traditional COLI applications. Code section 264 prevents leveraged arbitrage from tax-deductible borrowing "related to" a corporate-owned life insurance policy. Code section 7702 and 7702A require corporate-owned policies to provide a reasonable amount of death benefit protection. And qualified plan limits restrict the amount of insurance that can be purchased by an employer on a currently deductible basis. It is not clear what public purpose extending these rules to cover unrelated interest deductions would serve.

The effect of the President's COLI proposal would be to limit wholly appropriate business uses of life insurance by making the cost of insurance products economically infeasible. Eliminating business owned life insurance could result in the elimination or reduction in the amount of employer-provided employee and retirement

benefits. Such a change would put unnecessary and undue pressure on Social Security and public financing of benefits. At a time when the country faces significant funding problems with Social Security, there is no sound policy reason to put additional burdens on financing of employee benefits and retirement savings.

In attempting to correct perceived abuses of COLI, the proposal unnecessarily deprives businesses of the legitimate benefits of COLI to protect against business interruption, loss of a key employee, or to fund employee benefits. The COLI proposal is overly broad and imposes restrictions far beyond those needed to address any perceived abuse. If there are abuses to be corrected, they should be addressed in a more narrow manner.

*5) COLI Proposal is Inconsistent with Well-founded Savings and Retirement Policies*

At the very same time that the President and Congress are calling for more tax incentives for personal savings and directing attention to the impending retirement security crisis, the President is proposing a provision that would ultimately reduce personal savings.

The President and Congress have repeatedly called for new long-term savings provisions (*e.g.,* ROTH IRAs, Education IRAs, SIMPLE IRAs) and expansions of existing savings provisions (*e.g.,* increases in traditional IRA limits). By indirectly "taxing" life insurance which funds retirement and benefit programs, the COLI proposal moves in the complete opposite direction of such efforts. By undermining these initiatives, the COLI proposal stands out as a stark example of inconsistent and contradictory tax and retirement policy.

*6) Retroactive Tax Increase*

Finally, the effective date of the COLI proposal would create a retroactive tax increase on millions of businesses and middle-class working Americans by denying an interest deduction on policies that have been in place. Businesses that relied on existing tax laws would be penalized and employees who relied on benefits funded by existing insurance policies would be unconscionable harmed.

We applaud the strong opposition by the Committee to retroactive tax increases, as expressed most recently by Chairman Archer, who made the following statement regarding the Administration's FY 1999 Budget:

"I do not intend to put my name on anything that is retroactive."

A precedent of retroactive application of tax increases to existing contracts, particularly in the case where there is no attempt at "tax avoidance" or "tax abuse," is inherently unfair and would reduce the incentives provided in the tax code for establishing private savings by injecting significant uncertainty into long-term planning.

## V. *Conclusion*

We urge the Committee to reject in its entirety the President's COLI proposal. The COLI proposal is seriously flawed, inequitable, overly broad, and unjustified. Moreover, it goes well beyond any perceived abuses raised by the Administration.

We would be happy to provide the Committee with additional information about the legitimate business uses of life insurance at any time.

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## Statement of Massachusetts Mutual Life Insurance Company

Massachusetts Mutual Life Insurance Company is the seventh largest mutual life insurance company in the United States, doing business throughout the nation. The Company offers life and disability insurance, deferred and immediate annuities, pension employee benefits, mutual funds and investment services. Massachusetts Mutual serves more than two million policyholders nationwide and, with its subsidiaries and affiliates, has more than $130 billion in assets under management. We are very concerned about the proposals in the President's Fiscal Year 1999 Budget which would significantly alter the tax treatment of life insurance and annuity products. We appreciate the opportunity to offer testimony with respect to these critical areas of concern.

### Exchanges Involving Variable Life and Annuity Contracts

The President's Budget proposals would tax any exchange of contracts involving either a variable life insurance policy or a variable annuity contract. In addition, the President's proposals would treat as a taxable exchange the internal reallocation

of values among the different funds offered under a variable insurance or annuity contract. Currently, a policyholder can avoid tax on the surrender of a life insurance or annuity contract by exchanging it for a new contract in accordance with the limitations of Section 1035 of the Internal Revenue Code. On a Section 1035 exchange, the contract gain is deferred until it is withdrawn or otherwise distributed from the new policy. The tax-deferral offered by Section 1035 is available for all cash value life insurance and annuity contracts, whether fixed, traditional policies or variable contracts.

Variable life insurance and annuity contracts represent an increasing percentage of MassMutual's business. The Company has over 74,000 individual variable life insurance policies in force, with approximately $14 billion of death benefits. Variable contracts represent the preponderance of the Company's annuity sales with $10.9 billion of assets under all of its variable annuities. The average account balance for our non-tax-qualified variable annuity contracts is $45,000.

Variable insurance and annuity products give policyholders an effective means to tailor long-term financial plans to their own specific needs and those of their families. By taxing exchanges that involve variable contracts or the transfer of funds within a variable contract, the Administration would gut the usefulness of these products for most taxpayers. A policyholder would be bound to his or her initial investment decision regardless of the subsequent performance of the insurance or annuity contract or the funds underlying the contract.

The Administration has indicated that current taxation of exchanges or fund reallocations would place variable contracts on a par with other investments. This is simply not correct. Federal tax law already subjects variable insurance and annuity contracts to numerous stringent requirements that do not apply to other assets. For instance, a life policy that is overly investment-oriented will fail the definition of life insurance set out in Code Section 7702. Even if a life policy meets that definition, too rapid premium payments will cause it to become a modified endowment contract, subjecting loans and other distributions during the life of the insured to harsh income tax rules. A ten percent distribution penalty tax also applies to modified endowment contracts and annuities.

Furthermore, the underlying investments of variable life and annuity contracts must meet specific diversification requirements under Code Section 817 and its regulations, and must comply with the investor control rules articulated by the Internal Revenue Service. However long the owner holds a variable contract, any gain distributed is always taxed as ordinary income not as capital gains. In contrast to other assets, the gift transfer of an annuity contract is taxable as income to the original owner and may trigger the additional 10% penalty tax. Moreover, there is no step-up in the cost basis of an insurance or annuity contract when the policyholder dies. In fact, while the tax laws do not mandate liquidation of other investments on the owner's death, annuity contracts must begin distributions when the policyholder dies.

The Administration's proposal is in direct conflict with its stated commitment to private savings and personal responsibility for retirement income. Within the restrictions already imposed by the tax laws, life insurance and annuity contracts provide a valuable means for achieving those goals. There is no justifiable basis for penalizing exchanges that involve variable contracts or transfers of funds among the investment options offered within a variable contract. Code Section 1035 was enacted for the express purpose of enabling policyholders to replace, without tax liability, those insurance and annuity contracts that no longer met their particular needs. Congress long ago recognized the validity and merit of variable life and annuity contracts as integral components to prudent survivor and retirement planning. The Administration's proposal would penalize variable contract owners who tried to protect their insurance and retirement income.

### Business Owned Life Insurance

In the past two years, Congress created appropriate limitations on a business' ability to deduct interest on debt when it has cash value life insurance. Following amendments enacted in 1996, federal law allows a business to take an interest deduction for loans against only those insurance policies covering the life of either a 20% owner of the business or another key person. No more than 20 individuals may qualify as key persons and the business can deduct interest on no more than $50,000 of policy debt per insured life. A special rule grandfathers policies issued before June 21, 1986. The 1997 tax act limited the interest a business can deduct on general debt if the business also has cash value life insurance on a person other than its employee, officer, director and 20% owner (or a 20% owner and spouse). To determine its allowable interest deductions, a business must reduce its general debt

by the unborrowed cash value in policies covering insureds who do not come within these exceptions. This "pro to policies issued or materially changed after June 8, 1997.

The President's Budget proposals would destroy the carefully crafted limitations set by the 1996 and 1997 amendments. First, the proposals would eliminate the ability of a business to deduct interest on loans against a policy insuring any person other than an individual who owned at least 20% of the business. Second, the Administration would extend the pro rata disallowance rule to all business owned life insurance policies except those covering a 20% owner. Further, the proposals apparently would not grandfather policies purchased under prior laws.

The proposals would make cash value life insurance prohibitively expensive for all businesses. By excepting only policies that insure 20% owners, the Administration proposals ignore the fact that business life insurance serves many legitimate, non-tax purposes. Clearly, life insurance provides a means for businesses to survive the death of an owner, offering immediate liquidity for day-to-day maintenance or the funds for co-owners to purchase the decedent's interest from heirs who are unwilling or incapable of continuing the business. However, although insurance to fund business buy-outs serves an important function, businesses use life insurance for many other equally meritorious purposes.

A business must protect itself from the economic drain and instability caused by the loss of any major asset. More than any machinery, realty or tangible goods, the particular talents of its key personnel sustain a business as a viable force. Life insurance provides businesses with the means to protect the workplace by replacing revenues lost on the death of a key person and by offsetting the costs of locating and training a suitable successor. Businesses also use life insurance to provide survivor and post-retirement benefits to their employees, officers and directors. As part of a supplemental compensation package, these benefits help attract and retain talented and loyal personnel, the very individuals who are crucial to the ongoing success of any business.

In 1996, Congress revised the rules for deducting for deducting interest on policy loans to impose sharp limits on the number of insureds and policy debt. The new rules successfully curtailed the abusive sale of life insurance for tax leverage and there is no reason to change the rules yet again. However, businesses need to retain the ability to borrow against policies on key persons without incurring a tax penalty. Although buying key person insurance makes sound business sense, the decision to do so requires a long-term commitment of capital. The business must have the flexibility to borrow against such policies in times of need without adverse tax consequences. The current key person exception is especially important to smaller businesses that have less access to alternative sources of borrowing.

Last year, Congress examined the tax treatment of unrelated debt where a business also happened to hold cash value life insurance. Based on this review, it created a tax penalty for companies that hold life insurance on their debtors, customers or any insureds other than their own employees, officers, directors or 20% owners. The Administration would now set aside this careful analysis and overturn a provision approved by the President only a few months ago. The legitimate needs for workplace protection insurance have not altered in that short span of time. The business need for life insurance will not disappear if Congress extends the pro rata disallowance rule to policies covering any insured other than 20% owners, but the resulting costs for businesses will increase. Generally, term insurance does not provide businesses with a reasonable alternative to cash value life insurance. While often appropriate for temporary arrangements, term insurance is both costly and unsuitable for long-range needs. The loss of interest deductions on unrelated borrowing is an exceedingly harsh punishment to impose on a business for taking prudent financial measures to protect its valuable human assets or to provide benefits for its employees and retirees.

### Reduction in Cost Basis

The Administration's proposals would reduce a policyholder's cost basis in any life insurance or annuity contract by the total mortality and expense charges attributable to the protection offered under the contract. With respect to annuity contracts, the Administration would assume annual charges equal to 1.25% of the contract's average cash value for the year, regardless of the actual charges imposed by the insurer. The proposed reductions in a contract's cost basis would create phantom income for all policyholders. Although a policyholder would receive no more cash on any distribution from a contract, a larger portion would be taxable as income.

Reducing a policy's cost basis would unfairly penalize one particular form of asset and would greatly increase the cost of annuities and cash value life insurance.

There is no similar cutback in a taxpayer's basis to reflect the use and enjoyment of other assets. Thus, homeowners do not reduce their cost basis by the annual value of their residence on the property. Moreover, many other assets qualify for an automatic increase in cost basis when their owner dies. This "step-up" rule can raise cost basis to the value of the asset on the date of the owner's death; if the heirs or the estate subsequently sell the property, only the sale proceeds in excess of the stepped-up basis would be taxed as income. No step-up in basis is available when the owner of a life insurance or annuity contract dies before the insured. Indeed, as opposed to its treatment of other assets, the tax law, with limited exceptions, actually requires liquidation of an annuity contract to begin after the owner's death.

While the proposal to reduce cost basis would adversely affect all policyholders, it would most severely hit those policies insuring older individuals and those policies maintained for the longest periods of time. As an insured ages, mortality charges associated with his coverage necessarily increase. The cumulative adjustments to reflect mortality and expense charges could deplete a policy's cost basis simply because the insured lived too long. Since mortality charges can also vary with the insured's gender and health, the charges for many insureds will consume cost basis more rapidly than for others. Income taxes should not punish taxpayers for their age, gender or state of health.

The proposal to deduct mortality and expense charges from the cost basis of an annuity contract is in direct opposition to the Administration's rhetorical commitment to encourage private savings and funding for retirement. The longer a policyholder kept an annuity contract in force, the less basis there would be to recover when the contract began distributions. With an automatic annual reduction equal to 1.25% of the annuity contract's average cash value for the year, the proposal would also effectively dock the policyholder's basis by a portion of the earnings on the contract. For no other asset does the tax law require a reduction in basis to reflect its appreciation in value.

With the proposed reduction in basis, a policyholder who in fact held an annuity contract as a long-term retirement vehicle would find a larger portion of his distributions includible in gross income than if he had withdrawn the same amount at an earlier date. The Internal Revenue Code already imposes a 10% penalty tax on early withdrawals from annuity contracts as a disincentive to using them as short-term investments. The new proposal would also penalize a policyowner for holding an annuity contract too long. The proposal would allow a taxpayer to recover the lost basis only by annuitizing the contract over life, a limited exception that would force individuals to lock into an arrangement that may not best suit their private needs. In any effort to revitalize personal savings for future income needs, a rule that increases tax on such savings and dictates the form of payout will at best be counterproductive.

### Taxation of Annuity Contract Reserves

An insurance company is allowed a federal tax deduction for its annuity reserves, which are the amounts it must set aside to pay its policyowners in the future. To protect policyholders, state insurance regulators set guidelines for an insurer to compute the minimum reserves it must hold. The Internal Revenue Code specifies how an insurer would compute its tax deduction for annuity reserves, using as a base the state method of calculation that produces the minimum amount of reserves (called CARVM) and making certain adjustments. Under current tax law, an annuity contract's net surrender value is the least amount that can be taken as a reserve deduction.

The President's Budget proposals would limit an insurer's reserve deduction for annuity contracts to the lesser of (1) the CARVM reserve (again, the minimum reserve amount required under state law), or (2) the contract's net surrender value plus a declining percentage of net surrender value phased out over seven years. The Administration would effectively limit the reserve deduction to a contract's net surrender value, regardless of the minimum reserve required under state law.

State reserve requirements are designed specifically to protect policyholders by providing some safeguard that the insurer will be able to meet its long-term obligations. Given the increases in longevity, the National Association of Insurance Commissioners (NAIC) is reviewing an update of the mortality tables used to determine annuity reserves. The longer an annuitant is expected to live, the greater the insurer's financial commitment and the larger the reserve it must set aside to meet that commitment. With updated mortality tables, state laws would then require insurers to increase their annuity reserves. However, the Administration proposal would restrict the insurer's tax deduction to only that portion of the reserves equal to an

annuity contract's net surrender value. It is inappropriate to limit the deduction to an annuity's net surrender value, a measure that does not take into account the risks that reserves are intended to meet.

State insurance regulators are better able than the federal tax authorities to determine the reserves needed to satisfy obligations to policyholders. The states do not set their reserve requirements in order to provide insurers with excessive federal tax deductions. The federal government should not use the tax laws to usurp the states' authority to prescribe appropriate financial guidelines to protect their policyholders.

The Administration has characterized this proposal as an increase in the income tax burden for insurers, not for annuity policyholders. Nevertheless, insurers will ultimately pass the tax cost on to their policyholders, making annuities more expensive for the many individuals who try to save for their personal retirement needs. As with the other tax proposals for insurance and annuity products, the increased tax on annuity reserves is completely at odds with the Administration's stated goals of fostering private savings and financial responsibility.

## CRUMMEY WITHDRAWAL RIGHT

Under the combined federal estate and gift tax laws, a single donor can make annual gifts of up to $10,000 per recipient without triggering a tax liability; married donors may give up tts made through a trust qualify for the gift tax exclusion if the trust agreement grants the beneficiary what is called a "Crummey" withdrawal right, essentially the right to withdraw gifts made into a trust on his behalf. Since the trust beneficiary could demand immediate distribution, a gift in trust is treated as an outright gift eligible for the gift tax exclusion.

The Administration's Budget proposal would disqualify gifts in trust from the gift tax exclusion, whether or not the trust agreement granted the beneficiaries any withdrawal rights. Only outright gifts would remain eligible for the exclusion. Effective for gifts made after 1998, the proposal would not grandfather any existing trust arrangements.

Given the fact that federal gift and estate taxes are inter-linked, a change in the treatment of lifetime gifts increases the donor's ultimate estate tax burden. The Administration proposal would effectively raise federal death taxes at a time when many members of Congress have indicated that the tax is already too onerous.

There is no sound reason for taxing gifts to a Crummey trust differently from outright gifts. The Internal Revenue service and the courts have established strict guidelines to ensure that Crummey rights have substance and are not mere "legal fictions," as described by the Administration. The trust agreement must require the trustee to provide prompt written notice to a beneficiary that a gift has been made on his behalf; the trust must grant the beneficiary a reasonable period to request a withdrawal; and, the trustee must maintain sufficient liquidity to satisfy any such requests made during the withdrawal period. As a result, there is no material difference between a gift made to a Crummey trust and an outright gift.

For thirty years, the law has recognized contributions to a Crummey trust as eligible for the gift tax exclusion. Virtually all irrevocable trusts grant beneficiaries Crummey withdrawal rights. A change in the tax treatment of gifts to such trusts would disrupt the long-term estate plans of many American families. Since the trusts are irrevocable, their provisions cannot be revised to match a change in the tax law.

Trusts created to hold life insurance policies almost universally rely on Crummey provisions to avoid tax on the annual gifts in trust to pay premiums. Over 30,000 MassMutual life insurance policies are currently held in such trusts. If those gifts no longer qualify for the exclusion, families would have to choose between paying the tax or lapsing the policy. As a practical matter, life insurance trusts are designed to provide liquidity on the insured's death, including funds to meet estate taxes. The proposal to tax gifts in trust would thus inflate the cost of making prudent arrangements to pay estate taxes.

## CONCLUSION

The revenue provisions contained in the President's Budget proposed for fiscal year 1999 would unduly increase the tax burden on holders of life insurance and annuity contracts. The proposals would effectively penalize taxpayers who try to provide for their future financial needs, as well as those of their families and their businesses. By radically altering well-established tax laws, the Administration proposals would disrupt the long-term plans of individuals and businesses. The proposals are particularly unsettling at a time when both Congress and the Administra-

tion agree that there should be a significant increase in the amount Americans save for their future financial needs.

**Statement of Merrill Lynch & Co., Inc.**

Merrill Lynch is pleased to provide this written statement for the record of the February 25, 1998 hearing of the Committee on Ways & Means on "Revenue Provisions in the President's Fiscal Year 1999 Budget Proposal." [1]

I. *Introduction*

Merrill Lynch believes that a strong, healthy economy will provide for increases in the standard of living that will benefit all Americans as we enter the challenges of the 21st Century. Investments in our nations future through capital formation will increase productivity enabling the economy to grow at a healthy rate. Merrill Lynch is, therefore, extremely supportive of fiscal policies that raise the United States savings and investment rates. For this reason, Merrill Lynch has been a strong and vocal advocate of policies aimed to balance the federal budget. Merrill Lynch applauds the efforts of this Congress to finally reach the commendable goal of balancing the budget.

While Merrill Lynch applauds the efforts of many to balance the federal budget, it is unfortunate that some of the tax changes proposed by the Administration in its FY 1999 Budget would raise the costs of capital and discourage capital investment—policies contradictory to the objective of a balanced budget. The Administration's FY 1999 Budget contains a number of revenue-raising proposals that would raise the cost of financing new investments in plant, equipment, research, and other job-creating assets. This will have an adverse effect on the economy.

Moreover, many of these proposals have previously been fully considered and rejected out-of-hand by this same Congress. On many prior occasions, Merrill Lynch has spoken out against the negative impact such proposals would have on our Nation.

Merrill Lynch agrees with comments by Chairman Bill Archer in announcing these hearings, where he stated:

"Given the public reaction to the numerous tax increase proposals in the budget, including proposals which have been rejected previously and new proposals increasing the tax burden on savings and investment, the Administration has a very heavy burden to carry."

These remarks are consistent with Chairman Archer's prior statement to President Clinton when many of these same proposals were being considered for inclusion in prior budgets. On a broad basis, Chairman Archer stated that he is "deeply troubled and believe(s) that the impact of your plan is fundamentally anti-business, anti-growth and . . . further concerned that the manner in which you have arrived at these proposals appears to be based on how much revenue you can raise from tax increases rather than how to improve the current tax code based on sound policy changes." See, Letter from Chairman Bill Archer to President Clinton (dated December 11, 1995). Chairman Archer also stated that:

"you have proposed numerous new tax increases on business which reflect anti-business bias that I fear will diminish capital formation, economic growth, and job creation. For example, I don't understand why you would want to exacerbate the current problem of multiple taxation of corporate income by reducing the intercorporate dividends received deduction and denying legitimate business interest deductions. . . . it will not only be America's businesses that pay the tab; hard-working, middle income Americans whose nest-eggs are invested in the stock market will pay for these tax hikes."

Based on these and other serious concerns by Congress, many of the capital market proposals which the Administration is now reproposing were rejected outright in prior years. We see no legitimate reason to now reconsider these unsound policies.

The U.S. enjoys the world's broadest and most dynamic capital markets. These markets allow businesses to access the capital needed for growth, while providing investment vehicles individuals can rely on to secure their own futures. Our preeminent capital markets have long created a competitive advantage for the United States, helping our nation play its leading role in the global economy.

[1] Merrill Lynch also endorses the comments submitted to the Committee on these provisions by the Securities Industry Association and The Bond Market Association.

Merrill Lynch remains seriously concerned about the damage the Administration's proposals could cause to the capital-raising activities of American business and the investments these companies are making for future growth. Merrill Lynch believes these proposals are anti-investment and anti-capital formation. If enacted, they would increase the cost of capital for American companies, thereby harming investment activities and job growth.

Unfortunately, the Administration's proposals would serve to limit the financing alternatives available to businesses, harming both industry and the individuals who invest in these products. Merrill Lynch believes this move by the Administration to curtail the creation of new financial options runs directly counter to the long-run interests of our economy and our country.

While Merrill Lynch is opposed to all such proposals in the Administration's FY 1998 Budget,[2] our comments in this written statement will be limited to the proposals that:

• Defer original issue discount deduction on convertible debt. This proposal would place additional restrictions on the use of hybrid preferred instruments and convertible original issue discount ("OID") bonds and would defer the deduction for OID and interest on convertible debt until payment in cash (conversion into the stock of the issuer or a related party would not be treated as a "payment" of accrued OID). This proposal is nearly identical to ones proposed by the Administration in its FY '97 and FY '98 budget plans, which were rejected by Congress.

• Eliminate the dividends-received deduction ("DRD") for certain preferred stock. This proposal would deny the 70-and 80-percent DRD for certain types of preferred stock. The proposal would deny the DRD for such "nonqualified preferred stock" where: (1) the instrument is putable; (2) the issuer is required to redeem the securities; (3) it is likely that the issuer will exercise a right to redeem the securities; or (4) the dividend on the securities is tied to an index, interest rate, commodity price or similar benchmark. This proposal is also nearly identical to ones proposed in previous budgets, which were rejected by Congress.

Hereinafter these proposals will be referred to as the "Administration's proposals."

To be clear, these proposals are *not* "loopholes" or "corporate welfare." They are fundamental changes in the tax law that will increase taxes on savings and investment. They do little more than penalize middle-class Americans who try to save through their retirement plans and mutual funds. Rather than being a hit to Wall Street, as some claim, these proposals are a tax on Main Street—a tax on those who use capital to create jobs all across America and on millions of middle-class individual savers and investors.

It is unfortunate that the Treasury has chosen to characterize these proposals as "unwarranted corporate tax subsidies" and "tax loopholes." The fact is, the existing tax debt/equity rules in issue here have been carefully reviewed—some for decades—by Treasury and Internal Revenue Service ("IRS") officials, and have been deemed to be sound tax policy by the courts. Far from being "unwarranted" or "tax loopholes," the transactions in issue are based on well established rules and are undertaken by a wide range of the most innovative, respected, and tax compliant manufacturing and service companies in the U.S. economy, who collectively employ millions of American workers.

Merrill Lynch urges Congress to get past misleading "labels" and weigh the proposals against long standing tax policy. Under such analysis, these proposals will be exposed for what they really are—nothing more than tax increases on Americans.

Merrill Lynch believes that these proposals are ill-advised, for four primary reasons:

• They Will Increase The Cost of Capital, Undermining Savings, Investments, and Economic Growth. While Treasury officials have stated their tax proposals will primarily affect the financial sector, this is simply not so. In reality, the burden will fall on issuers of, and investors in, these securities—that is, American businesses and individuals. Without any persuasive policy justification, the Administration's proposals would force companies to abandon efficient and cost-effective means of financing now available and turn to higher-cost alternatives, and thus, limit productive investment. Efficient markets and productive investment are cornerstones to economic growth.

• They Violate Established Tax Policy Rules. These proposals are nothing more than ad hoc tax increases that violate established rules of tax policy. In some cases, the proposals discard tax symmetry and deny interest deductions on issuers of debt

[2] Other anti-business, anti-growth proposals include the tax on certain exchanges of insurance contracts (the "annuities" proposal), the increase in the proration percentage for property & casualty (P&C) insurance companies, and the real estate investment trust ("REIT") proposals. There is no inference of support for proposals not mentioned in this written statement.

instruments, while forcing holders of such instruments to include the same interest in income. Disregarding well-established tax rules for the treatment of debt and equity only when there is a need to raise revenue is a dangerous and slippery slope that can lead to harmful tax policy consequences.

• They Will Disrupt Capital Markets. Arbitrary and capricious tax law changes have a chilling effect on business investment and capital formation. Indeed, the Administration's proposals have already caused significant disruption in capital-raising activities, as companies reevaluate their options.

• They Will Fail to Generate Promised Revenue. The Administration's proposals are unlikely to raise the promised revenue, and could even lose revenue. Treasury's revenue estimates appear to assume that the elimination of the tax advantage of certain forms of debt would cause companies to issue equity instead. To the contrary, most companies would likely move to other forms of debt issuance—ones that carry higher coupons and therefore involve higher interest deductions for the issuer.

At a time when the budget is balanced and the private sector and the federal government should join to pursue ways to strength the U.S. economy, the Administration has proposed tax law changes that would weaken the economy by disrupting capital-raising activities across the country. Merrill Lynch strongly urges the Administration and Congress to set aside these proposals. Looking forward, Merrill Lynch would be delighted to participate in full and open discussions on the Administration's proposals, so that their ramifications can be explored in depth.

The following are detailed responses and reaction to three of the Administration's proposals that would directly affect capital-raising and investment activities in the U.S.

II. *Proposal To Defer OID Deduction on Convertible Debt*

The Administration's FY 1999 Budget contains proposals that would defer the deduction for original issue discount ("OID") until payment and deny an interest deduction if the instrument is converted to the stock of the issuer or a related party. These proposed changes to fundamental tax policy rules relating to debt and equity come under two separate (but related) proposals. Similar proposals were proposed and rejected by Congress a number of times in the past two years.

One proposal, among other things, defers OID on convertible debt. The only stated "Reasons for Change" relating specifically to this proposal is contained in the Treasury Department's "General Explanations of the Administration's Revenue Proposals" (February 1998) (the "Green Book"):

In many cases, the issuance of convertible debt with OID *is viewed by market participants as a de facto purchase of equity*. Allowing issuers to deduct accrued interest and OID is inconsistent with this market view."

This is the same justification used in Treasury's February 1997 Green Book and rejected by Congress.

Merrill Lynch strongly opposes the Administration's proposal to defer deductions for OID on Original Issue Discount Convertible Debentures ("OIDCDs") for a number of reasons more fully described below. To summarize:

• The Treasury's conclusion that the marketplace treats OIDCD as de facto equity is erroneous and inconsistent with clearly observable facts;

• In an attempt to draw a distinction between OIDCDs and traditional convertible debt, Treasury has in prior years misstated current law with regard to the deduction of accrued but unpaid interest on traditional convertible debentures, and apparently continues to rely on such misstatements;

• The proposal ignores established authority that treats OIDCDs as debt, including guidance from the IRS in the form of a private letter ruling;

• The proposed elimination of deductions for OID paid in stock is at odds with the tax law's general treatment of expenses paid in stock;

• The proposal would destroy the symmetry between issuers and holders of debt with OID. This symmetry has been the pillar of tax policy regarding OID. The Administration offers no rationale for repealing this principle;

• The proposal disregards regulations adopted after nearly a decade of careful study by the Treasury and the Internal Revenue Service. Consequently, the Administration's proposal would hastily reverse the results of years of careful study; and

• While billed as a revenue raiser, it is clear that adoption of the Administration's proposal would in fact reduce tax revenue.

• Finally, this proposal has been fully considered by this same Congress and rejected in prior years.

*A. Treasury's Conclusion That The Market Treats OIDCD As De Facto Equity Is Erroneous And Inconsistent With Clearly Observable Facts.*

The proposal is based on demonstrably false assumptions about market behavior, which assumptions are also inconsistent with clearly observable facts. *There is no uncertainty in the marketplace regarding the status of OIDCDs as debt*. These securities are booked on the issuers' balance sheets as debt, are viewed as debt by the credit rating agencies, and are treated as debt for many other legal purposes, including priority in bankruptcies. In addition, zero coupon convertible debentures are typically sold to risk averse investors who seek the downside protection afforded by the debentures. Thus, both issuers and investors treat convertible bonds with OID as debt, not equity. Accordingly, *it is clear that the market's "view" supports the treatment of OIDCD as true debt for tax purposes*.

Treasury makes clear that its proposal would not affect "typical" convertible debt on the grounds that the "typical" convertible debentures are not certain to convert. Because OIDCDs have been available in the market place in substantial volume for over ten years, it is possible to compare the conversion experience of so-called "typical" convertible debentures with the conversion experience of OIDCDs, nearly all of which have been zero coupon convertible debt. The data shows that "typical" convertible debentures are much more likely to convert to equity, that is, to be paid off in stock, than zero coupon convertible debentures.

The instruments in question are truly debt rather than equity. An analysis of all 97 liquid yield option notes ("LYONs") sold in the public market since 1985, shows that 57 of those issued had already been retired (as of December 1997). Of those 57, only 15 were finally paid in stock. The other 42 were paid in cash. The remaining 40 of the 97 issues were still outstanding as of December 31, 1997. If those 40 securities were called, only 19 of them would have converted to stock and the other 21 would have been paid in cash. In other words, the conversion features of only 19 of the 40 issues remaining outstanding are "in the money." Overall, only 35% of the public issuances of LYONs had been (or would be if called) paid in stock. Thus, in only 35% of these OIDCD issuances had the conversion feature ultimately controlled.

On the other hand, an analysis of 669 domestic issues of "typical" convertible debt retired since 1985 shows just the opposite result (as of December 1997). Seventy-three percent (73%) of these offerings converted to the issuer's common stock. Accordingly, based on historical data, typical convertible debt is significantly more likely to be retired with equity than cash, as compared to LYONs.

The Treasury's proposal is clearly without demonstrable logic. It makes no sense to say that an instrument that has approximately a 30% probability of converting into common stock is "viewed by market participants as a de facto purchase of equity," and therefore, the deduction for OID on that instrument should be deferred (or denied), while an instrument that has over a 70% probability of conversion should be treated for tax purposes as debt.[3] We would be happy to provide this data, and any other relevant information, to the Administration and Congress.

*B. Prior Misstatements of Current Law Continue to Be Relied Upon*

In prior year's Budget proposals, Treasury's has made statements of "Current Law," which apparently continue to be relied upon in the FY 1999 Budget plan. These statements misstate the law regarding interest that is accrued but unpaid at the time of the conversion. The Treasury has in the past suggested that the law regarding "typical" convertible debt is different from the law for convertible debt with OID. This is clearly not the case. Both the Treasury's own regulations and case law require that stated interest on a convertible bond be treated the same as OID without regard to whether the bondholder converts.

When the Treasury finalized the general OID regulations in January, 1994 (T.D. 8517), the Treasury also finalized Treasury Regulations section 1.446–2 dealing with the method of accounting for the interest. The regulations state:

"Qualified stated interest (as defined in section 1.1273–1(c)) accrues ratably over the accrual period (or periods) to which it is attributable and accrues at the stated rate for the period (or periods). See, Treas. Reg. Section 1.446–2(b).

All interest on a debt obligation that is not OID is "qualified stated interest." Treasury regulations define "qualified stated interest" under Treas. Reg. Section 1.1273–1(c) as follows:

[3] Given this data, even if one accepted the Treasury's assertion that probability of conversion in some way governed appropriate tax treatment, the proposal obviously addresses the wrong convertible security.

(i) In general, qualified stated interest is stated interest that is unconditionally payable in cash or in property . . . or that will be constructively received under section 451, at least annually at a single fixed rate . . .

(ii) Unconditionally payable . . . *For purposes of determining whether interest is unconditionally payable, the possibility of a nonpayment* due to default, insolvency or similar circumstances, or *due to the exercise of a conversion option described in section 1272–1(e) is ignored*. This applies to debt instruments issued on or after August 13, 1996 (emphasis added).

Thus, according to the Treasury's own regulations, fixed interest on a convertible bond is deductible as it accrues without regard to the exercise of a conversion option. The Treasury's suggestion to the contrary in the description of the Administration's proposal contradicts the Treasury's own recently published regulations.

In addition, case law from the pre-daily accrual era established that whether interest or OID that is accrued but unpaid at the time an instrument converts is an allowable deduction depends on the wording of the indenture. In *Bethlehem Steel Corporation v. United States*, 434 F.2nd 1357 (Ct. Cl. 1971), the Court of Claims interpreted the indenture setting forth the terms of convertible bonds and ruled that the borrower did not owe interest if the bond converted between interest payment dates. The Court merely interpreted the indenture language and concluded that no deduction for accrued but unpaid interest was allowed because no interest was owing pursuant to the indenture. The Court stated that if the indenture had provided that interest was accrued and owing, and that part of the stock issued on conversion paid that accrued interest, a deduction would have been allowed. The indentures controlling all of the public issues of zero coupon convertible debt were written to comply with the *Bethlehem Steel* court's opinion and thus, the indentures for all of these offerings provide that if the debentures convert, part of the stock issued on conversion is issued in consideration for accrued but unpaid OID.

Thus, there is no tax law principle that requires a difference between "typical" convertible bonds and zero coupon convertible deductions. The only difference is a matter of indenture provisions and that difference has been overridden by the Treasury's own regulations.

*C. Proposal Ignores Established Authority That Treats OIDCDs As Debt, Including Guidance From The IRS In The Form Of A Private Letter Ruling.*

Under current law, well-established authority treats OIDCDs as debt for tax purposes, including guidance from the IRS in the form of a private letter ruling. The IRS has formally reviewed all the issues concerning OIDCDs and issued a private letter ruling confirming that the issuer of such securities may deduct OID as it accrues. See, PLR 9211047 (December 18, 1991). Obviously rather than having not exploited [a] lack of guidance from the IRS, issuers of OIDCDs have relied on official IRS guidance in the form of a private letter ruling. That the IRS issued a ruling on this topic confirms that OIDCDs do not exploit any ambiguity between debt and equity. If any such ambiguity existed the IRS would not have issued its ruling.

*D. Proposal Is Inconsistent With The Fundamental Principle That Payment In Stock Is Equivalent To Payment In Cash.*

We would now like to focus not on the timing of the deduction but on the portion of the Administration's proposal that would deny the issuer a deduction for accrued OID if ultimately paid in stock. The proposal is inconsistent with the general policy of the tax law that treats a payment in stock the same as a payment in cash. A corporation that issues stock to purchase an asset gets a basis in that asset equal to the fair market value of the stock issued. There is no difference between stock and cash. A corporation that issues stock to pay rent, interest or any other deductible item may take a deduction for the item paid just as if it had paid in cash.

More precisely on point, the 1982 Tax Act added section 108(e)(8)[4] to repeal case law that allowed a corporate issuer to escape cancellation of indebtedness income if the issuer retired corporate debt with stock worth less than the principal amount of the corporate debt being retired. The policy of that change was to make a payment with stock equivalent to a payment with cash. Section 108(e)(8) clearly defines the tax result of retiring debt for stock. As long as the market value on the stock issued exceeds the amortized value of the debt retired, there is no cancellation of indebtedness income. The Administration's proposal to treat payment of accrued OID on convertible debt differently if the payment is made with stock rather than cash is inconsistent with the fundamental rule that payment with stock is the same

[4] All section references are to the Internal Revenue Code of 1986, as amended.

as payment with cash. The Administration's proposal would create an inconsistency without any reasoned basis.

*E. Treasury's Proposal Removes The Long Established Principle Of Tax Symmetry Between Issuers And Holders Of Debt With OID.*

As discussed above, the current law is clear that an issuer of a convertible debenture with OID is allowed to deduct that OID as it accrues. The Service's private letter ruling, cited above, confirms this result. It is important to note that the OID rules were originally enacted to ensure proper timing and symmetry between income recognition and tax deductions for tax purposes. Proposals that disrupt this symmetry violate this fundamental goal of tax law.

The Administration's proposal reverses the policy of symmetry between issuers and holders of OID obligations. Since 1969, when the tax law first addressed the treatment of OID, the fundamental policy of the tax law has been that holders should report OID income at the same time that the issuer takes a deduction. The Administration's proposal removes this symmetry for convertible debt with OID. Not only would the holders report taxable income before the issuer takes a deduction, but if the debt is converted, the holders would have already reported OID income and the issuer would never have an offsetting deduction. The Administration does not offer any justification for this unfairness.

*F. Treasury's Proposal Is An Arbitrary Attempt To Reverse Tax Policies That Were Adopted After Nearly A Decade Of Careful Study.*

The manner in which this legislative proposal was offered is a significant reason to doubt the wisdom of enacting a rule to defer or deny deductions for OID on convertible debentures. When the Treasury issued proposed regulations interpreting 1982 and 1984 changes in the Internal Revenue Code regarding OID, the Treasury asked for comments from the public regarding whether special treatment was necessary for convertible debentures. *See,* 51 Federal Register 12022 (April 18, 1986).

This issue was studied by the Internal Revenue Service and the Treasury through the Reagan, Bush and Clinton Administrations. Comments from the public were studied and hearings were held by the current administration on February 16, 1993. When the current Treasury Department adopted final OID regulations in January of 1994, the final regulations did not exclude convertible debentures from the general OID rules. After nearly nine years of study under three Administrations and after opportunity for public comment, the Treasury decided that it was not appropriate to provide special treatment for OID relating to convertible debentures. Merrill Lynch suggests that it is not wise policy to reverse a tax policy that Treasury had adopted after nearly a decade of study and replace it with a policy previously rejected by Congress on a number of occasions.

*G. Proposal Regarding OID Convertible Debentures Would Reduce Tax Revenue.*

While billed as a "revenue raiser," adoption of the Administration's proposal with respect to OIDCDs would in fact reduce tax revenue for the following reasons:

- Issuers of OIDCDs view them as a debt security with an increasing strike price option imbedded to achieve a lower interest rate. This a priori view is supported by the historical analysis of OIDCDs indicating that over 70% have been, or if called would be, paid off in cash.
- If OIDCDs were no longer economically viable, issuers would issue straight debt.
- Straight debt rates are typically 200 to 300 basis points higher than comparable rates. Therefore, issuers' interest deductions would be significantly greater.
- According to the Federal Reserve Board data, at June 30, 1995 over 60% of straight corporate debt is held by tax deferred accounts versus less that 30% of OIDCDs held by such accounts.

Consequently, the empirical data suggests that if OIDCDs are not viable, issuers will issue straight debt with higher interest rates being deducted by issuers and paid to a significantly less taxed holder base. The Administration's proposal would therefore reduce tax revenue while at the same time interfering with the efficient operation of the capital markets.

Giving full consideration to the above data, Merrill Lynch believe rejection of the proposal with respect to OIDCDs is warranted and the reasons for doing so compelling.

III. *Proposal To Reduce the DRD, Modify the DRD Holding Period, and Eliminate the DRD on Certain Limited Preferred Stock*

The Administration has proposed to deny the 70- and 80-percent DRD for certain types of preferred stock. The proposal would deny the DRD for such "nonqualified preferred stock" where: (1) the instrument is putable; (2) the issuer is required to redeem the securities; (3) it is likely that the issuer will exercise a right to redeem the securities; or (4) the dividend on the securities is tied to an index, interest rate, commodity price or similar benchmark. A similar proposal was proposed and rejected by Congress a number of times in the past two years.

It has long been recognized that the "double taxation" of dividends under the U.S. tax system tends to limit savings, investment, and growth in our economy. The DRD was designed to mitigate this multiple taxation, by excluding some dividends from taxation at the corporate level.

Unfortunately, the Administration's proposal eliminate the DRD on certain stock would significantly undermine this policy. In the process, it would further increase the cost of equity capital and negatively affect capital formation.

From an economic standpoint, Merrill Lynch believes that in addition to exacerbating multiple taxation of corporate income, the Administration's proposal is troubling for a number of reasons and would have a number of distinct negative impacts:

• Dampen Economic Growth. If the DRD elimination were enacted, issuers would react to the potentially higher cost of capital by: lowering capital expenditures, reducing working capital, moving capital raising and employment offshore, and otherwise slowing investments in future growth. In particular, American banks, which are dependent on the preferred stock market to raise regulatory core capital, would see a significant increase in their cost of capital and, hence, may slow their business-loan generation efforts.

• Limit Competitiveness of U.S. Business. The elimination of the DRD would also further disadvantage U.S. corporations in raising equity vis-à-vis our foreign competitors, especially in the UK, France, and Germany. In these countries, governments have adopted a single level of corporate taxation as a goal, and intercorporate dividends are largely or completely tax free. As long as American firms compete in the global economy under the weight of a double- or triple-taxation regime, they will remain at a distinct competitive disadvantage.

• Discriminate Against Particular Business Sectors and Structures. The Administration's proposal may have a disproportionate impact on taxpayers in certain industries, such as the financial and public utility industries, that must meet certain capital requirements. Certain types of business structures also stand to be particularly affected. Personal holding companies, for example, are required to distribute their income on an annual basis (or pay a substantial penalty tax) and thus do not have the option to retain income to lessen the impact of multiple levels of taxation.

• Companies Should Not Be Penalized for Minimizing Risk of Loss. As a result of the Administration's proposal, the prudent operation of corporate liability and risk management programs could result in disallowance of the DRD. Faced with loss of the DRD, companies may well choose to curtail these risk management programs.

• No Tax Abuse. In describing the DRD proposal, the Administration suggests that some taxpayers "have taken advantage of the benefit of the dividends received deduction for payments on instruments that, while treated as stock for tax purposes, economically perform as debt instruments." To the extent Treasury can demonstrate that the deduction may be subject to misuse, targeted anti-avoidance rules can be provided. The indiscriminate approach of eliminating the DRD goes beyond addressing inappropriate transactions and unnecessarily penalizes legitimate corporate investment activity.

While the overall revenue impact of the DRD proposal may be positive, Merrill Lynch believes the revenue gains will not be nearly as large as projected, due to anticipated changes in the behavior of preferred-stock issuers and investors.

• Issuers of Preferred Stock. Eliminating the DRD will increase the cost of preferred-stock financing and cause U.S. corporations to issue debt instead of preferred stock because of interest deductibility. This overall increase in deductible interest would result in a net revenue loss to Treasury.

• Secondary Market for Preferred Stock. Currently, the market for outstanding preferred stock is divided into two segments:

(1) A multi-billion dollar variable-rate preferred stock market where dividends are set via Dutch auctions. The dividend rate on these securities will necessarily increase to adjust for the elimination of the DRD, and may cause some of these issuers to call these preferred securities at par and replace them with debt. This will result in a revenue loss to Treasury.

(2) A multi-billion dollar fixed-rate preferred stock market where the issuing corporations cannot immediately call the securities. Retail investors, who comprise 80% of this market cannot utilize the DRD and therefore pay full taxes on dividends. Hence, there will be no meaningful revenue gains to Treasury from this market segment.

This proposal may also create losses for individual investors. Institutions, which own approximately 20% of all fixed-rate preferred stock, may sell their holdings given the increased taxation. Individual investors will bear the brunt of any price decline, because they currently account for about 80% of the fixed-rate preferred market. These capital losses, when taken, will offset any capital gains and result in a revenue loss to Treasury.

At a time when U.S. tax policy should be moving toward fewer instances of "double taxation," Merrill Lynch believes it would be a mistake to eliminate the DRD on certain limited-term preferred stock. Any such action will make "triple taxation" even more pronounced in, and burdensome on, our economy.

V. *Conclusion*

Based on the discussion set forth above, Congress should reject the Administration's proposals out of hand. These proposals which include the deferral of legitimate interest deductions and the elimination of the DRD are nothing more than tax increases which raise the cost of financing new investments, plant, equipment, research, and other job-creating assets. These tax increases hurt the ability of American companies to compete against foreign counterparts and are born by the millions of middle-class Americans who try to work and save through their retirement plans and mutual fund investments. These impediments to investment and savings would hurt America's economic growth and continued leadership in the global economy.

Moreover, from a tax policy perspective, the Administration's proposals are ill-advised, arbitrary and capricious tax law changes that have a chilling effect on business investment and capital formation. Indeed, the Administration's proposals are nothing more than ad hoc tax increases that violate established rules of tax policy. In some cases, the proposals discard tax symmetry and deny interest deductions on issuers of certain debt instruments, while forcing holders of such instruments to include the same interest in income. Disregarding well-established tax rules for the treatment of debt and equity only when there is a need to raise revenue is a dangerous and slippery slope that can lead to harmful tax policy consequences.

The Administration's proposals also are unlikely to raise the promised revenue, and could even lose revenue. Treasury's revenue estimates appear to assume that the elimination of the tax advantage of certain forms of debt would cause companies to issue equity instead. To the contrary, most companies would likely move to other forms of debt issuance—ones that carry higher coupons and therefore involve higher interest deductions for the issuer.

Far from being "unwarranted" or "tax loopholes," the transactions in issue are based on well established rules and are undertaken by a wide range of the most innovative, respected, and tax compliant manufacturing and service companies in the U.S. economy, who collectively employ millions of American workers.

Merrill Lynch urges Congress to get past misleading "labels" and weigh the proposals against long standing tax policy. Under such analysis, these proposals will be exposed for what they really are—nothing more than tax increases on Americans.

For all the reasons stated above, the Administration's proposals should AGAIN be rejected in total.

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**Statement of the Price Waterhouse LLP Multinational Tax Coalition**

The Multinational Tax Coalition ("MTC"), a coalition of U.S. companies in a wide range of industries competing in world markets, appreciates the opportunity to respond to the Chairman's request for testimony to the Committee on Ways and Means on the revenue-raising provisions of President Clinton's FY 1999 budget plan.

Specifically, we are testifying in opposition to the Administration's proposal to expand the Treasury Department's regulatory authority to address the tax consequences of "hybrid" transactions. This proposal is the latest in a series of international tax initiatives undertaken by the Clinton Administration that would penalize cross-border business operations that support U.S. exports and American jobs.

In our testimony, we explain our chief tax policy concerns over the Administration's proposal and related Treasury pronouncements (IRS Notices 98–11 and 98–

5). We also weigh these initiatives from an economic viewpoint, taking into account their impact on U.S. competitiveness. We conclude that these initiatives, taken together, represent fundamental changes in U.S. international tax policy that properly should be considered by Congress.

MTC members include AES Corporation, Caterpillar Inc., Chrysler Corporation, Citicorp, The Clorox Company, Coty Inc., DuPont, Emerson Electric Co., General Electric, General Mills, Inc., Hallmark Cards, Inc., Hewlett-Packard Company, IBM Corporation, J.P. Morgan, Morgan Stanley, Dean Witter & Co., NationsBank Corporation, PepsiCo, Inc., Philip Morris Companies, Inc., and Tupperware Corporation. Price Waterhouse LLP serves as consultant to the group.

## BACKGROUND

The Administration's FY 1999 budget, submitted to Congress on February 2, includes a proposal to direct the Treasury Department to prescribe regulations clarifying the tax treatment of hybrid transactions, effective on the date of enactment. Treasury's "Green Book" description of the proposal defines "hybrid transactions" generally as transactions that utilize "hybrid entities" (i.e., entities that are treated as corporations in one jurisdiction and as branches or partnerships in another jurisdiction), "hybrid securities" (e.g., securities that are treated as debt or royalty rights for U.S. tax purposes and as equity interests for foreign purposes), or other types of hybrid structures.

The Treasury proposal states that the regulations "would set forth the appropriate tax results under hybrid transactions in which the taxpayer's intended results are not consistent with the purposes of U.S. law." Treasury anticipates that this regulatory authority would be used, in part, to "deny tax benefits or results arising in connection with various types of tax arbitrage transactions, including transactions that circumvent the purposes of the U.S. Subpart F rules, U.S. tax treaty provisions, and the U.S. foreign tax credit rules." The Green Book describes some of the broad areas in which the expanded regulatory authority might be used:

- "use of hybrid entities and hybrid securities that, contrary to the purposes of the Subpart F rules, result in deductions for foreign tax purposes with respect to certain cross-border payments that do not generate Subpart F income."
- "use of hybrid securities and other hybrid transactions in order to achieve results that can not be achieved through the use of hybrid entities" because of section 894(c) and the regulations thereunder.[1]
- "inappropriate foreign tax credits that arise in connection with certain hybrid transactions."

The Green Book notes that the extent of Treasury's current authority to issue regulations in these areas is unclear in some instances.

The Treasury proposal comes on the heels of two Internal Revenue Service pronouncements (Notice 98–11[2] and Notice 98–5[3]) that discuss similar issues. In Notice 98–11, the IRS announced that Treasury regulations will be issued to prevent the use of certain "hybrid branch" arrangements deemed contrary to the policies and rules of Subpart F. Notice 98–11 states that the regulations would apply to hybrid branch arrangements entered into (or substantially modified, including, for example, by acceleration of payments or increases in principal) on or after January 16, 1998.

At issue, Notice 98–11 states, are hybrid branch arrangements generally involving the use of deductible payments to reduce the taxable income of a CFC and the creation in a hybrid branch of low-taxed, passive income that is not taxed under Subpart F. Notice 98–11 states that the creation of hybrid branches in these arrangements has been facilitated by recent entity classification ("check-the-box") regulations.

Notice 98–11 also states that Treasury and the IRS are aware that the Subpart F issues raised by hybrid branches also may be raised by certain partnership or trust arrangements. Notice 98–11 states that Treasury and the IRS intend to address these issues in separate "ongoing" regulations projects.

In Notice 98–5, the IRS has announced that regulations will be issued to disallow U.S. foreign tax credits for taxes generated in certain "abusive arrangements." According to the Notice, arrangements generally will be considered abusive where the "reasonably expected economic profit is insubstantial compared to the value of the foreign tax credits" claimed. Five examples of these arrangements are provided. The Notice states that the regulations will be effective with respect to taxes paid or accrued on or after December 23, 1997.

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[1] Section 894(c) denies treaty benefits for certain payments through hybrid entities.
[2] 1998–6 Internal Revenue Bulletin, February 9, 1998.
[3] 1998–3 Internal Revenue Bulletin, January 20, 1998.

In addition, Notice 98–5 indicates that the IRS will begin scrutinizing foreign tax credit claims in connection with the types of transactions described by the notice as abusive and may disallow credits under "existing law," independently of the regulations to be issued. The Notice suggests that such challenges based on existing law may seek to deny credits for taxes paid or accrued before the effective date of the notice.

Finally, Notice 98–5 identifies several other areas in which Treasury and IRS are considering guidance to limit the availability of foreign tax credits. These include situations involving high withholding taxes, "mismatches" between the timing of payment of foreign taxes and recognition of foreign source income, and portfolio hedging strategies.

## TAX POLICY CONCERNS

The MTC is seriously concerned about the application of Notices 98–11 and 98–5 to legitimate business transactions and about the breadth of the regulatory authority requested by Treasury in its FY 1999 budget proposal. The stated goal of these initiatives is to prevent certain transactions that Treasury and the IRS consider to be "inconsistent with the purposes of U.S. tax law (including tax treaties)." Apart from a few examples, however, neither the budget proposal nor the Notices specify which transactions will be affected, or how and when this determination will be made. These open-ended initiatives have created significant uncertainty for taxpayers and already have had a chilling effect on normal business operations.

We also are troubled by the retroactive impact of Notices 98–5 and 98–11. The regulations contemplated by these Notices would fundamentally alter the treatment of existing arrangements entered into by taxpayers in reliance on current law. Notice 98–5 was issued on December 23, 1997, to deny foreign tax credits for amounts due to accrue eight days later under binding contracts. It remains unclear, after almost three months, precisely which transactions would be affected by this measure. Similarly, in circumstances yet to be specified, Notice 98–11 would prohibit the adoption of certain business structures as of January 16, 1998, the date on which it was issued. In addition, Notice 98–11 would require many businesses, including businesses that relied on the recent "check-the-box" regulations, to complete major restructuring by June 30, 1998, again without any guidance to date regarding its exact reach. We believe these Notices represent a questionable use of the limited exceptions to the general prohibition on retroactive regulations enacted by Congress in 1996.

In addition to these procedural fairness concerns, we have fundamental policy concerns regarding the new initiatives. At one level, Notice 98–5 and Notice 98–11 appear to be motivated by opposite concerns. Notice 98–5 expresses concern regarding reduction of U.S. tax, while Notice 98–11 is concerned about reduction of foreign tax. The common suggestion is, however, that the United States generally should impose tax where an adequate tax is not imposed by the foreign country. This thinking raises major tax policy issues that are not addressed by the stated rationales for these initiatives.

Notice 98–11 targets "hybrid branch" arrangements on the grounds that such arrangements "circumvent the purposes of Subpart F." Without citing specific statutory provisions or legislative history, Notice 98–11 presents a broad account of Congress' intent in enacting Subpart F in 1962. According to Notice 98–11, one of the purposes of Subpart F is to prevent controlled foreign corporations from earning "low-or non-taxed income on which United States tax might be permanently deferred" as a result of inconsistencies between U.S. and foreign tax systems.

Subpart F clearly does not presume that U.S. tax should be imposed currently wherever a certain level of foreign tax is not. If Congress had meant to provide such a rule, it presumably would have enacted an effective tax rate test. Instead, Congress enacted a general deferral regime, and chose to impose U.S. tax currently only on specified types of income. Even under Subpart F, U.S. tax generally is deferred without regard to whether the income is earned in a high-tax or low-tax jurisdiction. It is clear that Congress considered the issue of foreign tax rates in this context, because Subpart F provides a broad exception for income subject to high foreign tax. Treasury and the IRS would now do the converse, by denying deferral for income subject to low foreign tax. But they would do so administratively, where Congress has declined to do so legislatively. And they seek to do so without indicating what they would consider to be an appropriate tax burden.

Notice 98–11's account of the legislative intent underlying Subpart F diverges in important respects from the official legislative history provided by Congress. First, Subpart F does not focus on inconsistencies between U.S. and foreign law. In fact, neither the statute nor the legislative history even mentions such inconsistencies.

Subpart F focuses solely on the issue of when U.S. tax should be imposed on certain types of income. Apart from the taxpayer-favorable exception noted above, Subpart F does not condition deferral on whether or how foreign tax is imposed on that income.

Second, while the legislative history indicates that Congress sought to strike a balance in enacting Subpart F, it gave far more weight to competitiveness concerns than is suggested by the account provided by Treasury and the IRS. This is evidenced clearly by both the House and Senate reports, which cite preservation of the international competitiveness of U.S. business as the major reason for rejecting the Administration's bid to repeal deferral. It also is evidenced by the resulting statute, which clearly retains deferral as the general rule, not the exception.

If anything, competitiveness concerns have become even more important since Subpart F was enacted in 1962. First, the Tax Reform Act of 1986 greatly expanded the reach of Subpart F to encompass more types of active business income and imposed numerous new limitations ("baskets") on the foreign tax credit. Second, U.S. businesses face far more intense competition around the world than was the case in 1962. With the increasing globalization of the economy, it has become critical for businesses to compete internationally if they wish to remain competitive in their home markets. If U.S. businesses are to succeed in the global economy, they will need a U.S. tax system that permits them to compete effectively against foreign-based companies. This requires a system that permits broad deferral for active business income and provides a full foreign tax credit to prevent double taxation. The new Treasury and IRS initiatives would move in the opposite direction.

Notice 98–5 similarly oversteps its statutory bounds. Like the budget proposal, it rests on a vision of the foreign tax credit regime that is not evidenced by—and, indeed, is inconsistent with—the statute.

According to Notice 98–5, the purpose of the foreign tax credit is "to preserve neutrality between U.S. and foreign investment and to minimize the effect of tax consequences on taxpayers' decisions about where to invest and conduct business." It objects that allowing a foreign tax credit in "abusive" cases would serve "no statutory purpose." Notice 98–5 further contends that allowing a foreign tax credit in such cases would be incompatible with "the existence of the detailed foreign tax credit provisions and cross-crediting limitations enacted by Congress." Notice 98–5 is premised, therefore, on a broad vision of the role of the foreign tax credit regime, coupled with a narrow reading of the cross-crediting permitted by that regime.

There is no evidence, however, that Congress ever intended the foreign tax credit to do anything other than remove a disincentive to foreign investment by U.S. companies, which would otherwise be subject to double taxation under our worldwide tax system. It is true that Congress has imposed some limitations on the use of the foreign tax credit, such as separate "baskets" for certain types of income, but those limitations are specified in great detail in the statute, as Notice 98–5 itself acknowledges.

The cross-crediting to which Notice 98–5 objects is an integral part of our foreign tax credit regime. The Notice concedes that the U.S. foreign tax credit regime generally permits taxpayers to cross-credit by using foreign taxes imposed on high-taxed foreign source income to offset residual U.S. tax on low-taxed foreign source income. Indeed, the Notice acknowledges that such cross-crediting is allowed because it is viewed as "consistent with the interrelated quality of multinational operations of U.S. persons."

In seeking to deny credits in cases they regard as "abusive," Treasury and the IRS would move the foreign tax credit regime carefully constructed by Congress away from a system that explicitly permits cross-crediting to average high-and low-taxed foreign income towards an item-by-item limitation that would deny taxpayers the ability to cross-credit. It would accomplish this major change by administrative action—a significant and burdensome restriction on the foreign tax credit that Congress has declined to enact by statute. This would depart from the long-established procedure of having Congress consider fundamental changes to our foreign tax credit laws—a procedure acknowledged by Treasury only last year in its efforts to impose certain holding period requirements (see section 901(k)(4)).

These concerns are exacerbated by the unacceptable vagueness of Notice 98–5 and the budget proposal. While Notice 98–5 signals the view that certain transactions are "abusive," it provides no clear basis for distinguishing "abusive" transactions from transactions for which a foreign tax credit should be allowed. According to the Notice, certain types of transactions will be considered abusive wherever the expected economic profit is "insubstantial" compared to the foreign tax credits involved. The Notice does not define the term "insubstantial," and Treasury officials have publicly commented that the regulations to be issued under the Notice will not define the term.

Compounding this uncertainty is the fact that a finding of "abuse" would not require any demonstration of tax motivation. In this regard, Notice 98–5 and the budget proposal venture far beyond accepted anti-abuse principles. In fact, it is clear that they would reach even transactions entered into by a taxpayer in the ordinary course of conducting its business. For example, they would deny credits for foreign withholding taxes incurred by U.S. securities dealers in connection with routine hedging positions taken in the ordinary course of their business. This is contrary to the intent of legislation enacted by Congress only last year. In adding section 901(k)(4) to the Code, that legislation provided a broad ordinary-course exception to its general holding period requirements, which Treasury and the IRS would now simply disregard in many cases. As Congress recognized in enacting section 901(k)(4), ordinary-course exceptions are essential if U.S. business is to remain competitive in the world marketplace.

In sum, it is clear that Notice 98–5 seeks to impose extra-statutory limits on the foreign tax credit, while Notice 98–11 seeks to limit deferral in a manner that Congress has declined to do. These initiatives would seriously undermine the competitiveness of U.S. businesses. However, Treasury and the IRS present the Notices and the budget proposal as measures designed to preserve the existing principles of the U.S. international tax regime. They take the view that the balance that has been established by Congress should be interpreted more restrictively than either the legislative history or the statute would require.

The MTC respectfully suggests that, if anything, our Subpart F and foreign tax credit rules should be relaxed rather than tightened. They contain a number of restrictions that have become unworkable or outmoded. For example, unlike the law of other countries, Subpart F continues to deny deferral for active income earned by financial services companies. And the foreign tax credit system has reached a level of complexity that is daunting for taxpayers and tax administrators alike. While the basic framework of our law remains solid, it needs to be updated to ensure that U.S. businesses will remain able to compete in the 21st century. This role properly is that of Congress, however, not Treasury or the IRS.

### INITIATIVES OVERRIDE LONG-STANDING DOCTRINES

The Administration's initiatives conflict with long-standing U.S. tax law doctrines. First and foremost, Notice 98–11 and the budget proposal are based on the premise that transactions are abusive if they allow U.S. multinationals to reduce their foreign tax burden in a manner perceived as inconsistent with Subpart F. As discussed above, we do not agree with the Treasury/IRS reading of Subpart F. In any event, however, the IRS and the courts have recognized that a reduction of foreign tax is a legitimate business purpose for a transaction. See, e.g., Rev. Rul. 89–101 and *Betty M. Ellis v. Commissioner*, 50 T.C.M. 1202 (1985). In fact, if U.S. multinationals pay less in foreign taxes, they can be expected over the long term to claim fewer foreign tax credits—and thus to pay more residual U.S. tax. In short, there does not appear to be any valid policy reason why the United States should insist that its multinationals pay more foreign taxes than their foreign competitors.

Second, by making the Subpart F or other U.S. tax consequences depend on how the foreign taxing jurisdiction treats a transaction, Notice 98–11 and the budget proposal would overturn the principle that the foreign tax law treatment of a transaction should not dictate the U.S. tax results. See *Biddle v. Commissioner*, 302 U.S. 573 (1938); *United States v. Goodyear Tire and Rubber Co. et al.*, 493 U.S. 132 (1989).

Third, by preventing taxpayers from conducting their overseas operations in a form that will be considered a branch for all purposes of the Internal Revenue Code, Notice 98–11 and the budget proposal would overturn the principle that taxpayers are free to choose the form in which they will do business. See *Higgins v. Smith*, 308 U.S. 473 (1940) ("A taxpayer is free to adopt such organization for his affairs as he may choose.").

Fourth, Subpart F currently contains a branch rule that is set forth in the statute and that is limited to foreign base company sales income. In Notice 98–11, Treasury effectively seeks to create a new Subpart F branch rule, for foreign personal holding company income (and perhaps other categories of Subpart F income as well), despite a lack of similar statutory authority. Given that Congress saw fit to create only one branch rule, and to limit it to foreign base company sales income, it seems clear that Treasury lacks the authority to create additional branch rules.

Finally, the branch rule that Treasury seeks to create is fundamentally different from the existing Subpart F branch rule. Whereas the existing branch rule merely recharacterizes income derived from transactions with other parties, Treasury's new branch rule would actually *create* income where the CFC has not entered into a

transaction with another party (for example, by treating a remittance from the corporate home office to a branch as "income," as in Example 2 of Notice 98–11). By creating income where none exists under general U.S. tax principles, this new rule would represent a radical departure, beyond the bounds of Subpart F. While allowing the recharacterization of existing income under certain circumstances, the rules of Subpart F do not give Treasury and the IRS the authority to create income.

## ECONOMIC CONCERNS

*Competitiveness*

From an income tax perspective, particularly since the Tax Reform Act of 1986, the United States currently has become one of the least attractive countries in which to locate the headquarters of a multinational corporation. As a result, U.S.-based multinationals tend to be disadvantaged relative to non-U.S. multinationals in competing around the world. The Administration's proposal would further burden U.S.-based multinationals.

First, it should be noted that many of our major trading partners (12 of the 24 OECD countries as of 1990) operate under the principle of "territorial" taxation, under which a parent company is not subject to tax on the active income earned by a foreign subsidiary.[4] By contrast, the United States taxes income earned through foreign corporations when it is repatriated or deemed to be repatriated under various "anti-deferral" rules in the tax code.

Second, among countries that tax income on a worldwide basis, the active business income of a foreign subsidiary is generally not subject to tax before it is remitted to the parent.[5] This differs from the U.S. treatment of foreign base company sales and service income and financial services income, and certain other types of active business income, which are subject to current U.S. tax even if reinvested abroad.

Third, other countries with worldwide tax systems generally have fewer restrictions on the use of foreign tax credits than the United States.[6]

Fourth, most of the major trading partners of the United States provide for some form of integration of the corporate and individual income tax systems, which reduces or eliminates the extent to which corporate income is double taxed—at both the corporate and shareholder level.[7]

The net effect of these tax differences is that a foreign subsidiary of a U.S. corporation frequently pays a greater share of its income in foreign and U.S. tax than a similar foreign subsidiary owned by a company headquartered outside of the United States.[8] This makes it more expensive for U.S. companies to operate abroad than their foreign-based competitors.

A decline in activity of U.S. companies abroad can have important negative consequences for the U.S. economy. For example, foreign affiliates of U.S.-owned companies are responsible for a significant amount of exports from the United States.[9] As another example, a reduction in foreign activity would reduce headquarter-based activities, such as research and development, that tend to provide high wages and enhance U.S. productivity.[10]

*Equity*

One argument for the Administration's budget proposal is equity. For instance, if some taxpayers are able to reduce foreign taxes through the use of certain hybrid

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[4] Organization for Economic Cooperation and Development, Taxing Profits in a Global Economy, 1991.

[5] Organization for Economic Cooperation and Development, Controlled Foreign Company Legislation, 1996.

[6] A variety of U.S. rules limit the crediting of foreign taxes against U.S. tax liability. These include multiple separate "baskets" for calculating tax credits, the apportionment of interest and certain other deductions against foreign source income, and the attribution to a foreign subsidiary of a larger measure of income for U.S. purposes ("Earnings and Profits") than used by other countries. See Taxation of U.S. Corporations Doing Business Abroad: U.S. Rules and Competitiveness Issues, Price Waterhouse LLP (Financial Executives Research Foundation, 1996).

[7] Organization for Economic Cooperation and Development, Taxing Profits in a Global Economy, 1991.

[8] Organization for Economic Cooperation and Development, Taxing Profits in a Global Economy, 1991.

[9] Survey of Current Business, October 1997, p. 50.

[10] See Irving Kravis and Robert Lipsey, "Sources of Competitiveness of the United States and of its Multinational Firms," Review of Economics and Statistics, May 1992, for a discussion of the relationship between R&D intensity and human capital intensity and worldwide trade shares of U.S. multinationals.

arrangements, while other taxpayers do not make use of these arrangements, then there may be an inequity.

As the Joint Committee on Taxation notes in its analysis of the Administration's proposal, however: "hybrid transactions are not inherently inequitable. Any business may choose to organize itself to take advantage of the benefits of these structures." [11]

Given the general applicability of hybrid arrangements, any concern about disparate treatment of similarly situated taxpayers appears to be unfounded.

*Efficiency*

The JCT analysis of the Administration's proposal raises the possibility that hybrid arrangements may result in three types of economic inefficiencies.

1. Potential misallocation of investment.—First, if some international activities can make use of hybrid arrangements while other international activities cannot, then there may be a concern that too much investment will be directed to the relatively tax-favored activity. However, since the opportunity to make use of hybrid arrangements is generally available, there is little reason to suggest that these structures create a misallocation of investment resources among alternative international activities.

2. Potential for inefficient increase in administrative costs.—A second efficiency concern is that the use of hybrid arrangements causes real resources to be expended merely to achieve tax savings.

In fact, the "check the box" regulations under which many hybrid arrangements operate were motivated by a concern for reducing administrative costs relative to the costs required to achieve similar tax effects through more complex legal structures. The recent notices issued by the IRS on a retroactive basis will cause taxpayers to incur substantial costs to modify structures adopted in reliance on present law. Moreover, the testing of individual transactions for economic substantiality, as contemplated in Notice 98–5, would be an enormous compliance burden on taxpayers that engage in large numbers of transactions.

3. Potential for inefficient increase in foreign investment.—A third efficiency concern is that if hybrid arrangements facilitate the reduction of foreign taxes, there may be an incentive for U.S. multinationals to increase foreign investment relative to domestic investment. This would be inefficient if, on a pre-tax basis, domestic investment were more productive than foreign investment.

Academic research and government data on the foreign direct investment of U.S. multinationals suggest that increased foreign investment is efficiency enhancing and results in important benefits to the U.S. economy.

For example, research by Martin Feldstein concludes that an additional dollar of foreign direct investment by U.S. multinationals leads to an increase (in present value) of $1.72 in interest, dividend receipts, and tax payments to the United States, relative to $1 of such receipts on domestic investment.[12]

*Tax Revenue Effects*

The official revenue estimate by the Joint Committee on Taxation shows that enactment of the proposal would result in no change in revenues in any year over the fiscal year 1998–2008 period.

Aspects of the Administration proposal can even be seen to reduce U.S. tax collections if the Treasury Department were to use its grant of regulatory authority to restrict the use of hybrid arrangements. Current use of hybrid arrangements often results in a reduction in foreign taxes paid. A reduction in foreign taxes increases the after-tax return (in present value) to the United States from foreign investment. A reduction in foreign taxes also increases the amount of taxes paid to the U.S. government when the income is repatriated, since a smaller amount of foreign taxes would be creditable against U.S. tax liability.

Treasury concerns about the creditability of withholding taxes levied by third countries with respect to financial instruments held abroad appears misplaced. Foreign governments generally allow these withholding taxes to be credited against their income taxes. In these cases, the withholding tax does not add to the total foreign tax burden borne by U.S. investors.

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[11] Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 1999 Budget Proposal (JCS–4–98), February 24, 1998, p. 197.

[12] Martin Feldstein, "Tax Rules and the Effect of Foreign Direct Investment on U.S. National Income," in Taxing Multinational Corporations, eds. Martin Feldstein, James R. Hines, Jr., and R. Glenn Hubbard (University of Chicago Press, 1995).

The Administration's proposal can be seen to harm U.S. investors and ultimately reduce U.S. tax collections. Again, it should be noted that other countries do not tax the transactions that the Administration proposes to tax under this proposal.

*Capital Export Neutrality*

One theoretical principle that is sometimes invoked in discussions of international tax policy is capital export neutrality (CEN). Under this principle, taxes would not affect the investment location decisions of multinational corporations.

One way to achieve CEN would be to tax worldwide income on a current basis (whether or not repatriated) with an unlimited foreign tax credit. No country has adopted a pure CEN tax system. The U.S. tax system can be seen as a compromise: by providing only a limited foreign tax credit, total tax paid on certain foreign source income exceeds that paid on domestic source income, while deferral of U.S. taxation on certain unremitted active business income can result in a lower rate of tax.

Many countries follow the principle of capital import neutrality (CIN) with respect to active business income. Under this principle, an investment in a foreign country is subject to the same amount of tax regardless of the nationality of the investor. CIN is obtained by exempting foreign source income from domestic tax.

The Administration's proposal does not move the U.S. tax system closer to either location neutrality (CEN) or competitiveness (CIN). By restricting the use of hybrid arrangements, taxes on foreign source income are increased both by further limiting the use of foreign tax credits and by further restricting deferral on active foreign income.

Of course, more important than adherence to an abstract principle is to evaluate directly whether U.S. living standards are increased by tax policies which encourage foreign direct investment by U.S. multinationals.[13] As discussed earlier and in the next section, the evidence is quite strong that foreign direct investment by U.S. multinationals increases U.S. living standards in a number of different ways.

*Effects of Foreign Investment on the U.S. Economy*

The primary motivation for U.S. multinationals to operate abroad is to better compete in foreign markets, not domestic markets. A large body of research has documented that U.S. operations abroad on balance increase exports of goods and services from the United States. In 1995, U.S.-controlled foreign corporations contributed a net surplus of $27 billion to the U.S. trade balance.[14]

Foreign direct investment is one means by which U.S. multinationals can increase their return on firm-specific assets, including patents, skills, and technologies. As noted by Robert Lipsey, the ability to earn an enhanced return on these firm-specific assets through foreign direct investment provides an incentive to increase investment in the activities that generate these assets, such as research and development.[15] These and other high-value activities are disproportionately undertaken by U.S. multinationals in the United States. For example, over the past 20 years, between 43% and 62% of total U.S. R&D was performed by or for U.S. multinationals.[16]

Other research has focused on the effect of foreign direct investment on U.S. employment and U.S. wages and salaries. This research finds little or no evidence of an adverse effect on the U.S. labor market.[17] In 1995, approximately 80 percent of new foreign affiliate assets and employees of U.S. multinationals were located in high-wage foreign countries. These and other findings suggest that foreign investment is primarily undertaken to pursue market opportunities abroad rather than to substitute low-cost foreign labor for U.S. operations.

## CONCLUSION

Treasury's FY 1999 budget proposal and the issuance of Notice 98–11 and 98–5 are the latest in a series of Clinton Administration anti-competitive international tax initiatives that have been blocked by Congress. For example, Congress in 1997 rejected Treasury proposals to eliminate the export sales source rules under section

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[13] Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States*, JCS–6–91, May 30, 1991.

[14] Survey of Current Business, October 1997, p.50.

[15] Robert Lipsey, "Outward Direct Investment and the U.S. Economy," in The Effects of Taxation on Multinational Corporations, eds. Martin Feldstein, James R. Hines, Jr., and R. Glenn Hubbard (University of Chicago Press, 1995).

[16] Bureau of Economic Analysis and National Science Foundation data.

[17] See, e.g., S. Lael Brainard and David Riker, "Are U.S. Multinationals Exporting U.S. Jobs?" National Bureau of Economic Research Working Paper 5958, March 1997.

863(b), which help support U.S. exports. In addition, Congress in 1996 repealed ill-conceived limitations on deferral, under section 956A, that had been proposed by the Administration in 1993. The MTC applauds the Congress for having provided a counterbalance with respect to these initiatives, and would urge Congress to continue its vigilance.

We have two requests. First, in light of strong concerns and uncertainty over the regulatory authority requested by Treasury in the Administration's FY 1999 budget, we ask Congress not to adopt this proposal. Policy changes of the scope envisioned by Treasury should be made by the Congress after input from all interested constituencies, not by notice or regulation.

Second, we respectfully ask the Congress to limit the Treasury's ability to take preemptive active in the areas discussed in Notice 98–11 and Notice 98–5. Specifically, we ask that Congress consider the possibility of a moratorium on regulations to be promulgated pursuant to Notices 98–11 and 98–5 until Congress, with input from the Treasury and Commerce Department, has an appropriate opportunity to study the issues involved and the ramifications for the ability of American businesses to compete in world markets.

The MTC stands ready to work with Congress and the Treasury Department to reach a resolution of these issues.

# Multinational Tax Coalition

FOR IMMEDIATE RELEASE
February 25, 1998

## Tax Regulatory Barriers to International Trade Should Be Rejected, U.S. Companies Say

The Multinational Tax Coalition ("MTC"), a group of U.S. companies in a wide range of industries competing in world markets, is urging Congress to reject a proposal in the Clinton Administration's FY 1999 budget submission that would give the Treasury Department and the Internal Revenue Service broad new authority to revise long-standing U.S. tax law principles governing international business operations. The Administration proposal threatens to create new tax obstacles to cross-border business operations that support U.S. exports and American jobs.

The Administration's proposal would grant Treasury broad authority to determine the tax consequences of cross-border transactions involving the use of so-called "hybrid" entities, transactions, and structures that Treasury believes would yield results "inconsistent with the purposes of U.S. tax law."

The proposal raises a number of important tax policy concerns. Fundamentally, it threatens to limit significantly the availability of foreign tax credits and deferral – cornerstones of U.S. tax and trade policy that help prevent overtaxation of an American business operating in a foreign country as compared to its competitors. Enactment of the proposal would adversely affect the ability of American companies to compete in world markets.

The MTC also believes that the Administration's proposal asks that Congress provide an overly broad grant of regulatory authority to the IRS. Policy changes of the scope envisioned by Treasury should be made by the Congress after input from all interested constituencies, not by regulation.

Hybrid arrangements and transactions – where treatment under U.S. and foreign tax laws may differ – are commonplace in a typical multinational corporation's international operations. The MTC is concerned that an open-ended grant of regulatory authority to Treasury would leave companies without needed tax certainty as they seek to compete worldwide.

The proposal is the latest in a series of efforts by the Administration to expand its regulatory authority in the international tax area. In Notices 98-5 and 98-11, the IRS separately has announced it intends to issue broad regulations that could significantly restrict the availability of foreign tax credits and deferral with respect to existing arrangements. These IRS Notices, which resemble the Administration proposal in their open-ended scope, have had a chilling effect on standard business operations.

The Treasury initiatives would make major substantive changes to the tax law that alter carefully implemented international tax and trade policy decisions. These types of decisions are best and properly made by the Congress and not unilaterally by the Administration.

Price Waterhouse LLP serves as consultant to the MTC.

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## Statement of National Association of Manufacturers

### INTRODUCTION

The National Association of Manufacturers (NAM) wishes to express its appreciation to the Committee's chairman, Mr. Archer, for holding a hearing on the revenue provisions in the Administration's FY 1999 budget proposal. The NAM is the nation's oldest and largest broad-based industrial trade association. Its more than 14,000 member companies and subsidiaries, including approximately 10,000 small manufacturers, are in every state and produce about 85 percent of U.S. manufactured goods. Through its member companies and affiliated associations, the NAM represents every industrial sector and the interests of more than 18 million employees.

The Administration's FY 1999 Budget proposal jeopardizes last year's balanced-budget agreement and threatens to revive big government with proposals to increase new spending by $21 billion financed by a $25 billion tax hike. The majority of the included tax proposals are anti-growth and bad tax policy, with a few notable exceptions. Overall, the proposals run counter to the NAM's goal of maintaining sustained economic growth to enhance living standards for all Americans. Although this is not an exhaustive list, following are the NAM's comments on some of the specific provisions.

### PRO-GROWTH PROPOSALS

*Accelerating the Effective Date of Look-Through Treatment for 10/50 Companies*

This proposal would accelerate the effective date of a tax change made in the 1997 Tax Relief Act affecting foreign joint ventures owned between 10 and 50 percent by U.S. parents (so-called "10/50 companies"). This change will allow 10/50 companies to be treated similarly to controlled foreign corporations by allowing "look-through" treatment for foreign tax credit purposes for dividends from such joint ventures. Under the 1997 Act, the change is effective only for dividends received after the year 2003 and, even then, two sets of rules are required to be applied: one for dividends from earnings and profits (E&P) generated before 2003 and another for dividends from E&P accumulated after 2002. The Administration's proposal will instead apply the look-through rules to all dividends received in tax years after 1997, regardless of when the E&P constituting the dividend were accumulated.

This change will result in a tremendous reduction in complexity and compliance burdens for U.S. multinationals doing business overseas through foreign joint ventures. It will also reduce the competitive bias against U.S. participation in such ventures by placing U.S. companies on a much more level playing field from a corporate tax standpoint. This proposal epitomizes the favored policy goal of simplicity in the tax laws and will go a long way toward helping the U.S. economy by strengthening the competitiveness of U.S.-based multinationals.

*Extending the Research and Experimentation (R&E, commonly known as R&D) Tax Credit*

Technology progress accounts for nearly one-third of economic growth over the long run because of the direct correlation between technology progress and increased productivity. Although the credit's benefits are many, a principal benefit of the credit is its effect on lowering the cost of investing in technology. Thus, the NAM commends the President for recognizing the importance of the credit's contribution to sustaining our robust economic growth by including a one-year, seamless extension of the credit.

NAM economic analysis shows that a perminant R&D tax credit would, over time, actually increase the rate of GDP growth over the long term, as opposed to a one-time shift in the level of GDP. This is an important distinction from most policy initiatives, which have no effect on the rate of long-term economic growth. Since manufacturers are the principal parties engaging in U.S.-based R&D activities and many of our nation's foreign trade competitors offer permanent tax and financial incentives for R&D, the credit helps mitigate this unfair competitive disadvantage to U.S. companies. The Congress and the President are urged to work together to end the continuing 15-plus year saga of temporary lapses of the credit with extensions that may or may not be retroactive to the expiration date. Thus, the NAM strongly supports ending the uncertainty of credit extensions by making the R&D tax credit permanent.

*"Global" Interest Netting on Underpayments and Overpayments*

The NAM supports this long-overdue taxpayer simplification proposal and urges speedy enactment. Specifically, this proposal will allow global interest netting for income taxes by adding a new interest rate to Internal Revenue Code section 6621. Thus, this proposal will allow netting an overpayment, or interest thereon, against a prior deficiency of tax or interest that has already been paid in full by the taxpayer, or conversely netting an underpayment against a prior refund (of tax or interest) that has already been paid by the IRS.

*Tax Incentives To Promote Energy Efficiency and Improve the Environment*

In general, the NAM supports a voluntary approach to improving energy efficiency and the environment rather than federal mandates. While the NAM generally approves of the thrust of the Administration's tax incentive proposals pertaining to energy efficiency, the manufacturing community would prefer a general, permanent extension of the R&D tax credit to better allow the market to allocate limited resources.

GROWTH-INHIBITING PROPOSALS

*Repeal of the Export Source Rule*

The NAM strongly opposes the Administration's proposal to replace the current export source rule with an activity-based sourcing rule. Since 1922, tax regulations have contained the export source rule, which allows the income from goods that are manufactured in the United States and sold abroad to be treated as 50-percent U.S. source income and 50-percent foreign source income. As a result, the export source rule increases the ability of U.S. exporters to make use of foreign tax credits and thus avoid double taxation of foreign earnings.

The Administration contends that the export source rule is not needed to alleviate double taxation because of our tax treaty network. We strongly disagree. The United States has tax treaties with fewer than a third of all jurisdictions. More significantly, double taxation is generally caused by the many restrictions in U.S. tax laws on crediting foreign taxes paid on the international operations that U.S. companies must have to compete in the global marketplace. Among these restrictions are the allocation rules for interest and R&D expenses, the many foreign tax credit "baskets," and the treatment of domestic losses.

By reducing double taxation, the export source rule encourages U.S.-based manufacturing and exports. A recent Hufbauer/DeRosa study estimates that, for the year 1999 alone, the export source rule will account for an additional $30.8 billion in exports, support 360,000 jobs and add $1.7 billion to worker payrolls in the form of export-related wage premiums. (This study is an analysis of the economic impact of the export source rule, a document submitted as part of Gary Hufbauer's testimony on March 12, 1997.) The Administration's proposal would essentially eliminate this WTO-consistent (World Trade Organization) export incentive. Such action would be harmful to U.S. economic growth and high-paying, export-related jobs. This proposal would also take away the administrative simplicity of the export source rule and require enormously complex factual determinations that would add administrative burdens and create controversies. The NAM strongly urges Congress to retain the current export source rule.

*Estate and Gift Tax Provisions*

In the area of estate and gift taxes, the Administration proposes to scrap the techniques that allow a business owner to move illiquid assets out of the estate first. Forcing business owners to delay transfer of business ownership until death will result in an even higher failure rate for family-owned businesses.

The best example of this is the Administration's proposal to eliminate the "Crummey" rule. The Crummey rule allows transfer of ownership in an orderly fashion during the donor's lifetime. Since the case was decided nearly 30 years ago, thousands of estate plans have been built on the decision. The revenue gains from its elimination are small because gifting can and will continue. This change would make it harder to give business assets to children in the business and non-business assets to children outside the business. The Crummey rule allows movement of illiquid assets outside of the estate; without it, the estate will most likely be drained of its liquid assets first, leaving the family business to face the maximum tax with the minimum of resources.

The Qualified Terminable Interest Property Trust (QTIP) was designed by Congress to allow both spouses to use their full individual unified credits. QTIPs were expressly set up to prevent the estate tax from impoverishing a surviving spouse.

Disallowing QTIPs would force an estate to choose between losing the unified credit, breaking up the business, or divesting the surviving spouse of cash, leaving the "second to die" holding the illiquid assets.

Personal Residence Trusts are significant tools for estate planners only because the family home is another illiquid asset. Allowing parents to give the family home to their children at a future date while retaining the parent's right to live in the house for as long as they desire permits a planner to give the estate the maximum liquidity to deal with the death tax bill.

Finally, the rules on minority valuation again produce little revenue gain, but they allow the IRS to decide whether the cash or cash equivalents of an active business exceed the "reasonable working capital needs of the business." This test is already defined under the accumulated earnings tax, and it has been the subject of much litigation already. Courts often side with the corporations, but too many companies are already in court fighting the IRS's unrealistic formula.

Fewer than one-third of family businesses survive to the second generation. These proposals offer minimal revenue and would drive down the survival rate even further. The Treasury Department derides these estate-planning tools as legal fictions. But estate and gift taxes themselves are bad. Family-owned businesses should not need to resort to legal fictions to stay in business. Federal estate and gift taxes should be abolished, not raised.

*Repeal Tax-Free Conversions of Large C-Corporations to S-Corporations*

This proposal would repeal Internal Revenue Code Section 1374 that governs the tax treatment of C-corporations that convert to S-corporation status. Specifically, these conversions would be treated as taxable liquidations by repealing the method of taxing built-in gains such that it would be harmful to small and medium-size companies. Small and medium-size companies, many of which are S-corporations (4000 of which are NAM members), are central to the growth of our economy. About one-fourth of our national income is generated by small and medium-size companies. The Congress has recognized the integral and productive contribution of S-corporations to our economy, as evidenced by the Small Business Job Protection Act of 1996 that encouraged the formation of new S-corporation entities. If passed, this proposal would be a barrier to many businesses desiring to operate as S-corporations. Thus, the NAM opposes this ill-conceived provision that has been proposed repeatedly without success. S-corporation rate-relief legislation, introduced by Representative Phil Crane (R–IL–8) (H.R. 2884) would help mitigate some of the remaining deterrents for companies to convert to S-corporation status.

*Limiting Use of "Hybrid" Entities*

The NAM is very concerned about the Administration's request for congressional authority to issue potentially sweeping legislative regulations to implement nonspecific tax guidance. If the Administration feels that a specific abuse is being perpetrated, it should be addressed through relevant legislation. This would permit normal congressional consideration, including hearings on such legislation.

One specific Administration proposal would limit the ability of certain foreign and U.S. persons to enter into transactions that use so-called "hybrid entities," which are entities that are treated as corporations in one jurisdiction but as branches or partnerships in another. Although most hybrid transactions do not attempt to generate tax results that are "inconsistent with the purposes of U.S. tax law," the Administration feels that there are enough taxpayers taking unfair advantage of the current rules that it is necessary to codify and extend the earlier government issued tax guidance (Notices 98–5 and 98–11) on this subject.

U.S. multinationals compete in an environment wherein foreign competitors use tax-planning techniques to reduce foreign taxes without incurring home country tax. The use of "hybrid entities" allows U.S. multinationals to compete on a level playing field and promotes additional U.S. exports. The use of hybrids is consistent with the initial balance between competitiveness and export neutrality that was intended by Congress in enacting the "Subpart F" rules. Although Congress specifically enacted a branch rule for foreign base company sales under Code section 954(d)(3), similar rules were not enacted for foreign personal holding company income. If enacted, these proposals would represent an unwarranted extension of legislative authority by Congress to the executive branch to circumvent congressional debate by imposing new rules through regulation.

Notices 98–5 and 98–11 have a chilling effect on the ability of U.S. companies to structure their foreign operations consistently with the commercial objective of regionalizing their businesses. They also adversely impact companies' abilities to effectively reduce their overall costs by reducing local taxes in their overseas operations. The notices are drafted so broadly and so vaguely that they confuse U.S. taxpayers

and their advisors, and introduce a compelling need to seek clarification as to whether taxpayers can continue to rely on the simple "check-the-box" regulations issued just last year. All these effects are exacerbated by the notices' immediate effective dates.

The world has changed dramatically since enactment of the Subpart F rules in 1962. The NAM feels it would be more appropriate for Congress to request a study regarding the trade and tax policy issues associated with Notices 98–5 and 98–11. In this regard, a moratorium on further regulatory action by the Treasury Department should be imposed until enactment of specific legislative proposals resulting from well-reasoned analysis and debate.

*Foreign Built-in Losses*

Another proposal would require the Treasury Department to issue regulations to prevent taxpayers from "importing built-in losses incurred outside U.S. taxing jurisdictions to offset income or gain that would otherwise be subject to U.S. tax." The Administration argues that, although there are rules in the Code that limit a U.S. taxpayer's ability to avoid paying U.S. tax on built-in gain (e.g. Code 367(a), 864(c)(7), and 877), similar rules do not exist that prevent built-in losses from being used to shelter income otherwise subject to U.S. tax, and, as a result, taxpayers are avoiding Subpart F income inclusions or capital gains tax. We believe that this directive, which is written extremely broadly, is unnecessary due to the existence of rules already available in the Code. Both this proposal and the one immediately above regarding the use of hybrid entities would severely impact the ability of U.S. multinationals to compete on an equal footing against foreign-based companies.

*Superfund Taxes*

The Superfund program has historically been funded by the following taxes—the corporate environmental income tax and excise taxes on petroleum, chemical feed stock, and imported chemical substances—all of which expired as of Dec. 31, 1995. The Administration's budget proposal would reinstate the excise taxes at their previous levels for the period after the date of enactment until Oct. 1, 2008. The corporate environmental income tax would be reinstated at its previous level for taxable years beginning after Dec. 31, 1997 and before Jan. 1, 2009.

Under the "pay-go" rules of the federal budget laws, any Superfund reauthorization bill that includes spending provisions must also include provisions to reinstate the former Superfund taxes or provide equivalent revenues "within the four corners of the bill" to keep it revenue neutral. Thus, as a practical matter, if Congress were to extend the Superfund taxes separate from a Superfund reauthorization bill, then such action would end the prospects for major legislative reform of the Superfund program during the period for which the taxes are re-enacted. Furthermore, an additional revenue offset would be needed because the taxes collected would be scored for general revenues to balance the budget. The use of such tax revenues for deficit-reduction purposes should be rejected. The NAM urges that the decision to reinstate these taxes dedicated to financing Superfund should instead be made only as part of comprehensive programmatic changes to a Superfund reform bill. The Administration's proposal to reinstate the Superfund taxes without Superfund reform is merely an attempt to raise revenue for new spending programs.

*Foreign Oil and Gas Income Tax Credits*

The President's budget proposal dealing with foreign oil and gas income moves in the opposite direction by limiting use of the foreign tax credit on such income. This selective attack on a single industry's use of the foreign tax credit is not justified. U.S.-based oil companies are already at a competitive disadvantage under current law, since most of their foreign-based competition pay little or no home country tax on foreign oil and gas income. The proposal increases the risk of foreign oil and gas income being subject double taxation, which will severely hinder U.S. oil companies in the global oil and gas exploration, production, refining, and marketing arena. The NAM is particularly opposed to this provision because it undermines the entire foreign tax credit system and sets a very bad tax-policy precedent by making the recoupment of double taxation costs contingent on the industry in which a company is engaged.

*Payments to 80/20 Companies*

Currently, a portion of interest or dividends paid by a domestic corporation to a foreign entity may be exempt from U.S. withholding tax, provided the payor corporation is a so-called "80/20 company," i.e., at least 80 percent of its gross income for the preceding three years is foreign-source income attributable to the active conduct of a foreign trade or business. The Administration believes that the testing pe-

riod is subject to manipulation and allows certain companies to improperly avoid U.S. withholding tax on certain distributions attributable to a U.S. subsidiary's U.S. source earnings. As a result, it proposes to arbitrarily change the 80/20 rules by applying the test on a group-wide (as opposed to individual company) basis. However, there is little evidence that these rules have been manipulated on a broad scale in the past and we do not believe such a drastic change is needed at this time.

*Dividends-Received Deduction for Certain Preferred Stock*

The dividends-received deduction (DRD) was designed to alleviate the impact of multiple layers of corporate taxation. Without the DRD, income would be taxed three times: 1) when it is earned by a corporation; 2) when the income is paid as a dividend to a corporate shareholder; and 3) when the income of the receiving corporation is paid as a dividend to an individual shareholder. The DRD was enacted to provide for full deductibility of intercorporate dividends.

The Administration's revenue-raising proposal would result in asymmetrical tax treatment between a payor and payee of what purports to be a dividend is not appropriate tax policy. Thus, the NAM objects to this provision.

*Limiting Mark-to-Market Accounting*

Certain trade receivables would no longer be eligible for treatment under the mark-to-market accounting rules. Under those rules, certain taxpayers who purchase and sell their own trade receivables are exempt from the mark-to-market method of accounting unless they elect to be included. If they make the election, those taxpayers can currently write-off certain non-interest bearing receivables, and account, note, and trade receivables unrelated to the active business of a securities dealer. There appear to be no tax policy reasons for prohibiting taxpayers from accelerating their bad debt deductions for these trade receivables, only government revenue considerations.

*Lower of Cost or Market Inventory Accounting Method*

A taxpayer that sells goods in the active conduct of its trade or business generally must maintain inventory records in order to determine the cost of goods it sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period. Because of the difficulty of applying the specific identification method of accounting, taxpayers often use methods such as "first-in, first-out" (FIFO) and "last-in, first-out" (LIFO). Taxpayers not using a LIFO method are allowed to determine the carrying values of their inventories by applying the lower of cost or market (LCM) method and by writing down the cost of goods that are unsalable at normal prices or unusable in the normal way because of damage, imperfection or other causes (the "subnormal goods" method).

The Administration's proposal would repeal the LCM method. The NAM is opposed to repeal of LCM because, particularly in a time of rapid technological advance, the value of items accounted for in inventory is often diminished due to external factors. LCM allows this loss of value to be accounted for in the period in which it occurs. To retain the historic cost basis in such instances would be both unfair and fail to achieve a proper matching of costs and revenue, resulting in a failure to clearly reflect income. The NAM strongly urges the retention of the LCM method.

*Deferral of Original Issue Discount (OID) on Convertible Debt*

The Administration has included a number of past proposals aimed at financial instruments and the capital markets, which were fully rejected during the last session of Congress. These reintroduced proposals should again be rejected. One proposal would defer deductions by corporate issuers for interest accrued on convertible debt instruments with original issue discount (OID) until interest is paid in cash. The proposal would completely deny the corporation an interest deduction unless the investors are paid in cash (e.g. no deduction would be allowed if the investors convert their bonds into stock). Investors in such instruments would still be required to pay income tax currently on the accrued interest. In effect, the proposal defers or denies an interest deduction to the issuer, while requiring the holder to pay tax on the interest currently.

The NAM opposes this proposal because it is contrary to sound tax policy and symmetry that matches accrual of interest income by holders of OID instruments with the ability of issuers to deduct accrued interest. There is no justifiable reason for treating the securities as debt for one side of the transaction and as equity for

the other side. There is also no reason, economic or otherwise, to distinguish a settlement in cash from a settlement in stock.

Moreover, the instruments in question are truly debt rather than equity. Recent statistics show that more than 70 percent of all zero-coupon convertible-debt instruments were retired with cash, while only 30 percent of these instruments were convertible to common stock. Recharacterizing these instruments as equity for some purposes is fundamentally incorrect and will put American companies at a distinct disadvantage to their foreign competitors, who are not bound by such restrictions. These hybrid instruments and convertible OID bond instruments have allowed many U.S. companies to raise tens of billions of dollars of investment capital used to stimulate the economy. Introducing this imbalance and complexity into the tax code will discourage the use of such instruments, limit capital raising options, and increase borrowing costs for corporations.

*Modifying Corporate-Owned Life Insurance (COLI) Rules*

The Administration proposes to substantially change the taxation of business-owned life insurance by disallowing a pro-rata portion of a business' general deduction for interest expense. Moreover, the Administration has proposed retroactive application of the new tax to existing life insurance contracts. This proposal should not be adopted.

Life insurance has long been used by businesses to protect against financial loss caused by the death of key employees and to finance the cost of employee benefits, especially post-retirement health benefits. Life insurance provides a secure and stable source of financing for such employee benefits, and it is particularly well suited to this purpose because its long-term nature matches the correspondingly long-term nature of the liabilities. The Administration's proposal would have a devastating effect on key-person protection by effectively taxing life insurance contracts out of existence. Businesses should not be discouraged from providing employee health benefits or from seeking to protect themselves from key-person losses.

Moreover, the Administration's proposal would apply retroactively to existing life insurance contracts that were purchased by businesses in good faith, based on existing law. There can be no question of abuse: business use of life insurance is well known and the taxation of insurance contracts has been settled for many years. In addition, Congress has reviewed the taxation of business-owned life insurance in each of the last two years and, in each case, has carefully preserved the existing taxation of business-owned life insurance on the lives of employees. The Administration's proposal represents the worst kind of retroactive tax—it would not only cause the termination of most or all existing contracts but would also have the effect of taxing past earnings under those contracts.

*Tax Insurance Contract Exchanges or Reallocate Assets with Variable Insurance Contracts*

Annuity contract investments are a valuable retirement and investment tool. Currently, owners of variable annuity contracts can allocate their investments in a contract among different investment options (e.g. a bond fund, a stock fund, and a balanced fund). Owners may reallocate their account values within the contract among the various options without incurring a current tax, so long as the investment remains committed to a retirement annuity. This flexibility provides an important savings incentive for retirement. A taxable event occurs when funds are taken out of an annuity. Regardless, the Administration proposes to tax any exchange of a life insurance, endowment, or annuity contract, for a variable contract, or vice versa. In addition, any reallocation among accounts within the same variable life or annuity contract would result in a taxable event, even though no funds were taken out of the contract. An exchange of contracts, without tax liability, is a long-standing proviso of the Code.

The NAM opposes this provision as a tax increase on middle-class Americans and retirement savers. Moreover, the proposal completely contradicts the President's recent statements to "save Social Security first." Any new tax on private retirement savings puts further strain on the overall private and public retirement system. Variable life and annuity contracts are used respectively to insure against premature death and for long-term retirement savings. Like other retirement-saving vehicles, including defined contribution and defined benefit plans, annuities allow savings to grow tax-free until they are needed for retirement. All retirement savers periodically shift their savings among different options as they grown older and more conservatives, or as the market changes. Under this proposal, annuity owners who shift accounts would be taxed immediately, thereby forcing them to keep bad investments or pay a tax on undistributed funds.

Recent surveys have shown that more than 80 percent of the owners of deferred annuity contracts have total annual household incomes of under $75,000. Such middle income savers rely on these well-designed products to encourage them to commit funds to retirement. At a time when Congress and the President are concerned about saving social security, the last thing that they should do is tax private retirement savings options.

*Reduction in Basis (Investment in the Contract) for Mortality-Related Charges*

The Administration's proposal would reduce a policy-holder's tax basis in an insurance or annuity contract for certain charges under the contract by subtracting these charges include the cost of the insurance and related expenses. For deferred annuity contracts, the assumed mortality and expenses charges, which must be subtracted, are deemed to equal the contract's average cash value during the year multiplied by 1.25 percent. This proposal is nothing but a tax on private retirement savings. Increasing the cost of such savings vehicles by reducing a product's tax basis creates a disincentive to use these important savings tools. Life insurance and annuity contracts are designed to both accumulate retirement savings and insure against premature death (e.g. mortality-related risks). Taxes on income from the savings element of such contracts should not be increased just because those contracts also provide insurance protection.

This provision will likewise result in a tax increase on middle-class Americans and retirement savers. In addition, the proposal is inconsistent with general tax rules relating to the determination of tax basis and will further increase the complexity of the tax code with no recognizable benefit. Under the proposal, life insurance companies would be required to maintain additional records to keep track of two different basis amounts for annuity contracts. This will undoubtedly result in increased administrative burdens and compliance costs, which most likely will be passed on to Americans trying to save for retirement.

*Tightening the Substantial Understatement Penalty for Large Corporations*

The NAM opposes this anti-business proposal because the percent test of 10 percent is appropriate for all size companies. This proposal would treat a corporation's deficiency of more than $10 million as substantial for purposes of the substantial understatement penalty, regardless of whether it exceeds 10 percent of the taxpayer's total tax liability. There is no need to discriminate against large, multinational, and publicly-held companies by inserting into the tax code an absolute dollar amount based on their proportionately higher tax liabilities and greater tax ambiguities faced by these companies.

*Effective Dates*

Finally, certain proposed revenue raising provisions contained in the Administration's FY 1999 budget proposal would have retroactive effective dates. The NAM believes that the effective dates of any new revenue raising proposals should not disrupt market activities and normal business transactions. In this regard, the completion of many contractually binding business transactions can be subject to delays or contingencies, such as shareholder approval or government antitrust or tax clearances. Nevertheless, these bona fide transactions would fail the Administration's effective date rule if final closing were to occur after the effective date, even though the transactions were contractually bound prior to that time. This disrupts on-going commercial activities and ultimately amounts to a retroactive tax increase on pending but not completed transactions.

The NAM believes it would be highly inappropriate to adversely affect pending business transactions in this way. Accordingly, the NAM urges that if Congress adopts any revenue raisers, whatever effective date it chooses, it should include an exception for pending transactions that are publicly announced, subject to binding contracts or contingent upon necessary third party approvals.

## CONCLUSION

The NAM fully supports a balanced federal budget and, in fact, believes it is necessary to the economic health of the country. However, we believe that the revenue raisers discussed above would provide disincentives to savings and investment and raise the cost of capital for manufacturers. The NAM not only doesn't support these and other tax increases in the Administration's budget, but we believe that pro-growth policies, such as corporate alternative minimum tax (AMT) reform, estate tax repeal, permanent extension of the R&D tax credit, and S-corporation rate relief, combined with substantive social security reform and spending reductions, would help maintain robust economic growth concurrent with a low rate of inflation.

**Statement of Steven J. Guttman, NAREIT Chair and Chairman and Chief Executive Officer, Federal Realty Investment Trust; on behalf of National Association of Real Estate Investment Trusts®**

As requested in Press Release No. FC–11 (February 18, 1998), the National Association of Real Estate Investment Trusts® ("NAREIT") respectfully submits these comments in connection with the Ways and Means Committee's review of certain revenue provisions presented to the Committee as part of the Administration's Fiscal Year 1999 Budget.

NAREIT's comments will address the Administration proposals to (1) amend section 1374 of the Internal Revenue Code to treat an "S" election by a large C corporation as a taxable liquidation of that C corporation; (2) restrict real estate investment trusts ("REITs") from owning more than 10 percent of the value of so-called "subsidiary service corporations;" (3) modify treatment of closely held REITs; and (4) freeze the grandfather status of stapled (or paired-share) REITs. We appreciate the opportunity to present these comments.

NAREIT is the national trade association for real estate companies. Members are REITs and other public businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses. REITs are companies whose income and assets are mainly connected to income-producing real estate. By law, REITs regularly distribute most of their taxable income to shareholders as dividends. NAREIT represents over 250 REITs or other public real estate companies, as well as over 2,000 investment bankers, analysts, accountants, lawyers and other professionals who provide services to REITs.

## BACKGROUND ON REITS

A REIT is essentially a corporation or business trust combining the capital of many investors to own and, in most cases, operate income-producing real estate, such as apartments, shopping centers, offices and warehouses. Other REITs also are engaged in financing real estate. REITs must comply with a number of requirements, some of which are discussed in detail in this statement, but the most fundamental of these are as follows: (1) REITs must pay at least 95 percent of their taxable income to shareholders; (2) REITs must derive most of their income from real estate held for the long term; and (3) REITs must be widely held. In exchange for satisfying these requirements, REITs (like mutual funds) benefit from a dividends paid deduction so that most, if not all, of a REIT's earnings are taxed only at the shareholder level. On the other hand, REITs pay the price of not having retained earnings available to expand their business. Instead, capital for growth must come from new money raised in the investment marketplace from investors who have confidence in the REIT's future prospects and business plan.

Congress created the REIT structure in 1960 to make investments in large-scale, significant income-producing real estate accessible to the smaller investor. Based in part on the rationale for mutual funds, Congress decided that the only way for the average investor to access investments in larger-scale commercial properties was through pooling arrangements. In much the same ways as shareholders benefit by owning a portfolio of securities in a mutual fund, the shareholders of REITs can unite their capital into a single economic pursuit geared to the production of income through commercial real estate ownership. REITs offer distinct advantages for smaller investors: greater diversification by investing in a portfolio of properties rather than a single building and expert management by experienced real estate professionals.

Despite the advantages of the REIT structure, the industry experienced very little growth for over 30 years mainly for two reasons. First, at the beginning REITs were handcuffed. REITs were basically passive portfolios of real estate. REITs were permitted only to own real estate, not to operate or manage it. This meant that REITs needed to use third party independent contractors, whose economic interests might diverge from those of the REIT's owners, to operate and manage the properties. This was an arrangement the investment marketplace did not accept warmly.

Second, during these years the real estate investment landscape was colored by tax shelter-oriented characteristics. Through the use of high debt levels and aggressive depreciation schedules, interest and depreciation deductions significantly reduced taxable income—in many cases leading to so-called "paper losses" used to shelter a taxpayer's other income. Since a REIT is geared specifically to create "tax-

able" income on a regular basis and a REIT is not permitted to pass "losses" through to shareholders like a partnership, the REIT industry could not compete effectively for capital against tax shelters.

In the Tax Reform Act of 1986 (the "1986 Act"), Congress changed the real estate investment landscape in two important ways. First, by limiting the deductibility of interest, lengthening depreciation periods and restricting the use of "passive losses," the 1986 Act drastically reduced the potential for real estate investment to generate tax shelter opportunities. This meant, going forward, real estate investment needed to be on a more economic and income-oriented footing.

In addition, as part of the 1986 Act, Congress took the handcuffs off REITs. The Act permitted REITs to operate and manage—in addition to owning—most types of income-producing commercial properties by providing "customary" services associated with real estate ownership. Finally, for most types of real estate (other than hotels, health care facilities and some other activities that consist of a higher degree of personal services), the economic interests of the REIT's shareholders could be merged with those of the REIT's operators and managers.

Despite Congress' actions in 1986, significant REIT growth did not begin until 1992. One reason was the real estate recession in the early 1990s. During the late 1980s banks and insurance companies kept up real estate lending at a significant pace. Foreign investment, particularly from Japan, also helped buoy the marketplace. But by 1990 the combined impact of the Savings and Loan crisis, the 1986 Act, overbuilding during the 1980s by non-REITs and regulatory pressures on bank and insurance lenders, led to a depression in the real estate economy. During the early 1990s commercial property values dropped between 30 and 50 percent. Credit and capital for commercial real estate became largely unavailable. As a result of this capital crunch, many building owners defaulted on loans, resulting in huge losses by financial institutions. The Resolution Trust Corporation took over the real estate assets of insolvent financial institutions.

Against this backdrop, starting in 1992, many private real estate companies realized that the best and most efficient way to access capital was from the public marketplace through REITs. At the same time, many investors decided that it was a good time to invest in commercial real estate—assuming recovering real estate markets were just over the horizon. They were right.

Since 1992, the REIT industry has attained astounding growth as new publicly traded REITs infused much needed equity capital into the over-leveraged real estate industry. Today there are over 200 publicly traded REITs with an equity market capitalization exceeding $150 billion. These REITs are owned primarily by individuals, with 49 percent of REIT shares owned directly by individual investors and 37 percent owned by mutual funds, which are owned mostly by individuals. Today's REITs offer smaller real estate investors three important qualities never accessible and available before: liquidity, security and performance.

Liquidity. REITs have helped turn real estate liquid. Through the public REIT marketplace of over 200 real estate companies, investors can buy and sell interests in portfolios of properties and mortgages—as well as the management associated with them—on an instantaneous basis. Illiquidity, the bane of real estate investors, is gone.

Security. Because real estate is a physical asset with a long life during which it has the potential to produce income, investors always have viewed real estate as an investment option with security. But now through REITs small investors have an added level of security never available before in real estate investment. Today's security comes from information. Through the advent of the public REIT industry (which is governed by SEC and securities exchange-mandated information disclosure and reporting), the flow of available information about the company and its properties, the management and its business plan, and the property markets and their prospects are available to the public. As a result, REIT investors are provided a level of security never available before in the real estate investment marketplace.

Performance. Since their inception, REITs have provided competitive investment performance. Both over the past two years and the past twenty years, REIT market performance has been comparable to that of the S&P 500 and has greatly exceeded the returns from fixed income and direct real estate investments. Because REITs annually pay out almost all of their taxable income, a significant component of total return on investment reliably comes from dividends. In 1997, REITs paid out over $8 billion in dividends to their shareholders. Just as Congress intended, today through REITs small investors have access to large-scale, income producing real estate on a basis competitive with large institutions and wealthy individuals.

But REITs don't just benefit investors. The lower debt levels associated with REITs compared to real estate investment overall has a positive effect on the overall economy. Average debt levels for REITs are 35 percent of market capitalization,

compared to leverage of 80 percent and higher used by privately owned real estate (which have the effect of minimizing tax liabilities). The higher equity capital cushions REITs from the severe effects of fluctuations in the real estate market that have traditionally occurred. The ability of REITs to better withstand market downturns has a stabilizing effect on the real estate industry and lenders, resulting in fewer bankruptcies and work-outs. The general economy benefits from lower real estate losses by federally insured financial institutions.

NAREIT believes the future of the REIT industry will see an acceleration in the shift from private to public ownership of U.S. real estate. At the same time, future growth may be limited by the competitive pressures for REITs to be able to provide more services to their tenants than they are currently allowed to perform. Although the 1986 Act took off the handcuffs and the Taxpayer Relief Act of 1997 included additional helpful REIT reforms, REITs still must operate under significant, unnecessary restrictions. NAREIT looks forward to working with Congress and the Administration to further modernize and improve the REIT rules so that REITs can continue to offer smaller investors opportunities for rewarding investments in income-producing real estate.

## I. Section 1374

The Administration's Fiscal Year 1999 Budget proposes to amend section 1374 to treat an "S" election by a C corporation valued at $5 million or more as a taxable liquidation of that C corporation followed by a distribution to its shareholders. This proposal was also included in the Administration's Fiscal Year 1997 and 1998 proposed budgets.

### *A. Background and Current Law*

Prior to its repeal as part of the Tax Reform Act of 1986, the holding in a court case named *General Utilities* permitted a C corporation to elect S corporation, REIT or mutual fund status (or transfer assets to an S corporation, REIT or mutual fund in a carryover basis transaction) without incurring a corporate-level tax. With the repeal of the *General Utilities* doctrine in 1986, such transactions arguably would have been subject to tax but for Congress' enactment of Internal Revenue Code section 1374.[1] Under section 1374, a C corporation making an S corporation election can elect to have the S corporation pay any tax that otherwise would have been due on the "built-in gain" of the C corporation's assets, but only if those assets were sold or otherwise disposed of during a 10-year "recognition period." The application of the tax upon the disposition of the assets, as opposed to the election of S status, worked to distinguish legitimate conversions to S status from those made for purposes of tax avoidance.

In Notice 88–19, 1988–1 C.B. 486 (the "Notice"), the Internal Revenue Service (the "IRS") announced that it intended to issue regulations under section 337(d)(1) that in part would address the avoidance of the repeal of *General Utilities* through the use of REITs and regulated investment companies ("RICs," *i.e.* mutual funds). In addition, the IRS noted that those regulations would permit the REIT or RIC to be subject to rules similar to the principles of section 1374. Thus, C corporations can elect REIT status and incur a corporate-level tax only if the REIT sells assets during the 10-year "recognition period."

In a release issued February 18, 1998, the Treasury Department announced that it intends to revise Notice 88–19 to conform to the Administration's proposed amendment to limit section 1374 to corporations worth less than $5 million, with an effective date similar to the statutory proposal. This proposal would result in a double layer of tax: once to the shareholders of the C corporation in a deemed liquidation and again to the C corporation itself upon such deemed liquidation.

Because of the Treasury Department's intent to extend the proposed amendment of section 1374 to REITs, these comments address the proposed amendment as if it applied to both S corporations and REITs.

### *B. Statement in Support of the Current Application of Section 1374 to REITs*

As stated above, the Administration proposal would limit the use of the 10-year election to REITs valued at $5 million or less. NAREIT believes that this proposal would contravene Congress' original intent regarding the formation of REITs, would be both inappropriate and unnecessary in light of the statutory requirements governing REITs, would impede the recapitalization of commercial real estate, likely

[1] Hereinafter all references to "section" are to the Internal Revenue Code of 1986 (as amended).

would result in lower tax revenues, and ignores the basic distinction between REITs and partnerships.

A fundamental reason for a continuation of the current rules regarding a C corporation's decision to elect REIT status is that the primary rationale for the creation of REITs was to permit small investors to make investments in real estate without incurring an entity level tax, and thereby placing those persons in a comparable position to larger investors. H.R. Rep. No. 2020, 86th Cong., 2d. Sess. 3–4 (1960).

By placing a toll charge on a C corporation's REIT election, the proposed amendment would directly contravene this Congressional intent, as C corporations with low tax bases in assets (and therefore a potential for a large built-in gains tax) would be practically precluded from making a REIT election. As previously noted, the purpose of the 10-year election was to continue to allow C corporations to make S corporation and REIT elections when those elections were supported by non-tax business reasons (*e.g.*, access to the public capital markets), while protecting the Treasury from the use of such entities for tax avoidance.

Additionally, REITs, unlike S corporations, have several characteristics that support a continuation of the current section 1374 principles. First, there are statutory requirements that make REITs long-term holders of real estate. The 100 percent REIT prohibited transactions tax[2] complements the 10-year election mechanism.

Second, while S corporations may have no more than 75 shareholders, a REIT faces no statutory limit on the number of shareholders it may have, is required to have at least 100 shareholders, and in fact some REITs have hundreds of thousands of beneficial shareholders. NAREIT believes that the large number of shareholders in a REIT and management's responsibility to each of those shareholders preclude the use of a REIT as a vehicle to be used primarily in the circumvention of the repeal of *General Utilities*. Any attempt to benefit a small number of investors in a C corporation through the conversion of that corporation to a REIT is impeded by the REIT widely-held ownership requirements.

The consequence of the Administration proposal would be to preclude C corporations in the business of managing and operating income-producing real estate from accessing the substantial capital markets' infrastructure comprised of investment banking specialists, analysts, and investors that has been established for REITs. In addition, other C corporations that are not primarily in the business of operating commercial real estate would be precluded from recognizing the value of those assets by placing them in a professionally managed REIT. In both such scenarios, the hundreds of thousands of shareholders owning REIT stock would be denied the opportunity to become owners of quality commercial real estate assets.

Furthermore, the $5 million dollar threshold that would limit the use of the current principles of section 1374 is unreasonable for REITs. While many S corporations are small or engaged in businesses that require minimal capitalization, REITs as owners of commercial real estate have significant capital requirements. As previously mentioned, it was Congress' recognition of the significant capital required to acquire and operate commercial real estate that led to the creation of the REIT as a vehicle for small investors to become owners of such properties. The capital intensive nature of REIT's makes the $5 million threshold essentially meaningless for REITs.

It should be noted that this proposed amendment is unlikely to raise any substantial revenue with respect to REITs, and may in fact result in a loss of revenues. Due to the high cost that would be associated with making a REIT election if this amendment were to be enacted, it is unlikely that any C corporations would make the election and incur the associated double level of tax without the benefit of any cash to pay the taxes. In addition, by remaining C corporations, those entities would not be subject to the REIT requirement that they make a taxable distribution of 95% of their income each tax year. While the REIT is a single-level of tax vehicle, it does result in a level of tax on nearly all of the REIT's income each year.

Last, but far from least, the Administration justifies its *de facto* repeal of section 1374 by stating that "[t]he tax treatment of the conversion of a C corporation to an S corporation generally should be consistent with the treatment of its [sic] conversion of a C corporation to a partnership." Regardless of whether this stated reason for change is justifiable for S corporations, in any event it should not apply to REITs because of the differences between REITs and partnerships.

Unlike partnerships, REITs cannot (and have never been able to) pass through losses to their investors. Further, REITs can and do pay corporate level income and excise taxes. Simply put, REITs *are* C corporations. Thus, REITs are not susceptible to the tax avoidance concerns raised by the 1986 repeal of the *General Utilities* doctrine.

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[2] I.R.C. § 857(b)(6).

*C. Summary*

The 10-year recognition period of section 1374 currently requires a REIT to pay a corporate-level tax on assets acquired from a C corporation with a built-in gain, if those assets are disposed of within a 10-year period. Combined with the statutory requirements that a REIT be a long-term holder of assets and be widely-held, current law assures that the REIT is not a vehicle for tax avoidance. The proposal's two level tax would frustrate Congress' intent to allow the REIT to permit small investors to benefit from the capital-intensive real estate industry in a tax efficient manner.

Accordingly, NAREIT believes that tax policy considerations are better served if the Administration's section 1374 proposal is not enacted.

## II. Subsidiary Service Corporations

As part of the asset diversification tests applied to REITs, a REIT may not own more than 10 percent of the outstanding voting securities of a non-REIT corporation pursuant to section 856 (c)(5)(B). The shares of a wholly-owned "qualified REIT subsidiary" ("QRS") of the REIT are ignored for this test. The Administration's Fiscal Year 1999 Budget proposes to amend section 856(c)(5)(B) to prohibit REITs from holding stock possessing more than 10 percent of the vote *or* value of all classes of stock of a non-REIT corporation (other than a wholly owned QRS).

*A. Background and Current Law*

The activities of REITs are strictly limited by a number of requirements that are designed to ensure that REITs serve as a vehicle for public investment in real estate. First, a REIT must comply with several income tests. At least 75 percent of the REIT's gross income must be derived from real estate, such as rents from real property, mortgage interest and gains from sales of real property (not including dealer sales).[3] In addition, at least 95 percent of a REIT's gross income must come from the above real estate sources, dividends, interest and sales of securities.[4]

Second, a REIT must satisfy several asset tests. On the last day of each quarter, at least 75 percent of a REIT's assets must be real estate assets, cash and government securities. Real estate assets include interests in real property and mortgages on real property. As mentioned above, the asset diversification rules require that a REIT not own more than 10 percent of the outstanding voting securities of an issuer (other than a QRS). In addition, no more than 5 percent of a REIT's assets can be represented by securities of a single issuer (other than a QRS).

REITs have been so successful in operating their properties and providing permissible services to their tenants that they have been asked to provide these services to non-tenants, building off of expertise and capabilities associated with the REIT's real estate activities. The asset and income tests, however, restrict how REITs can engage in these activities. A REIT can earn only up to 5 percent of its income from sources other than rents, mortgage interest, capital gains, dividends and interest. However, many REITs have had the opportunity to maximize shareholder value by earning more than 5 percent from third party service income.

Starting in 1988, the Internal Revenue Service issued private letter rulings to REITs approving a structure to facilitate a REIT providing a limited amount of services to third parties.[5] These rulings sanctioned a structure under which a REIT owns no more than 10 percent of the voting stock and up to 99 percent of the value of a non-REIT corporation through nonvoting stock. Usually, managers or shareholders of the REIT own the voting stock of the "Third Party Service Subsidiary" ("TPSS," also known as a "Preferred Stock Subsidiary"). The TPSS typically provides unrelated parties services already being delivered to a REIT's tenants, such as landscaping and managing a shopping mall in which the REIT owns a joint venture interest. The REIT receives dividends from the TPSS that are treated as qualifying income under the 95 percent income test, but not the 75 percent income test.[6] Accordingly, a REIT continues to be principally devoted to real estate operations. In addition, while the IRS has approved using TPSSs for services to third parties and "customary" services to tenants the REIT could otherwise provide, the IRS has

[3] I.R.C. § 856(c)(3).

[4] I.R.C. § 856(c)(2).

[5] PLRs 9440026, 9436025, 9431005, 9428033, 9340056, 8825112. *See also* PLRs 9507007, 9510030, 9640007, 9733011, 9734011, 9801012.

[6] The REIT does not qualify for a dividends received deduction with respect to TRSS dividends. I.R.C. § 857(b)(2)(A).

not permitted the use of these subsidiaries to provide impermissible, non-customary real estate services to REIT tenants.[7]

The Administration proposes to change the asset diversification tests to prevent a REIT from owning securities in a C corporation that represent either 10 percent of the corporation's vote *or* value. The proposal would apply with respect to stock acquired on or after the date of first committee action. In addition, to the extent that a REIT's ownership of TPSS stock is grandfathered by virtue of the effective date, the grandfather status would terminate if the TPSS engages in a new trade or business or acquires substantial new assets on or after the date of first committee action. This proposal is only expected to raise $19 million over five years.

*B. Statement Against Administration Proposal to Limit REIT Investments in Service Subsidiaries*

The REIT industry has grown significantly during the 1990s, from an equity market capitalization under $10 billion to a level exceeding $150 billion. The TPSS structure is used extensively by today's REITs and has been a small, but important, part of recent industry growth. These subsidiaries help ensure that the small investors who own REITs are able to maximize the return on their capital by taking full economic advantage of core business competencies developed by REITs in owning and operating the REIT's real estate. By halting the expansion of TPSSs, the Administration proposal would curtail REIT growth at a time when the industry is just realizing Congress' vision of making publicly owned, income-producing real estate accessible for small investors. Since the profits of the TPSS are taxable at the corporate level today, NAREIT sees no reason to restrain their future use and growth.

The REIT asset rules are patterned loosely after the asset diversification rules applicable to mutual funds, with the REIT rules being significantly more restrictive.[8] In contrast to the REIT rules, a mutual fund can own 100 percent of any one issuer so long as not more than 25 percent of the value of the fund's total assets are invested in that issuer. The REIT provisions do not provide the same flexibility. A REIT cannot own more than 10% of the voting securities of a non-REIT corporation, and securities of a non-REIT corporation cannot be worth more than 5 percent of the REIT's assets. The Administration proposal would further restrict REIT investment, in contrast with the flexibility afforded to mutual funds.

Over the years, Congress has modified and refined the REIT rules several times to ensure that REITs can continue to effectively fulfill their mission to promote investment by individuals in income-producing real estate. These modifications helped shift the focus of real estate investment generally from the tax loss orientation of the 1970s and 1980s to the taxable, income-oriented REIT environment today. Most recently, Congress reviewed the REIT rules and enacted the constructive REIT Simplification Act of 1997.

NAREIT believes strongly that the Administration proposal limiting REIT investment in TPSSs is a noticeable step backwards in thinking at a time when policymakers should seriously consider additional forward-thinking steps to make income-based real estate investments easily and economically accessible to small investors everywhere. To ensure REITs remain competitive in the real estate marketplace, an important step forward in this area is to enable REITs in the future to provide more services to both tenants and customers under appropriate tax rules.

While NAREIT strongly disagrees with the Administration proposal, we do believe that the TPSS approach is not an ideal solution to making certain that REITs can provide competitive services in the real estate marketplace. NAREIT looks forward to working with the Administration and Congress to formulate appropriate rules to enable REITs to serve their tenants and customers and thereby effectively compete with other real estate companies.

*C. Summary*

NAREIT strongly opposes the Administration proposal as it will only further restrict REITs from fulfilling their mission of making investment in large-scale, income-producing real estate accessible to small investors. NAREIT encourages Congress and the Administration to work towards a solution that will enable REITs to better serve their tenants and customers, thereby maximizing returns to REIT shareholders. For REITs to compete effectively with other real estate investors, they must be able to manage and operate their properties, including providing a wide range of customer services. There is no reason why REITs should not be able to provide noncustomary services to tenants as well as services to non-tenant customers on a basis taxable at the corporate level.

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[7] *But see* PLR 9804022.

[8] *Compare* I.R.C. § § 851(b)(3) and 856(c)(4).

## III. Closely Held REITs

The Administration's Fiscal Year 1999 Budget proposes to add a new rule, creating a limit of 50 percent on the vote or value of stock any entity could own in any REIT.

### *A. Background and Current Law*

As discussed above, Congress created REITs to make real estate investments easily and economically accessible to the small investor. To carry out this purpose, Congress mandated two rules to ensure that REITs are widely held. First, five or fewer individuals cannot own more than 50% of a REIT's stock.[9] In applying this test, most entities owning REIT stock are "looked through" to determine the ultimate ownership by individuals of the stock. Second, at least 100 persons (including corporations and partnerships) must be REIT shareholders.[10] Both tests do not apply during a REIT's first taxable year, and the "five or fewer" test only applies in the last half of all taxable years.[11]

The Administration appears to be concerned about non-REITs establishing "captive REITs" and REITs doing "step-down preferred" transactions used for various tax planning purposes it finds abusive. The Administration proposes changing the "five or fewer" test by imposing an additional requirement. The proposed new rule would prevent any "person" (*i.e.*, a corporation, partnership or trust) from owning stock of a REIT possessing more than 50 percent of the total combined voting power of all classes of voting stock or more than 50 percent of the total value of shares of all classes of stock. Certain existing REIT attribution rules would apply in determining such ownership, and the proposal would be effective for entities electing REIT status for taxable years beginning on or after the date of first committee action.

### *B. Statement Providing Limited Support for Administration Proposal on Closely Held REITs*

NAREIT shares the Administration's concern that the REIT structure not be used for abusive tax avoidance purposes, and therefore NAREIT welcomes the intent of the proposal. We are concerned, however, that the Administration proposal casts too broad a net, prohibiting legitimate and necessary use of "closely held" REITs. A limited number of exceptions are necessary to allow certain entities to own a majority of a REIT's stock. NAREIT would like to work with Congress and the Administration to ensure that any action to curb abuses does not disallow legitimate and necessary transactions.

First, an exception needs to be made so that a REIT may own more than 50 percent of another REIT's stock. For example, in the course of an acquisition, a REIT may need to own more than 50 percent of another REIT's stock while conducting a tender offer for the target REIT's shares. Also, in structuring a joint venture a REIT may desire to own a majority, controlling interest in another REIT. Neither of these situations raises abuse concerns. After all, the "control" REIT must comply with the full panoply of REIT rules—including any new ones—to ensure the private REIT is truly widely held.

Second, an exception should be allowed to enable a REIT's organizers to have a single large investor for a temporary period, such as in preparation for a public offering of the REIT's shares. Such "incubator REITs" sometimes are majority owned by its sponsor to allow the REIT to accumulate a track record that will allow it to go public. The Administration proposal would prohibit this important approach which, in turn, could curb the emergence of new public REITs in which small investors may invest.

In addition, there is no reason why a partnership, mutual fund or other pass-through entity should be counted as one entity in determining whether any "person" owns 50 percent of the vote or value of a REIT. A partnership, mutual fund or other pass-through entity is usually ignored for tax purposes. The partners in a partnership and the shareholders of a mutual fund or other pass-through entity should be considered the "persons" owning a REIT for purposes of any limits on investor ownership.

### *C. Summary*

NAREIT supports a change in the REIT rules to prevent abusive use of closely held REITs, but is concerned that the Administration proposal is overly broad.

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[9] I.R.C. § 856(h)(1).
[10] I.R.C. § 856(a)(5).
[11] I.R.C. § § 542(a)(2) and 856(h)(2).

NAREIT looks forward to working with Congress and the Administration to craft a solution that will prevent such abuses without impeding legitimate and necessary transactions, such as those mentioned above.

## IV. Paired Share REITs

The Administration's Fiscal Year 1999 Budget proposes to freeze the "grandfathered" status of the existing paired share REITs.

### *A. Background and Current Law*

In order to actively manage their properties within the strictures of the REIT rules, in the 1970s and early 1980s a handful of REITs sought and received permission from the IRS to establish a "paired" relationship with other companies that would manage the REIT-owned properties. A "paired-share" company is actually two companies the stock of which is "paired" or "stapled" such that they trade as a single unit. As a result, the two companies are owned by the same shareholders. One company, the REIT, owns real estate and, in some cases, may lease it to the second operating company. The operating company is typically organized as a C corporation with the accompanying corporate level tax. The operating company is unrestricted in the businesses it may operate, meaning it may operate those businesses, such as hotels or golf courses, which require a high level of services be provided to customers.

In 1984, Congress adopted section 269B in the Deficit Reduction Act of 1984 ("the Act") which requires that in applying the tests for REIT status, all stapled entities are treated as one entity.[12] In connection with considering and restricting the use of "paired share" entities by non-REIT U.S. corporations operating overseas, Congress decided in 1984 to "grandfather," or apply prior law to, a very limited number of REITs that earlier had received IRS permission to adopt a "paired share" structure.[13] Congress crafted this exception for the paired share REITs out of a concern for fairness to these companies and their shareholders who made their investments on the basis of existing law. No doubt the same fairness issues apply today.

The Administration proposes to limit the tax benefits of the existing paired share REITs that qualify under the 1984 Act's grandfather rules. Pursuant to the proposal, the general rules treating the REIT and the stapled C corporation as a single entity for purposes of the REIT qualification tests would be applied to properties acquired by grandfathered entities on or after the effective date and activities or services relating to such properties performed on or after the effective date.

### *B. Statement Concerning Freezing the Grandfathered Status of Stapled REITs*

NAREIT does not support the Administration proposal out of concern for the shareholders who reasonably relied on existing law when investments were made.

If enacted, the Administration proposal would cause investors in some of these entities to experience adverse consequences. The shareholders reasonably relied on Congress' grandfathering of the stapled REITs and the previous IRS rulings approving of their status. This authority should not be reversed without careful consideration of the extent to which the REITs, their investors and others have made long-term financial commitments in reasonable reliance on such authority.

### *C. Summary*

NAREIT does not support the Administration proposal out of concern for fairness to the stapled REITs and their shareholders who made their investments on the basis of existing law.

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[12] I.R.C. § 269B(a)(3).

[13] Over 200 publicly traded REITs are active in today's real estate marketplace. Of these, four are so-called "paired share" REITs.

**Statement of Fred F. Murray, Vice President For Tax Policy, National Foreign Trade Council, Inc.**

Mr. Chairman, and Members of the Committee:

The National Foreign Trade Council, Inc. (the "NFTC" or the "Council") is appreciative of the opportunity to present its views on the impact on international competitiveness of certain of the revenue raising foreign provisions in the administration's fiscal year 1999 budget proposals.

The NFTC is an association of businesses with some 550 members, founded in 1914. It is the oldest and largest U.S. association of businesses devoted exclusively to international trade matters. Its membership consists primarily of U.S. firms engaged in all aspects of international business, trade, and investment. Most of the largest U.S. manufacturing companies and most of the 50 largest U.S. banks are Council members. Council members account for at least 70% of all U.S. non-agricultural exports and 70% of U.S. private foreign investment. The NFTC's emphasis is to encourage policies that will expand U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax inequities in the treatment of U.S. companies operating abroad.

The founding of the Council was in recognition of the growing importance of foreign trade to the health of the national economy. Since that time, expanding U.S. foreign trade and incorporating the United States into an increasingly integrated world economy has become an even more vital concern of our nation's leaders. The value of U.S. international trade (imports plus exports) as a percentage of GDP has more than doubled in recent decades: from 7 percent in the 1960's to 17 percent in the 1990's. The share of U.S. corporate earnings attributable to foreign operations among many of our largest corporations now exceeds 50 percent of their total earnings. Direct investment by U.S. companies in foreign jurisdictions continues to exceed foreign direct investment in the United States (in spite of the net debtor status of the U.S.) by some $180 billion in 1994. In 1995, U.S. exports of goods and services totaled $805 billion—11.1 percent of GDP.[1] In 1993, 58 percent of the $465 billion of merchandise exports from the U.S. were associated with U.S. multinational corporations: $110 billion of the exports went to foreign affiliates of the U.S. companies, and another $139 billion of the exports were shipped directly to unrelated foreign buyers.[2] Even these numbers in and of themselves do not convey the full importance of exports to our economy and to American-based jobs, because they do not address the additional fact that many of our smaller and medium-sized businesses do not consider themselves to be exporters although much of their product is supplied as inventory or components to other U.S.-based companies who do export.

Foreign trade is fundamental to our economic growth and our future standard of living.[3] Although the U.S. economy is still the largest economy in the world, its growth rate represents a mature market for many of our companies. As such, U.S. employers must export in order to expand the U.S. economy by taking full advantage of the opportunities in overseas markets. Today, some 96% of U.S. firms' potential customers are outside the United States, and in the 1990's 86% of the gains in worldwide economic activity occurred outside the United States. Over the past three years, exports have accounted for about one-third of total U.S. economic growth; and, projected exports of manufactured goods reached a record level in 1996 of $653 billion.[4]

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[1] U.S. Department of Commerce, "Survey of Current Business," April 1996.

[2] U.S. Department of Commerce, "U.S. Multinational Companies: Operations in 1993," June 1995, at 39.

[3] "Continued robust exports by U.S. firms in a wide variety of manufactures and especially advanced technological products—such as sophisticated computing and electronic products and cutting-edge pharmaceuticals—are critical for maintaining satisfactory rates of GDP growth and the international competitiveness of the U.S. economy. Indeed, it is widely acknowledged that strong export performance ranks among the primary forces behind the economic well-being that U.S. workers and their families enjoy today, and expect to continue to enjoy in the years ahead." Gary Hufbauer (Reginald Jones Senior Fellow, Institute for International Economics) and Dean DeRosa (Principal Economist, ADR International, Ltd.), "Costs and Benefits of the Export Source Rule, 1998–2002," A Report Prepared for the Export Source Coalition, February 19, 1997.

[4] See, Fourth Annual Report of the Trade Promotion Coordinating Committee (TPCC) on the National Export Strategy: "Toward the Next Century: A U.S. Strategic Response to Foreign Competitive Practices," October 1996, U.S. Department of commerce, ISBN 0–16–048825–7; J. David Richardson and Karin Rindal, "Why Exports Matter: More!," Institute for International Economics and the Manufacturing Institute, Washington, D.C., February 1996.

THE COUNCIL'S COMMENTS AND CONCERNS

The NFTC believes that certain of the President's proposals related to international business are beneficial to the nation's export sector and to its economy; but, it also believes that certain of the proposals are not in the nation's interest. For example, the NFTC supports extension of the tax credit for research, as well as accelerating the effective date of the rules regarding look-through treatment for dividends received from "10/50 Companies." These provisions will serve to improve the competitive position of U.S. multinational companies.

However, in devising many of its other tax proposals, the Administration replaced sound tax policy with a short sighted call for more revenue. The NFTC is concerned that this and previous Administrations, as well as previous Congresses, have often turned to the international provisions of the Internal Revenue Code to find revenues to fund domestic priorities, in spite of the pernicious effects of such changes on the competitiveness of United States businesses in world markets. The Council is further concerned that such initiatives may have resulted in satisfaction of other short-term goals to the serious detriment of longer-term growth of the U.S. economy and U.S. jobs through foreign trade policies long consistent in both Republican and Democratic Administrations, including the present one.

United States policy in regard to trade matters has been broadly expansionist for many years, but its tax policy has not followed suit. The provisions of Subchapter N of the Internal Revenue Code of 1986 (Title 26 of the United States Code is hereafter referred to as the "Code") impose rules on the operations of American business operating in the international context that are much different in important respects than those imposed by many other nations upon their companies. Some of these differences, described in more detail in the sections that follow, may make American business interests less competitive in foreign markets when compared to those from our most significant trading partners:[5]

- The United States taxes worldwide income of its citizens and corporations who do business and derive income outside the territorial limits of the United States. Although other important trading countries also tax the worldwide income of their nationals and companies doing business outside their territories, such systems generally impose less tax on foreign source income and are less complex than their U.S. counterparts.
- The United States has more complex rules for the limitation of "deferral" than any other major industrialized country. Although the United States taxes the worldwide income of its companies, it permits deferral of the tax on unrepatriated foreign earnings of controlled foreign corporations, except where one of six complex, overlapping series of "anti-deferral" provisions of the Code apply. In addition, the anti-deferral provisions of most countries do not tax active business foreign income of their companies, while those of the U.S. inappropriately impose current U.S. tax on some active business foreign income as well as on passive foreign income.
- The current U.S. Alternative Minimum Tax (AMT) system imposes numerous rules on U.S. taxpayers that seriously impede the competitiveness of U.S. based companies. For example, the U.S. AMT provides a cost recovery system that is inferior to that enjoyed by companies investing in our major competitor countries; additionally, the current AMT 90-percent limitation on foreign tax credit utilization imposes an unfair double tax on profits earned by U.S. multinational companies—in some cases resulting in a U.S. tax on income that has been taxed in a foreign jurisdiction at a higher rate than the U.S. tax.
- The U.S. foreign tax credit system is very complex, particularly in the computation of limitations under the provisions of section 904 of the Code. While the theoretic purity of the computations may be debatable, the significant administrative costs of applying and enforcing the rules by taxpayers and the government is not. Systems imposed by other countries are in all cases less complex.
- The United States has more complex rules for the determination of U.S. and foreign source net income than any other major industrialized country. In particular, this is true with respect to the detailed rules for the allocation and apportionment of deductions and expenses. In many cases, these rules are in conflict with those of other countries, and where this conflict occurs, there is significant risk of double taxation.

As noted above, the United States system for the taxation of the foreign business of its citizens and companies is more complex than that of any of our trading partners, and perhaps more complex than that of any other country.

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[5] See, Financial Executives Research Foundation, Taxation of U.S. Corporations Doing Business Abroad: U.S. Rules and Competitiveness Issues, 1996, Ch. 9.

That result is not without some merit. The United States has long believed in the rule of law and the self-assessment of taxes, and some of the complexity of its income tax results from efforts to more clearly define the law in order for its citizens and companies to apply it. Other countries may rely to a greater degree on government assessment and negotiation between taxpayer and government—traits which may lead to more government intervention in the affairs of its citizens, less even and fair application of the law among all affected citizens and companies, and less certainty and predictability of results in a given transaction. In some other cases, the complexity of the U.S. system is simply ahead of development along similar lines in other countries—many other countries have adopted an income tax similar to that of the United States, and a number of these systems have eventually adopted one or more of the significant features of the U.S. system of taxing transnational transactions: taxation of foreign income, anti-deferral regimes, foreign tax credits, and so on. However, while difficult to predict the ultimate evolution, none of these other country systems seems prone to the same level of complexity that affects the United States system. This reluctance may be attributable in part to recognition that the U.S. system has required very significant compliance costs of both taxpayer and the Internal Revenue Service, particularly in the international area where the costs of compliance burdens are disproportionately higher relative to U.S. taxation of domestic income and to the taxation of international income by other countries.[6]

Many foreign companies do not appear to face the same level of costs in their operations. The European Community Ruding Committee survey of 965 European firms found no evidence that compliance costs were higher for foreign source income than for domestic source income.[7] Lower compliance costs and simpler systems that often produce a more favorable result in a given situation are competitive advantages afforded these foreign firms relative to their American counterparts.

Short of fundamental reform—a reform in which the United States federal income tax system is eliminated in favor of some other sort of system—there are many aspects of the current system that could be reformed and greatly improved. These reforms could significantly lower the cost of capital, the cost of administration, and therefore the cost of doing business for American firms. For example, the NFTC strongly supported the International Tax Simplification for American Competitiveness Act of 1997, H.R. 1783, introduced by Mr. Houghton (R–NY) and Mr. Levin (D–MI) of this Committee, and many of the provisions of which were enacted in the Taxpayer Relief Act of 1997. The NFTC continues to strongly support similar efforts in this session of the 105th Congress.

In the light of this background, the NFTC would today like to specifically address some of the President's Fiscal Year 1999 proposals as follows: (1) Accelerating the effective date of the "look-through" rules relating to noncontrolled section 902 corporations ("10/50 Companies"); (2) Extension of the Research Tax Credit; (3) Modification of the Export Source Rule (also known as the "Inventory Sales Source Rule," and sometimes as the "Title Passage Rule"); (4) Modification of foreign tax credits applicable to to foreign oil and gas income; (5) Certain others of the foreign proposals affecting foreign operations. We would also comment on a proposal from last year's budget submission that is being separately considered in the Senate that relates to a modification of the rules relating to foreign tax credit carrybacks and carryovers.

## PROPOSALS SUPPORTED

### *Accelerating the Effective Date of the "Look-Through" Rules Relating to 10/50 Companies*

*Description of Current Law*.—U.S. companies may credit foreign taxes against U.S. tax on foreign source income. The foreign tax credit is a fundamental requirement of the U.S. system of worldwide taxation because it eliminates double taxation of income. The amount of foreign tax credits that can be claimed in a year is subject to a limitation that prevents taxpayers from using foreign tax credits to offset U.S. tax on U.S. source income. Separate limitations are applied to specific categories of income under section 904.

"Look-through" treatment provides that income is apportioned to a foreign tax credit limitation category in proportion to the ratio of the earnings and profits at-

[6] See Marsha Blumenthal and Joel B. Slemrod, "The Compliance Cost of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications," in National Tax Policy in an International Economy: Summary of Conference Papers, (International Tax Policy Forum: Washington, D.C., 1994).

[7] Id.

tributable to income in such foreign tax credit limitation category to the total earnings and profits.

Under changes made by the Taxpayer Relief Act of 1997, U.S. parent corporations that own at least 10 percent but not more than 50 percent of the stock of a corporation will be able to use "look-through" treatment in computing indirect foreign tax credits under section 902 for the taxes paid by the owned corporation and attributable to the parent's ownership. Prior to such change, a separate limitation applied to each 10/50 Company owned by the parent corporation, irrespective of the amount and source of income of the subsidiary.

This structure is important to U.S. multinational groups because many foreign joint ventures are structured in this way—the parent has less than a majority interest and is not therefore subject to the controlled foreign corporation rules that apply look-through treatment—and in many cases multinationals own many hundreds of these ventures. The Taxpayer Relief Act of 1997 changed these rules to allow 10/50 Companies to be treated like controlled foreign corporations by allowing "look-through" treatment for foreign tax credit purposes for dividends from such joint ventures. The 1997 Act, however, did not make the change effective for such dividends unless they were received after the year 2002: Dividends paid by a 10/50 Company in taxable years beginning after December 31, 2002, from earning and profits ("E&P") accumulated in taxable years beginning before January 1, 2003, are subject to a single foreign tax credit limitation for all 10/50 companies. Dividends paid by a 10/50 company in taxable years beginning after December 31, 2002, from E&P accumulated in taxable years beginning after December 31, 2002, are treated as income in a foreign tax credit limitation category under look through treatment. Therefore, two different sets of rules apply for dividends from E&P generated before the year 2003 and dividends from E&P accumulated after the year 2002. Dividends paid by a 10/50 Company in taxable years beginning before January 1, 2003, are subject to a separate foreign tax credit limitation for each 10/50 Company (prior law).

The 1997 provision effects a significant simplification over current law, but is delayed in effective date and is still overly complex.

*The Administration's Proposal*.—The proposal would accelerate the effective date of the 1997 changes affecting foreign joint ventures owned between ten and fifty percent by U.S. parents (so-called "10/50 Companies"). This change will, instead, apply the look-through rules to all dividends received in tax years after 1997, no matter when the E&P constituting the makeup of the dividend was accumulated.

This change will result in a tremendous reduction in complexity and compliance burdens for U.S. multinationals doing business overseas through foreign joint ventures. It will also reduce the competitive bias against U.S. participation in such ventures (the minority position in such ventures is many times dictated by local law) by placing U.S. companies on a more level playing field.

The NFTC supports even further simplification of these rules by extension of them beyond the Administration's proposal to income other than dividends, including interest, rents, royalties, and gains from the sale of interests in partnerships and lower-tier subsidiary companies.

*Extending the R&E Tax Credit*

*Description of Current Law*.—The research credit generally applies on an incremental basis to a taxpayer's "qualified research" expenses for a taxable year. The credit is equal to 20 percent of the amount by which the taxpayer's qualified research expenses for the taxable year exceed a base amount. The Small Business Job Protection Act of 1996 provided an alternative incremental research credit.

The research credit expired on June 30, 1995. In the 1996 Act, the research credit was extended in modified form for eleven months to May 31, 1997. The credit was subsequently extended by the 1997 Act to apply to expenses incurred from June 1, 1997 to June 30, 1998. The 1997 Act also modified the alternative incremental research credit regime to permit taxpayers to elect the regime for any taxable year beginning after June 30, 1996.

*The Administration's Proposal*.—The research tax credit would be extended for twelve months, from July 1, 1998, through June 30, 1999 under the Administration's proposal. The NFTC supports this proposal to extend the research tax credit for another year. The credit has served to promote research that otherwise may never have occurred. The buildup of "knowledge capital" is absolutely essential to enhance the competitive position of the U.S. in international markets. Encouraging private sector research work through a tax credit has the decided advantage of keeping the government out of the business of picking specific winners or losers in providing direct research incentives. The NFTC encourages both the Administration and the Congress to make the research tax credit permanent.

PROPOSALS NOT SUPPORTED OR OPPOSED

*Modification of the Export Source Rule*

*Description of the Rule*.[8]—The "Export Source Rule," as it is commonly called, is but one of a number of sales source rules found in sections 861, 862, and 863 of the Internal Revenue Code of 1986 (the "Code"), and the Treasury regulations thereunder. In fact, the Export Source Rule is not in the statute, but is instead found in Treasury Regulations § 1.863–3(b), and has been there or in its predecessor provisions for more than 70 years.

As noted above, the United States taxes U.S. citizens and residents and U.S. corporations on their *worldwide* income. That is, a U.S.-based enterprise is taxed by the United States not only on the income from its operations and sales in the United States, but also on the income from its operations and sales in other countries. This worldwide taxation creates "double taxation" when that same foreign income is taxed in the other country where it is derived. Each of the affected countries has its own internal tax rules to determine the "source" of the income involved, the application of which rules may determine whether the income in question may be taxed under its laws and to what extent.

To mitigate double taxation of income earned abroad, the United States, like many other countries, has since 1918 allowed a credit for income taxes paid to foreign countries with respect to foreign source income—the "foreign tax credit." That is, in cases where it applies, the United States cedes its jurisdiction in favor of the foreign country where the income is sourced, (i.e., the source country taxes the income and the U.S. does not).

Since 1921, foreign tax credits have been subject to a limitation in some form. Generally, the limitation is intended to allow a credit to be claimed only to the extent that the credit does not exceed the amount of U.S. income tax that would be due on the foreign-source income absent the credit. In other words, the United States does not allow a credit for the entire amount of foreign tax imposed—only that amount that would have been the U.S. tax if it had chosen to impose its tax on the income. For example, a U.S. company paying a tax at a 40% rate in a foreign country would only receive a foreign tax credit up to the maximum 35% U.S. rate. The general limitation can be expressed in an algebraic equation:

U.S. tax (pre-credit) on worldwide income × *foreign source taxable income/worldwide taxable income*

Under the formula, as foreign source taxable income increases (e.g., by operation of the Export Source Rule), the limitation on foreign tax credits available to offset U.S. tax increases (and therefore the foreign tax credit that can be utilized in most cases increases, up to the full amount of foreign taxes paid or accrued).

To the extent that the foreign income tax is *less* than the limitation, the United States collects a residual tax on the foreign source income. If the foreign income tax *exceeds* the limitation, the taxpayer pays tax, in the current year, on foreign source income at the effective foreign tax rate (rather than the lower U.S. tax rate). This results in foreign tax credits in excess of the general limitation in the current year (an "excess foreign tax credit position"). These excess credits may, under current law, be "carried back" for up to two years and "carried forward" for up to five years, subject to the general limitation in each of those years.[9]

Higher foreign tax rates are only one reason many companies are in an excess foreign tax credit position. A multitude of other U.S. tax rules place restrictions on crediting foreign taxes.

As noted above, the amount of the credit is dependent on the amount of income designated as "foreign source" under U.S. tax law. For example, under restrictions in U.S. law, a portion of U.S. interest, as well as research and development costs, must be allocated to and reduce foreign source taxable income (even though no deduction may actually be allowed for these amounts in the foreign country). On the other hand, if a company incurs a loss in its domestic operations, it is never able to use foreign source earnings from that year to claim foreign tax credits.

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[8] Parts of the following discussion of the rule were abstracted from material prepared for the Export Source Coalition.

[9] In other words, the return for the second preceding tax year is recomputed with the newly available credit carryback, and to the extent that the foreign tax credits previously available in that year plus the foreign tax credits carried back to that year do not exceed the general limitation, the taxes carried back may be utilized in that year to reduce the U.S. tax paid in that year. If excess credits remain, the same procedures are followed for the first preceding tax year, and then the first succeeding tax year, the second succeeding tax year, and so on, until they are used up, or until the five year limitation causes them to "expire."

The system is further complicated by other rules, such as the "basket" limitation rules of section 904 of the Code. Under these provisions, foreign source income is divided into separate baskets for various situations and types of income to each of which the limitation is applied. These rules may result in hundreds of separate limitations being applied to the credits. (Thus, a U.S. company might nevertheless end up with excess foreign tax credits, even though without such rules the company would have been able to fully utilize its foreign tax credits.)

These U.S. rules are orders of magnitude more complex than the similar limitation systems of any of our foreign trading partners. Lost credits and the cost of compliance only add to the disparity in tax burden between U.S.-based and foreign-based multinationals, mitigated in part by the Export Source Rule.

The Code contains two source rules for the sale of inventory property that are of particular importance to U.S. exporters. One rule is for inventory property that the exporter produces and sells; and, the other is for inventory property that the exporter purchases and sells.[10]

The source of income derived from the sale of property *produced*[11] in the U.S. and sold outside the U.S. (or vice versa) is determined under section 863 of the Code. Treasury Regulations promulgated in 1996, following regulations that date back to 1922, and which implement section 863 and its predecessor statutes, provide three rules for making the determination of the amount of income that is foreign source. The first and most commonly used of these is known as the "50–50 Method" (also known as the "Export Source Rule").[12]

Under the so-called "50–50 Method," 50 percent of the income to be allocated between U.S. source and foreign source is allocated based on the location of the taxpayer's property used in the production of the inventory, and the source of the other 50 percent is based on the title-passage rule. Assuming title to the inventory passes outside the United States, this generally allows U.S. manufacturers to treat at least half of their export income from manufacture and sale of their products as derived from foreign sources, even though the manufacturer's production activity is located in the U.S.

EXAMPLE:[13]

American Widget Company exports widgets to European markets and is in an excess foreign tax credit position. It costs American $90 to produce, sell, and transport a unit from one of its 14 U.S. plants, but only $88 to produce and sell a unit in the Czech Republic where it has located a plant to make widgets for the East European market. The U.S. made units sell for $100 each in West European markets.

Assume American produces a widget in the U.S. with U.S. jobs and manufacturing plant, and passes title to the widget in Romania, paying no tax in Romania on the sale. American has $10 of pre-tax income, $5.00 of which is considered foreign source income. Assuming a 35% U.S. tax rate, it may utilize $1.75 additional foreign tax credits, and therefore has $8.25 of after-tax income from the sale [($10.00 × 65%) + $1.75].

As an alternative, American could produce a widget in the Czech Republic for sale in Romania. American would have $12.00 of net income. Assume again that American would pay no Romanian tax and that the Czech tax rate is 35%. American would have $7.80 of after-tax income.

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[10] The source of gross income derived from inventory property that is *purchased* by an exporter in the U.S. and sold outside the U.S. is determined under the "title-passage" rule of section 862(a)(6), which treats such income as derived entirely from the country in which the sale occurs. That is, such property sales generally produce foreign source income.

[11] Section 864 of the Code provides that "produced property" includes property that is "created, fabricated, manufactured, extracted, processed, cured, or aged."

[12] The second method is the "Independent Factory Price Method" or "IFP Method;" and, the third permits a method based on use of the taxpayer's own method of allocation made in its books and records with the IRS District Director's consent.

[13] For purposes of this example, a number of other U.S. tax rules, such as "deferral" and the "subpart F" rules, other credit limitations, and the like are ignored—they do not change the basic result, but serve to complicate the illustration.

With the Export Source Rule, American has an incentive to maintain production in the U.S. ($8.25 > $7.80). Without the Rule, American would have an incentive to increase its Czech production. ($7.80 > $6.50):

| | U.S. Production | | Czech Production |
|---|---|---|---|
| | With Export Source Rule | Without Export Source Rule | |
| Sales Price | $100.00 | $100.00 | $100.00 |
| Cost of Goods Sold | ($90.00) | ($90.00) | ($88.00) |
| Pre-tax Income | $10.00 | $10.00 | $12.00 |
| U.S. tax | $3.50 | $3.50 | $4.20 |
| Czech tax | — | — | $4.20 |
| Foreign Tax Credit | ($1.75) | — | ($4.20) |
| Net tax | $1.75 | $3.50 | $4.20 |
| After-tax Income | $8.25 | $6.50 | $7.80 |

As another way to view the situation, if American requires an 8.25% Return On Sales to support its capital structure, without the Export Source Rule, American would have to raise its unit price at least $2.69 to obtain the same $8.25 return. If the market would not support this new price, it would have to shift production to a location where a lower cost structure can be found, or lose its market to lower cost competitors.

For example, the following two structures result with and without the Export Source Rule:

| | With Export Source Rule | Without Export Source Rule |
|---|---|---|
| Sales Price | $100.00 | $102.69 |
| Cost of Sales | 90.00 | 90.00 |
| Profit | $10.00 | $12.69 |
| Net tax | $3.50 | $4.44 |
| Less: Foreign Tax Credit | ($1.75) | — |
| Net tax | $1.75 | $4.44 |
| After-tax profit | $8.25 | $8.25 |

*The Administration's Proposal*.—The President's Fiscal Year 1999 Budget contains a proposal to eliminate the "50/50 Rule" and replace it with an "activities based" test which would require exporters to allocate income from exports to foreign or domestic sources based upon how much of the activity producing the income takes place in the U.S. and how much takes place abroad.

In addition to introducing considerable administrative complexity and cost into the system,[14] this modification essentially eliminates the benefits of the rule. The justification given for eliminating the rule is essentially that it provides U.S. multinational exporters that also operate in high tax foreign countries a competitive advantage over U.S. exporters that conduct all their business activities in the U.S. In this regard, the Administration prefers the foreign sales corporation rules (FSC) which exempt a lesser portion of export income for all exporters that qualify. The Administration also notes that the U.S. tax treaty network protects export sales

[14] "Moreover, the 50/50 source rule of present law can be viewed as having the advantage of administrative simplicity; the proposal to apportion income between the taxpayer's production activities and its sales activities based on actual economic activity has the potential to raise complex factual issues similar to those raised under the section 482 transfer pricing rules that apply in the case of transactions between related parties." Joint Committee on Taxation, "Description and Analysis of Certain Revenue-Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposal," JCX–10–97, March 11, 1997.

from foreign taxation in countries with which we have treaties. The NFTC believes that these arguments are flawed.

The Export Source Rule does not provide a competitive advantage to multinational exporters vis-à-vis exporters who conduct all their operations in the United States. First, exporters with domestic only operations do not incur foreign taxes and therefore do not suffer double taxation. Also, domestic-only exporters are able to claim the full benefit of deductions for U.S. expenses for U.S. tax purposes (e.g., interest on borrowings and Research & Development costs) because they are also not subject to the rules applied to multinational operations that require allocation of a portion of these expenses against foreign source income. Absent the Export Source Rule, the current Code would have even more of a bias against foreign operations. Second, this is important because the Administration argument also ignores the fact that export operations ultimately lead to foreign operations for U.S. companies. Exporting companies conduct foreign operations to enter and serve foreign markets; marketing, technical and administrative services, and even specialized manufacturing activities are necessary to gain markets and to keep them—to compete with foreign-based companies. Further, and importantly, the Export Source Rule, by alleviating the cost of double taxation, encourages U.S. companies to locate production in the United States. Tax costs are like other costs (e.g., labor, material, and transportation) affecting the production and marketing of these products and services; a recent study suggests that these decisions are now much more tax-sensitive in fact than was previously the case.[15]

Although the FSC regime of the Code[16] is itself valuable to promoting U.S. exports, these provisions do not in themselves afford relief to U.S. exporters with foreign operations that face double taxation because of limited use of foreign tax credits. Further, because the FSC benefits are less than those attributable to the loss of foreign tax credits in a situation where the Export Source Rule may be applicable, they may be insufficient to keep an exporter from moving its production overseas to generate foreign source income.[17]

Our tax treaty network, valuable as it is, is no substitute for the Export Source Rule. First, the countries with which the U.S. currently has double taxation agreements number approximately forty-nine.[18] The current international consensus favoring income tax treaties is derived from sixty years of evolution, starting with the model income tax treaty drafted by the League of Nations in 1927, culminating in its "London Model" treaty in 1946, and carried on later by the United Nations, and the Committee on Fiscal Affairs of the Organization for Economic Cooperation and Development ("OECD"). The U.S. first signed a bilateral tax treaty in 1932 with France, which treaty never went into force. The first effective treaty, also with France, was signed July 25, 1939, and came into force on January 1, 1945.[19] A hearing intended to be held in early September of this year is expected to deal with four new treaties, and the termination of an existing one.[20] These nations tend to be our most developed trading partners, and relatively few developing nations are included.

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[15] "A second key is the sensitivity of plant location to the tax environment. Not right away perhaps, but over a period of years a country that penalizes export production with high taxes will forfeit first investment and then export sales." Hufbauer, DeRosa, Id., at 15.

[16] The Foreign Sales Corporation ("FSC") provisions of sections 921 through 927 of the Code are one of the most important U.S. tax incentives for exports from the United States. These provisions were adopted to offset disadvantages to U.S. exporters in relation to more favorable tax schemes allowed their foreign competitors in the tax systems of our trading partners. These provisions encourage the development and manufacture of products in the United States and their export to foreign markets.

[17] U.S. firms with excess foreign tax credits that use the Export Source Rule pay a "blended" tax rate of 17.5 percent on their export earnings—zero percent on half and 35 percent on half. U.S. firms can conduct their export sales through a FSC and exclude a maximum of 15 percent of their net export earnings from U.S. taxation. In this case, the "blended" rate is 29.75 percent—zero percent on 15 percent of export earnings and 35 percent on 85 percent of export earnings.

[18] The United States has in force some forty-nine Conventions for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income ("income tax treaties") with various jurisdictions, not including other agreements affecting income taxes and tax administration (e.g., Exchange of Tax Information Agreements or Treaties of Friendship and Navigation that may include provisions that deal with tax matters). It has taken more than sixty years to negotiate, sign, and approve the treaties that form the current network.

[19] A number of new agreements are being negotiated by the Treasury Department.

[20] Nevertheless, the U.S. treaty network has never been as extensive as the treaty networks of our principal competitors. The U.S. treaty network covers only a relatively small percentage percent of the developing world, compared to coverage of 40 to 46 percent by the networks of Japan and leading European nations. This discrepancy has persisted for many years, even though the United States relies on the developing world to buy a far larger share of its exports than does Europe.

Much of the world is not yet covered by these treaties. Further, the treaties provide relief from double taxation in such cases only where the export income is solely allocable to the U.S.—i.e., where the U.S.-based exporter does not have a permanent establishment in the foreign jurisdiction to which income is allocable. These circumstances only occur where a U.S. company exports to a foreign treaty partner, and has no operations in that host country that have anything to do with its export sales.

To the contrary, the Export Source Rule supports significant additional U.S. exports and worker earnings. For example, in 1999, for an adjusted net tax revenue cost of $1.1 billion, the U.S. will ship an additional $30.8 billion of exports and add $1.7 billion to worker payrolls in the form of the export earnings premium. The additional exports will support 360 thousand workers in export-related jobs who in a full employment economy would otherwise be working in lower paid sectors of the U.S. economy.[21]

*Limitation of Foreign Tax Credits from Foreign Oil and Gas Income*

*The Administration's Proposals*.—The President's Fiscal Year 1999 Budget contains a proposal to modify the rules affecting foreign tax credits for all "foreign oil and gas income." Such income would be trapped in a new separate FOGI basket under the separate basket foreign tax credit limitations of section 904. In situations where taxpayers are subject to a foreign tax and also receive an economic benefit from the foreign country (e.g., a royalty on production), taxpayers would be able to claim a foreign tax credit for such taxes under section 902 only if the country has a "generally applicable income tax" that has "substantial application" to all types of taxpayers and then only up to the level of taxation that would be imposed under the generally applicable income tax. Treaty provisions to the contrary (for foreign tax credit calculations) would be respected.

The NFTC opposes these proposals. Potential abuses of the foreign tax credit have been addressed previously in sections 901(f), 907(a) and (b) and (c), and 954(g) of the Code, and in the "dual capacity" income tax regulations under section 901 of the Code.[22] The Administration has not demonstrated that these provisions of law and regulation are not adequate and should be amended.

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[21] Hufbauer, DeRosa, Id., at 1.

[22] Congress legislated changes in the treatment of oil and gas income, and related foreign tax credits, in the 1970's and 1980's. These changes reflected concerns about the relatively high tax rates in some foreign jurisdictions in which there was significant oil recovery, and also a concern over whether payments by the petroleum companies were in fact disguised royalties.

Under section 907(a), the amount of taxes on foreign oil and gas extraction income ("FOGEI") may not exceed 35% (i.e., the highest U.S. marginal rate) on such income. Excess credits may be carried over like excess foreign tax credits in the general limitation basket. (FOGEI is income derived from the extraction of oil and gas, or from the sale of exchange of assets used in extraction activities.) In addition, under section 907(b), the Treasury has regulatory authority to determine that a foreign tax on foreign oil related income ("FORI") is not creditable to the extent that the foreign law imposing the tax is structured, or in fact operates, so that the tax that is generally imposed is materially greater than the amount of tax on income that is neither FORI nor FOGEI. (FORI is foreign source income from: (1) processing oil and gas into primary products; (2) transporting oil and gas or their primary products, (3) distributing or selling these products, or (4) disposing of assets used in the foregoing activities.) To date, the Treasury has not exercised this authority; however, see the discussion below of the safe harbor rule of Treas. Reg. § 1.901–2A(e)(1).

Under section 954(g), foreign base company oil related income (an element of subpart F income not eligible for deferral) generally includes FORI other than income derived from a source within a foreign country in connection with either (1) oil or gas which was extracted from a well located in that foreign country (FOGEI); or (2) oil, gas, or a primary product of oil or gas which is sold by the foreign corporation or a related person for use or consumption within that foreign country, or is loaded in that country on a vessel or aircraft as fuel for that vessel or aircraft.

In addition, in 1983, the I.R.S. promulgated the "dual capacity" regulations (Treas. Reg. § 1.901–2A). Since mineral rights in many countries vest in the sovereign, payments to the sovereign may take the form of royalties or other payments for the mineral or as taxes to the sovereign on the income represented by the production. To help resolve the possible controversy of whether such payment are royalties or creditable income taxes, the regulations provide that a taxpayer must establish under the facts and circumstances method the amount of the intended tax payment that otherwise qualifies as an income tax payment but is not paid in return for a specific economic benefit. The remainder is a deductible rather than creditable payment (in the case of oil and gas products, a royalty). A "safe harbor" method is available under Treas. Reg. § 1.901–2A(e)(1), under which a formula is used to determine the tax portion of the payment to the foreign sovereign (e.g., the amount that the taxpayer would pay under the foreign country's general income tax law). Where there is no generally applicable income tax, the safe harbor rule of the regulation allows the use of the U.S. tax rate in a "splitting" computation (the U.S. tax rate is considered the country's generally applicable income tax rate).

The proposals create significant new limitations on the foreign tax credits attributable to foreign oil and gas income, and represent significant limitations on the foreign tax credits available to this specific industry. This proposal will significantly increase the cost of capital in that industry and make U.S. companies even less competitive vis-à-vis their foreign competitors. U.S. based oil companies are already at a competitive disadvantage under current law since most of their foreign based competition pay little or no home country tax on foreign oil and gas income. The proposal increases the risk of foreign oil and gas income being subject to double taxation which will severely hinder U.S. oil companies in the global oil and gas exploration, production, refining and marketing arena.

*Other Foreign Proposals: Amend 80/20 Company Rules; Prescribe Regulatory Directive to Address Tax Avoidance Involving Foreign-Built-In Losses; Prescribe Regulatory Directive to Address Tax Avoidance Through Use of Hybrids; Modify Foreign Office Material Participation Exception Applicable to Inventory Sales Attributable to Nonresident's U.S. Office*

In each of these proposals the Treasury seeks legislative or regulatory authority to address perceived abuses. The NFTC is also concerned that current law not be subject to unwarranted abuse of statutory provisions in ways that undermine Congressional intent.

However, the General Explanations of the Administration's Revenue Proposals (the "Green Book" explanations) issued by the Treasury give little detail of the perceived abuses. Further, the changes to the statutes affected by the proposals—in some case statutes that have been settled law for many years—and the regulatory authority sought are very broad. Still further, recent notices issued by the Treasury that amplify certain of these proposals have created considerable uncertainty as to the intent of the Treasury in regard to its announced intent to issue legislative regulations in the very near future in these areas—given the breadth of the notices, and their application to a number of legitimate transactions that have been planned and in some cases implemented under current law and regulations. Lastly, NFTC is troubled by recent indications that Treasury is apparently seeking to broadly address efforts by U.S. taxpayers to legitimately reduce their foreign taxes under provisions of foreign law that do not affect U.S. tax receipts.

Therefore, the NFTC does not support these changes until a better analysis of these issues and perceived abuses can be produced by the Treasury, and until more specific legislation is crafted that better serves the interests of the U.S. by separating legitimate transactions from those not favored by current U.S. law.

Notice 98–5, and Notice 98–11 in particular, have had a chilling effect on the ability of U.S. companies to structure their foreign operations consistent with legitimate commercial objectives. They also adversely impact companies' abilities to effectively reduce their overall costs by reducing local taxes in their overseas operations. The Notices are drafted so broadly and so vaguely that they confuse U.S. taxpayers and their advisors, and introduce a compelling need to seek clarification as to whether taxpayers can continue to rely on the simple "check-the-box" regulations issued just last year. All these effects are exacerbated by the Notices' immediate effective dates.

U.S. multinationals compete in an environment wherein foreign competitors use tax planning techniques to reduce foreign taxes without incurring home country tax. It would appear that at least some of the concerns sought to be addressed are not inconsistent with the balance between competitiveness and export neutrality that was intended by Congress in enacting the "subpart F" rules. NFTC believes that it would be more appropriate for Congress to request a study regarding the trade and tax policy issues associated with Notices 98–5 and 98–11. In this regard, a moratorium on further regulatory action by Treasury should be imposed until enactment of specific legislative proposals resulting from well reasoned analysis and debate.

*Modification of the Rules for Foreign Tax Credit Carrybacks and Carryovers*

As noted above, if a foreign income tax exceeds the limitation, the taxpayer pays tax, in the current year, on foreign source income at the effective foreign tax rate (rather than the lower U.S. tax rate). This results in foreign tax credits in excess of the general limitation in the current year (an "excess foreign tax credit position"). These excess credits may, under current law, be "carried back" for up to two years and "carried forward" for up to five years, subject to the general limitation in each of those years.[23]

*The Administration's Proposal*.—The President's Fiscal Year 1998 Budget contained a proposal to reduce the carryback period for excess foreign tax credits from

[23] See footnote 9.

two years to one year. The proposal also would extend the excess foreign tax credit carryforward period from five years to seven years. This proposal is currently being considered in the Senate as a revenue raiser for one or more pending bills. The NFTC strongly opposes this proposal.

As noted by the Joint Committee on Taxation,[24] one of the purposes of the carryover of foreign tax credits is to address timing differences between U.S. tax rules and foreign tax rules. Income may be subject to tax in one year under U.S. rules and in another tax year under applicable foreign rules. The carryback and carryover of foreign tax credits helps to ensure that foreign taxes will be available to offset U.S. taxes on the income in the year in which the income is recognized for U.S. purposes. Shortening the carryback period and increasing the carryforward period also could have the effect of reducing the present value of foreign tax credits and therefore increasing the effective tax rate on foreign source income.

*In Conclusion*

Again, the Council applauds the Chairman and the Members of the Committee for giving careful consideration to the proposals raised by the Administration. The NFTC is appreciative of the opportunity to work with the Committee and the Congress in going forward into this process of consideration of various alternatives, and the Council would hope to make a contribution to this important business of the Committee.

## Statement of National Mining Association

The National Mining Association (NMA) appreciates the opportunity to submit this statement for the Committee's record on the President's fiscal 1999 tax proposals. The NMA is an industry association representing most of the Nation's producers of coal, metals, industrial and agricultural minerals. Our membership also includes equipment manufacturing firms and other providers of products and services to the mining industry. The NMA has not received a federal grant, contract or subcontract in fiscal years 1998, 1997, 1996 or 1995.

Mining directly employs over 300,000 workers. Nearly five million Americans have jobs as a result of the mining industry's contribution to personal, business and government income throughout the nation. The headquarters of NMA member company operations are located in nearly every state of the Union and some form of mining represented by the NMA occurs in all 50 states.

### THE PRESIDENT'S PROPOSAL

Of primary concern to our industry is the Administration's budget proposal to repeal the percentage depletion allowance for minerals mined on federal and former federal lands where mining rights were originally acquired under the Mining Law. The mining industry is adamantly opposed to this proposal. The President included this provision in his 1997 and 1998 budget proposals. It was a bad idea then, it is a bad idea now.

Repeal of the allowance is a major tax increase on companies whose mines are located primarily in the western United States. As it is not uncommon for ownership of mineral deposits to change hands, the proposal would especially penalize mining companies who purchased their properties from original claimants or other intermediary mining concerns.

The U.S. Department of Labor reports that the mining industry provides some of the highest paying nonsupervisory jobs in the United States. The average mining wage in 1996 was $47,612 (not including benefits)—far above the national average wage of $28,945. We believe that tax policy should foster the creation of more of these high-paying jobs. Unfortunately, the Administration's proposal places many of these jobs, principally in economically vulnerable rural areas in the West, at risk.

### MINING AND THE MINING LAW

From our perspective, the President's depletion proposal has more to do with mining on public lands in the western states than it does with tax policy. The NMA and its member companies continue to advocate responsible amendments to the Mining Law, including a reasonable royalty provision. This reform effort has been stymied at every turn by anti-mining groups. Those opposing responsible amend-

[24] JCX–10–97, Id., at 62.

ment to the Mining Law seek changes that would make mining on public lands nearly impossible. The President's proposal to increase the tax burden on certain hardrock mines would appear to be part of a sustained and coordinated effort to accomplish that goal.

It is a serious misconception to think that minerals mined on federal lands are free for the taking—that mining companies receive something for nothing and are therefore recipients of so-called "corporate welfare." The NMA wishes to set the record straight.

Minerals have no worth if left in the ground undiscovered in the hundreds of millions of acres of unused land controlled by the federal government. They only attain value after they are discovered and produced. And they won't be produced unless there is significant investment and a financial risk shouldered by the mining industry.

The pamphlet prepared by the Joint Committee on Taxation describing the President's fiscal 1999 tax proposals (Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's fiscal Year 1999 Budget Proposals (JCS–4–98), February 24, 1998) states that: Once a claimed mineral deposit is determined to be economically recoverable, and at least $500 of development work has been performed, the claim holder may apply for a "patent" to obtain full title to the land for $2.50 or $5.00 per acre.

The Committee should note that considerable funds must be expended in order to demonstrate to the satisfaction of the federal government that the claim contains an "economically recoverable" mineral deposit. The Nevada office of the Bureau of Land Management reports that: In Nevada, mineral patent applications have contained from one to 500 claims/sites per application. At a minimum it will cost an applicant $37,900 in direct costs to process a single claim or mill site. Cost can and do go much higher.

The $2.50 or $5.00 per acre fee note in the pamphlet is merely a patent application fee. The costs a mining company must incur to get to the patenting phase usually run in excess of $2,000 per acre, or $40,000 per 20-acre claim. It is impossible to obtain a patent simply by writing a check to the government for $2.50 or $5.00 per acre—a fact conveniently overlooked by mining's critics. Obtaining a patent is an expensive, time-consuming, laborious and by no means guaranteed process.

With or without a patent, a significant amount of capital must then be invested to develop the mine and build the necessary infrastructure to process raw ore into an acceptable product. It is not uncommon to spend in excess of $400 million to bring a domestic world-scale mine into production. The cost of processing facilities is high: A state-of-the-art smelter can have capital costs approaching $1 billion. To argue that minerals are "free for the taking" and mining companies are recipients of so-called corporate welfare is fallacious at best.

### THE IMPORTANCE OF THE DOMESTIC MINING INDUSTRY

The President's proposal coupled with other legislative and regulatory initiatives is effectively placing much federally controlled land off-limits to mineral exploration and is making the United States an increasingly hostile business environment for mining investment. As mining companies must continuously search for new reserves or literally mine themselves out of business, this negative environment is increasingly forcing them to look overseas for new exploration projects.

The NMA believes it is in the vital interest of the United States to have a viable domestic mining industry. A study prepared by the Western Economic Analysis Center reports that the domestic mining industry, directly and indirectly, accounts for significant economic activity—$524 billion in 1995 alone. It is beyond a doubt that continued economic growth and improvements in the standard of living for all Americans will depend upon a reliable supply of energy and raw materials. The U.S. mining industry has the potential to provide much of our resource needs—if it is allowed to do so.

### IMPACT OF REPEAL

Increasing the tax burden on the mining industry is effectively an increase in production costs. Because minerals are commodities traded in the international marketplace at prices determined by worldwide supply and demand factors, mining companies cannot recover higher costs by raising prices.

This tax increase is likely to have the following short- and long-term disruptive effects on the industry:

• Reduce the operating lives of many mines by increasing the ore cut-off grade. Minerals that would otherwise have been economic to extract will remain in the

ground and not be recovered, resulting in poor stewardship of our natural resources. Existing jobs, federal, state and local tax revenues will be lost.

• Higher taxes will reduce a company's ability to make the necessary investment in existing operations to improve production efficiencies and respond to constantly changing environmental, reclamation, health and safety standards.

• Investment in new projects will decline. This change to long-standing tax policy will adversely affect the economics of new projects. Many new projects will become uneconomic, resulting in lost opportunities for new jobs and tax revenues.

Clearly, the long-term consequences of this tax increase are serious. Without continuous investment in new domestic projects to replace old mines, mineral production in the United States will decline. The increasing short-fall between the nation's demand for mineral products and domestic supply will then be satisfied by imports of minerals mined by overseas by foreign workers. U. S. exports will become jobs and many areas of the country will experience economic decline and an erosion of state and local tax bases.

Despite the continued overall growth of the economy, the copper and gold metals mining industry (the primary target of the Administration's proposal) has entered into a serious cyclical decline. The price of gold is at its lowest point in 18 years (having declined over 25% in the last year) and the price of copper has declined over 30% in less than one year. Many mining companies are struggling to remain profitable and keep mines open and miners working to weather this downturn. Indeed, several companies have already announced mine closures and significant layoffs in the past six months.

### THE DEPLETION ALLOWANCE

The mining industry is characterized by relative rarity of commercially viable mineral deposits, high economic risks, geologic unknowns, high capital requirements and long lead times for development of new mines. The depletion allowance recognizes the unique nature of mineral extraction by providing a rational and realistic method of measuring the decreasing value of a deposit as minerals are extracted. As the replacement cost of a new mine is always higher in real terms than the mine it replaces, the allowance helps generate the capital needed to bring new mines into production.

### THE NEED FOR TAX REDUCTIONS

The mining industry (and other capital-intensive industries) already pay high average tax rates through the application of the corporate alternative minimum tax (AMT). The General Accounting Office in a 1995 study reported that the average effective tax rate for mining companies under the AMT is 32 percent. The AMT gives the United States the worst capital cost recovery system in the industrialized world. Rather than increasing the tax burden on mining, as proposed by the Administration, it should be reduced by reform of the corporate AMT.

### CONCLUSION

We urge the Committee and the Congress to reject this job-killing and self-defeating tax increase targeted at the mining industry. Instead, Congress should pass tax legislation designed to foster investment and economic growth in mining and other capital intensive industries and should include reform of the corporate AMT.

## Statement of National Realty Committee

National Realty Committee appreciates the opportunity to submit comments for the record of the February 25, 1998 hearing of the House Committee on Ways and Means regarding the revenue provisions of the Administration's fiscal year 1999 budget proposal.

National Realty Committee serves as Real Estate's Roundtable in Washington on national issues affecting real estate. Its members are America's leading public and private real estate owners, advisors, builders, investors, lenders and managers. The Administration's budget contains proposals that could significantly affect the real estate industry, some positively and others negatively, and we look forward to working with the Committee as it deliberates on these proposals.

REVENUE INCREASES IN PRESIDENT'S BUDGET PROPOSAL

*Real Estate Investment Trust (REIT) Proposals*

The Administration's proposed fiscal year 1999 budget includes four proposals that could substantially affect important aspects regarding the formation, operation and management of Real Estate Investment Trusts (REITs). The securitization of real estate through REITs that has occurred in the 1990s has been an important factor in the recovery of the real estate industry which itself is making a significant contribution to the strength of the overall economy. We are greatly concerned with the impact the Administration's proposals could have on capital flows to real estate and the potential resulting negative effect on asset values and jobs. Therefore, we urge you to carefully review these proposals to determine fully the nature and scope of any true abuses concerning REITs and act only to the extent required to address those specific problems.

Before discussing the Administration's individual proposals, we believe it would be useful to provide the Committee with some context and background concerning the important role of REITs in the real estate marketplace, their benefit to overall economic growth, and the general policy approach to this vehicle that we would urge.

*The Real Estate Crisis of the Late 1980s and Early 1990s*

Today's real estate markets, as a whole, are in overall good health. Interest rates and inflation are low; availability of capital and credit is good; and demand for work and shopping space, in most regions, is relatively strong. In the late 1980s and early 1990s, however, the economy was teetering on a recession and the real estate industry itself was close to experiencing a depression. During this period, the demand for building space had fallen with the fortunes of the economy. Over-building that occurred in the 1980s flooded some markets, driving vacancy rates up even further. Exacerbating the situation was the "credit crunch" that the commercial real estate industry faced. Many owners of commercial real estate properties experienced difficulties in obtaining reasonable financing, including the refinancing of existing properties—whether or not the property was performing. This dearth of capital contributed to a severe nationwide drop of property values, dampened investment returns, increased bankruptcies and foreclosures, and caused tremendous job losses. In turn, this resulted in a material erosion in state and local tax bases, which adversely impacted community services.

*The Role of REITs in the Recovery of Real Estate and the Economy*

One of the primary catalysts in real estate's recovery in the 1990s has been the emergence of the REIT as a broad-based public ownership entity. The REIT, along with the development and growth of the commercial mortgage-backed securities market, has provided real estate with access to much-needed funding via the public debt and equity markets. Such access to capital enabled billions of dollars of real estate to be recapitalized—thus stabilizing asset values nationwide and easing the tremendous negative pressure being placed on lenders' portfolios. These positive actions contributed significantly toward setting the nation on a course of job-creating economic growth.

REITs, in effect, act as real estate mutual funds by securitizing real estate equity and providing investors with a liquid investment in a diversified pool of real estate assets. Like stock mutual funds, this lowers the risk to investors, which in turn lowers the cost of capital to the REIT. The growth of REITs also increased the number and types of real estate investors, thereby opening new capital sources to real estate and reassuring traditional lending sources.

Today, REITs are the fastest growing form of real estate investment. In the last five years, the market value of REITs has increased from $10 billion to almost $150 billion. There are a total of 210 publicly traded REITs, approximately 45 of which have capitalizations exceeding $1 billion. This represents an extraordinary growth rate that has been positive for real estate values, whether publicly-held or privately-held.

Because real estate represents about 12 percent of America's gross domestic product, this in turn has produced positive ripple effects for the overall economy. Real estate accounts for nearly 9 million jobs in America. About $293 billion in tax revenues is generated annually by real estate, and almost 70% of all tax revenues raised by local governments come from real property taxes. Unquestionably, real estate is a vital and major contributor to the nation's economy and REITs play a significant, and growing, role in the real estate industry.

In short, the real estate markets and the nation's economy are being well served by the current capital formation and operational flexibility of REITs. This flexibility

should be preserved—particularly in anticipation of an inevitable economic downturn during which challenges to capital formation will be magnified.

*REITs Pay Significant Level of Tax Relative to Market Capitalization*

Contrary to the perception prevalent in a number of news articles and editorials, REITs are not a vehicle for tax avoidance. This misunderstanding presents a serious concern because of its potential to misinform policymakers and the public. Although REITs do not, themselves, pay Federal corporate level tax (so long as they distribute 95 percent of their taxable income annually), they are responsible, directly and indirectly, for a significant amount of tax revenues relative to their market capitalization. In 1997, REITs distributed $8 billion in dividends which are taxable to their shareholders for Federal and state income tax purposes. REITs themselves also pay substantial amounts in state and local taxes and payroll taxes.

*Congress's Proper Approach toward REITs*

Over the years, REIT tax laws have been modified and refined by Congress and the Treasury Department to ensure that REITs are able effectively to fulfill their mission in a changing economic and business environment. Federal tax policy should continue to provide this type of flexibility and reflect an understanding of the benefits REITs provide to the vitality of today's real estate markets and the overall economy.

Congress, and notably this Committee, has avoided any dramatic policy shifts affecting REITs, particularly during their recent proliferation and expansion. Your approach toward REIT policy has been measured and thoughtful, as evidenced by: (i) the liberalization of the independent contractor requirement by the Tax Reform Act of 1986, which enabled REITs to avoid the unnecessary expense of hiring independent contractors for routine management functions; (ii) the amendment of the closely held rules, in the Revenue Reconciliation Act of 1993, to allow a "look through" for pension funds investing in REITs; and (iii) the enactment of the REIT simplification provisions as part of the Taxpayer Relief Act of 1997. Collectively, these changes modernized the REIT tax regime, resulting in enhanced ability to raise capital, more efficient organization and improved flexibility to provide services to tenants, thereby maintaining the overall competitiveness of REITs.

This carefully thought-through and deliberative course of action should be continued. Therefore, as you consider the Administration's REIT proposals, and REIT policies in general, we urge you to proceed carefully. REITs are an important capital source for real estate that should not be impaired. Although none of the individual REIT proposals in the President's budget proposal would alone cripple REITs, the policy goal embedded in them appears aimed at undermining the capital formation flexibility of REITs. We do not agree with that policy. We believe it is important for this Committee to continue its leading role in preserving the organizational, operational and capital formation flexibility currently afforded REITs. Our recommendations concerning the Administration's specific proposals follow.

*President's Budget REIT Related Proposals*

• Restrict impermissible businesses indirectly conducted by REITs. Current law prohibits REITs from owning more than 10% of the voting stock of another corporation (other than another REIT as a qualified REIT subsidiary). The Administration proposes that this ownership restriction be amended so that REITs be prohibited from holding stock representing more than 10 percent of the voting rights or value of the corporation.

*Recommendation:* In our view, the Administration's proposal is unnecessarily heavy-handed. It would effectively end the use of all preferred stock subsidiaries in order to correct a narrow concern. The REIT structure established by Congress allows REITs to own securities which are not considered real estate assets, so long as such securities represent not more than 25 percent of the total REIT assets and certain limitations are met. The third party preferred stock subsidiary fits within this structure.

The Administration contends that the preferred stock subsidiary is often significantly leveraged with debt held by the REIT, which generates interest deductions intended greatly to reduce or eliminate the taxable income of such subsidiary. However, these third party subsidiaries typically are service providers and do not, by their nature, require large amounts of operating capital and, thus, significant leveraging. In these cases, the Administration's concern is minimized, if nonexistent.

We would emphasize that there are a number of provisions already existing in the Internal Revenue Code that effectively prevent REITs from using these preferred stock subsidiaries in ways that avoid taxation on the subsidiary's earnings.

Some of these provisions include: the rules under Section 482 affecting the allocation of income and deductions among taxpayers; Section 269 disallowing deductions or credits relating to acquisitions made to evade or avoid taxation; and the requirements under Section 162 for deduction of rental payments and business expenses. Further, although now discontinued, the IRS, beginning in 1988, issued favorable rulings on these subsidiaries. Congress also has been aware of these subsidiaries and found no reason to act upon them even though it recently enacted a number of REIT reforms.

Since it is not clear that abuses exist in any magnitude, we must oppose this proposal. In the event there are abuses with preferred stock subsidiaries, they should be specified and corrective action taken only to the extent they cannot otherwise be addressed under existing anti-tax abuse laws. National Realty Committee looks forward to working with the Committee and the Administration in this regard.

• Modify the treatment of closely held REITs. Under this proposal—which would constitute an additional requirement for REIT qualification—any "person" (that is, corporation, partnership or trust) would be prevented from owning stock in a REIT if the person controls more than 50 percent of the total combined voting power of all classes of voting stock or more than 50 percent of the total value of shares of all classes of stock.

*Recommendation:* It is fundamental to the concept of REITs that they be widely held entities, easily and economically accessible by small investors. National Realty Committee is in full agreement with this. The Administration's enunciated reason for proposing the additional qualification requirement is a concern about possible tax avoidance transactions involving the use of closely held REITs. However, the Administration's explanation of the proposal provides little description of the transactions at issue. Before National Realty Committee can constructively comment on this provision, and certainly before Congress should consider the proposal, further clarification should be provided as to the perceived abuses targeted by the proposal.

So called "incubator REITs" sometimes have a majority shareholder corporation for a transition period in order to prepare the REIT for going public by allowing it to develop a track record. Corporate majority shareholders of private REITs are also used for legitimate state and local income and real property tax planning purposes and as a vehicle for legitimate foreign investment in real estate. We do not believe these structures lend themselves to tax abuse, and any proposal on this issue should clarify the same.

Importantly, it also needs to be clarified that this proposal would not affect a REIT's ability to own interests in another REIT or to have a qualified REIT subsidiary. A special "look-through" rule (as in the case with respect to qualified trusts under section 401(a) of the Code) should apply in determining whether a REIT owning an interest in another REIT meets the 100 or more shareholders requirement.

National Realty Committee believes that before this Committee takes any action, the tax avoidance transactions involving the use of closely held REITs generally referred to in the Administration's proposal need to be more clearly and specifically set forth. This will help qualify the issue and quantify the extent, if any, remedial action is needed. Also, it would help insure that legitimate transactions important to real estate capital formation not be unduly affected.

• Repeal tax-free conversions of C corporations to S corporations (or REITs). Under current law (Section 1374 of the Code), a C corporation that converts or merges into an S corporation does not pay tax on "built-in" gains (the excess of asset value at such time over tax basis), unless the asset is sold within 10 years of the conversion or merger. The Administration proposes repealing Section 1374 for large corporations (valued at over $5 million), so that a converting or merging corporation would, immediately thereupon, pay a tax as if it had at that moment sold its assets and distributed the proceeds to its shareholders, producing an immediate second level of tax. The Administration's proposal also would apply to C corporations that convert into or merge with REITs.

*Recommendation:* National Realty Committee, together with a broad coalition of industry and small business organizations, opposed this proposal when it was put forth by the Administration in each of the last two budget proposals. Our position is unchanged—the proposal should be rejected. The current rules taxing the "built-in" gain of assets sold within a 10-year period of electing S corporation or REIT status is a fair standard that effectively prevents tax avoidance. Imposing two levels of tax on built-in gains likely would affect the economics of most transactions so significantly that they simply would not go forward. Thus, many C corporations would be precluded from converting or merging into an S corporation or REIT. The effect would be to negate the revenue-raising impact of the provision and to impede the continuing recapitalization of commercial real estate through the access to public capital markets that REITs provide.

• Freeze the grandfathered status of stapled (also known as paired-share) REITs. This proposal would allow stapled REITs to continue to operate in their stapled form for properties held by the REIT as of "the first date of congressional committee action on this proposal." Properties acquired on or after the first date of committee action would not be allowed to be operated by the company paired with the REIT.

*Recommendation:* We believe the Committee should continue to follow for this specific company issue the historically deliberative and carefully thought-through approach it has followed in making REIT policy in general. We are opposed to any retroactive legislative measures that would undercut someone's reasonable reliance on existing law. This issue has a long and somewhat convoluted history and, as a result, most Members of Congress have a limited understanding of REITs and, more particularly, the stapled REITs. Therefore, before any action is taken on the Administration's proposal, we believe it advisable for the Committee to study further and hold hearings on this issue to determine what, if any, remedial changes are warranted to the stapled structure.

*Other Real Estate-Related Revenue Provisions*

• Eliminate non-business valuation discounts (for family limited partnerships). The budget proposal asserts that family limited partnerships are being used to take "illusory" valuation discounts on marketable assets. The proposal contends that taxpayers are making contributions of these assets to limited partnerships, gifting minority interests in the partnerships to family members, and then claiming valuation discounts based on the interest being a minority interest of a non-publicly traded business. The proposal would eliminate such valuation discounts except as they apply to "active" businesses.

*Recommendation:* National Realty Committee opposes this proposal in concept because it increases the estate tax burden and specifically because it defines marketable assets as including "real property." The reference to real property, which lacks any elaboration, could be interpreted broadly to include much of the nation's directly or indirectly family-owned real estate. In all events, further clarification by the Administration is needed to determine the definition of "real property."

Nevertheless, National Realty Committee does not believe that real property or interests in real property should be included in a proposal targeted at truly passive investments, such as publicly traded stocks and bonds. We applaud the Committee for its work last year to reduce the estate and gift tax burden and its continuing efforts to that end. This proposal would take a number of steps backward and increase the estate tax burden. As a result, successors in family-owned real estate businesses could be faced with the troubling scenario of having to sell real property in the estate (often at distressed value prices) in order to pay death taxes.

We also would point out that the Internal Revenue Service itself, in Revenue Ruling 93–12, and the courts throughout the Nation, in a large number of recent cases, have recognized that minority interests as limited partners in closely held limited partnerships do not have the same value, by any means, as would a tenant in common in the underlying assets, irrespective of the nature of the assets.

Furthermore, on a related matter, it should be clarified that, for purposes of the estate tax exclusion for qualified family-owned businesses, owning rental real estate is considered a trade or business so long as the required ownership percentage requirements are met. This would place small, family-owned real estate businesses on a level playing field with other small businesses for purposes of the up to $1.3 million unified credit amount enacted last year.

• Disallow financial institutions' ability to deduct interest expense for tax-exempt investments. Under this proposal, a financial institution that invests in tax-exempt obligations would not be allowed to deduct a portion of its interest expense in proportion to its tax-exempt investments.

*Recommendation:* National Realty Committee opposed a similar proposal last year and opposes this proposal because it would reduce corporate demand for tax-exempt securities, such as industrial development and housing bonds. Reducing corporate demand for these important investment vehicles would increase the borrowing costs of municipalities throughout the country—thus, hindering urban reinvestment activity—and it would discourage corporate investment in state and local housing bonds issued to finance housing for low and middle income families.

• Clarify the meaning of "subject to" liabilities under Section 357(c). For transfers of assets to corporations, the distinction between the assumption of a liability and the acquisition of an asset "subject to" a liability would be eliminated and a facts-and-circumstances determination would be made. In general, if indebtedness is secured by more than one asset, and any of the assets securing the indebtedness are transferred subject to the indebtedness, the transferee shall be treated as assuming an allocable portion of the liability, based on relative fair market values.

*Recommendation:* Historically, court cases have provided specific guidelines under Section 357. In National Realty Committee's view, introducing a facts-and-circumstances determination criterion without providing safe harbors would create considerable uncertainty and result in increased transaction costs. The Code as now written, combined with the present Regulations and judicial authority, should provide sufficient comfort to the Service.

• Modify the depreciation of tax-exempt use property. Under current law, "tax-exempt use property" is defined as property leased by a tax-exempt entity under lease terms designed to transfer the benefits of tax deductions that the entity would not be eligible for if it, in fact, owned the property. Currently, such property is depreciated using the straight-line method over a period equal to the greater of the property's class life (40 years for non-residential real property) or 125 percent of the lease term. The Administration contends that current law may allow depreciation deductions to accrue more rapidly than economic depreciation. Therefore, the budget proposes that tax-exempt property be depreciated using the straight-line method over a period equal to 150 percent of the property's class life (60 years). The proposal would affect property that is placed in service, becomes tax-exempt or becomes subject to a new lease after December 31, 1998.

*Recommendation:* We believe the current depreciation rules adequately prevent tax abusive transactions involving the sale and leaseback of real property of tax-exempt organizations. The current law minimum 40-year depreciation period in no way provides a recovery of costs faster than economic depreciation. On its face, the proposal appears punitive and not grounded in sound economic or tax policy. The Administration needs to demonstrate its position more clearly and convincingly.

*Tax Incentives in the Budget Proposal*

• Tax credit for energy-efficient building equipment. The Administration's budget proposes a 20 percent tax credit for the purchase of certain highly-efficient building equipment, including fuel cells, electric heat pump water heaters, advanced natural gas and residential size electric heat pumps, and advanced central air conditioners. Specific technology criteria would have to be met to be eligible for the credit. The credit would apply to purchases made between 1999 and 2004.

*Recommendation:* National Realty Committee believes the immediate objective of this proposal—encouraging energy efficiency in buildings—has merit. In preparing for the 21st century, the real estate industry, like other major industries, is looking for ways to improve its overall performance from an economic and environmental perspective. National Realty Committee has taken notice of statistics from the Department of Energy identifying office buildings as consuming about 27% of the nation's electrical supply. If this is an accurate assessment, we are surprised that, of the six specific tax credit proposals for energy efficient building equipment, only one (fuel cells) has any practical application to commercial office buildings. More specifically on the matter of the fuel cell credit, while the amount of the incentive is not insignificant, it is not yet sufficient to encourage the use of this technology except in rare circumstances.

In addition to providing incentives to the acquisition of specific building technologies, the Administration's budget seeks to encourage the development of energy efficient homes. A credit for this purpose is targeted to single family homes where there are recognized standards by which the efficiency of these structures can be readily measured. Such standards also exist, however, for energy efficiency in commercial office buildings. Given the high energy usage by this division of the building sector, it makes sense to consider analogous credits for highly efficient commercial buildings.

• Expensing of brownfield remediation costs. The Administration proposes to make permanent the deduction for brownfield remediation costs. This deduction was enacted as part of last year's budget and tax law and is scheduled to expire after December 31, 2000.

*Recommendation:* National Realty Committee supports this proposal. However, the deductibility of clean-up expenses applies only to brownfields in specifically targeted areas, such as empowerment zones. We understand the social and economic policy goals intended to be furthered by this targeted clean-up provision. However, there are almost 450 brownfields across the nation, most of which are outside of these targeted areas. Allowing some type of deductibility or amortization of clean-up costs for all of these brownfields would help restore brownfields across America to viable and productive use. We acknowledge that allowing full deductibility of these expenses could have a substantial revenue cost. Therefore, we propose modifying the Administration's proposal by treating the clean-up costs in non-targeted areas as start up expenses under Section 195 of the Code, thereby allowing them to be amortized over 60 months. This would lessen the revenue cost to the Treasury,

while providing a valuable incentive to nationwide brownfield restoration. We look forward to the opportunity to work with the Committee on this important social, economic and environmental issue.

• Low-income housing tax credit expansion. The budget proposes a major expansion of the low-income housing tax credit, which could facilitate the construction of 150,000–180,000 new affordable housing units over five years. Under the White House proposal, the annual state low-income housing credit limitation would be raised from $1.25 per capita to $1.75 per capita, beginning January 1, 1999.

*Recommendation:* National Realty Committee supports this proposal. We also support related legislation, S. 1252 in the Senate and H.R. 2990, introduced by Mr. Ensign and cosponsored by Mr. Rangel and several other Members of the Committee on a bipartisan basis. We are very encouraged by the consensus developing between the Administration and key Members of Congress on the need for increasing the amount of low income housing tax credits allocated to the states. Since its inception in 1986, this credit program has encouraged private ownership of affordable rental housing by authorizing state and local agencies to allocate tax credits to owners of low-income rental properties. The program has enabled the construction and rehabilitation of more than 120,000 rental units annually and is used in approximately 35 percent of newly constructed rental units nationally. Demand for the housing credit nationwide has exceeded its supply, and this proposal will help states respond to the increasing demand for decent and affordable rental housing.

*Conclusion*

Again, we thank Chairman Archer and the Committee for the opportunity to comment on the record regarding the revenue proposals in the President's fiscal 1999 budget. We are encouraged by the proposals to increase the low income housing tax credit, make permanent the deductibility of brownfield clean-up costs and implement credits for energy-efficient improvements for buildings. The REIT proposals cause us considerable concern, particularly with respect to preferred stock subsidiaries, closely held REITs and C corporation conversions and mergers, and we urge that you reject such proposals outright.

We look forward to working with the Committee to ensure that the provisions of the Code dealing with REITs do not lead to abuses, yet allow REITs effectively to fulfill their mission in a continually changing economic and business environment.

Finally, while we object to the proposal to eliminate realistic valuation discounts in the non-business, family limited partnership situation, we strongly believe that, in all events, including real property in such proposal is ill-advised and should be dropped from any further consideration.

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## Statement of National Structured Settlements Trade Association

### A Stringent Excise Tax on Secondary Market Companies That Purchase Structured Settlement Payments from Injured Victims Should Be Adopted, Subject to a Limited Exception for Genuine Court-Approved Hardship, to Protect Structured Settlements and the Injured Victims

#### I. Background and Policy of the Structured Settlement Tax Rules

The National Structured Settlements Trade Association (NSSTA) is an organization composed of more than 500 members which negotiate and implement structured settlements of tort and worker's compensation claims involving persons with serious, long-term physical injuries. Structured settlements provide the injured victim with the financial security of an assured payout over time. Founded in 1986, NSSTA's mission is to advance the use of structured settlements as a means of resolving physical injury claims.

*A. Background*

• Structured settlements in wide use today to resolve physical injury tort claims

Structured settlements are used to compensate seriously-injured, often profoundly disabled, tort victims. A lump sum recovery used to be the standard in tort cases. All too often, this lump sum was prematurely dissipated by the victim or his or her relatives. When the money was gone, the victim was left still disabled and still unable to work. In such cases, the State Medicaid system and welfare system were left holding the bag to care for this disabled person.

Structured settlements provide a better approach. A voluntary agreement is reached between the parties under which the injured victim receives damages in the

form of a stream of periodic payments tailored to his or her future medical expenses and basic living needs from a well-capitalized, financially-secure institution. Often this payment stream is for the rest of the victim's life to make sure that future medical expenses and the family's basic living needs will be met, and the victim will not outlive his or her compensation.

• Structured settlements provide crucial financial protection to seriously-injured tort victims

—Protection against premature dissipation by injured victims unable to handle the financial responsibilities and risks of managing a large lump sum to cover a substantial, ongoing stream of medical and basic living expenses for a lengthy period.

—Payout tailored to the needs of the particular victim.

—Avoids shift of responsibility for care to the public sector.

• Congress has adopted special tax rules to encourage and govern structured settlements

Congress has adopted a series of special rules in sections 130, 104, 461(h), and 72 of the Internal Revenue Code to govern the use of structured settlements by providing that the full amount of the periodic payments constitutes tax-free damages to the victim and that the liability to make the periodic payments to the victim may be assigned to a structured settlement assignment company that will use a financially-secure annuity to fund the damage payments.

In the Taxpayer Relief Act of 1997, in a provision co-sponsored by a majority of the House Ways and Means Committee, Congress recently extended the structured settlement tax rules to the worker's compensation area to cover physical injuries suffered in the workplace.

*B. Structured Settlement Tax Rules Were Adopted by Congress to Protect Victims from Pressure to Squander Their Recoveries*

*Congressional Policy*.—In introducing the legislation that enacted the structured settlement tax rules, Sen. Max Baucus (D–Mont.) pointed to the concern over squandering of a lump sum recovery by injured tort victims or their families:

"In the past, these awards have typically been paid by defendants to successful plaintiffs in the form of a single payment settlement. This approach has proven unsatisfactory, however, in many cases because it assumes that injured parties will wisely manage large sums of money so as to provide for their lifetime needs. In fact, many of these successful litigants, particularly minors, have dissipated their awards in a few years and are then without means of support." [Congressional Record (daily ed.) 12/10/81, at S15005.]

By contrast, Sen. Baucus noted: "Periodic payments settlements, on the other hand, provide plaintiffs with a steady income over a long period of time and insulate them from pressures to squander their awards." (Id.)

Thus, the federal tax rules adopted by Congress to govern structured settlements reflect a policy of insulating injured victims and their families from pressures to squander their awards.

In addition, Congress was concerned that the injured victim not have the ability to exercise such control over the periodic payments that he or she would be deemed to have received a lump sum recovery that was then invested on his or her behalf, destroying the fully tax-free nature of the periodic payments to the injured victim. The House Ways and Means and Senate Finance Committee Reports adopting the structured settlement tax rules both state: "Thus, the periodic payments as personal injury damages are still excludable from income only if the recipient taxpayer is not in constructive receipt of or does not have the current economic benefit of the sum required to produce the periodic payments." (H.R. Rep. No. 97–832, 97th Cong., 2d Sess. (1982), 4; Sen. Rep. No. 97–646, 97th Cong., 2d Sess. (1982), 4.)

Reflecting this Congressional policy of protecting injured victims from pressure to squander their recoveries and the need to avoid any risk of constructive receipt of a lump sum by the victim, the structured settlement tax rules prohibit the victim from being able to accelerate, defer, increase, or decrease the periodic payments. (I.R.C. § 130(c)(2)(B)). In addition, the periodic payments must constitute tax-free damages in the hands of the recipient. (I.R.C. § 130(c)(2)(D)).

In compliance with these Congressional requirements and consistent with State insurance and exemption statutes, including "spendthrift" statutes that restrict alienation of rights to payments under annuities and under various types of claims (e.g., worker's compensation and wrongful death claims), structured settlement agreements customarily provide that the periodic payments to be rendered to the injured victim may not be accelerated, deferred, increased or decreased, anticipated, sold, assigned, pledged, or encumbered by the victim.

As the Treasury Department has noted, "Consistent with the condition that the injured person not be able to accelerate, defer, increase or decrease the periodic payments, [structured settlement] agreements with injured persons uniformly contain anti-assignment clauses." (U.S. Department of the Treasury General Explanations of the Administration's Revenue Proposals (Feb. 1998), at p. 122).

## II. Purchases of Structured Settlement Payments by Secondary Market Companies Directly Undermine the Important Public Policies Served by Structured Settlements

### *A. Background*

Over the past year, there has been dramatic growth in a transaction, variously known as a "factoring," "secondary market," or "gray market" transaction, that effectively takes the structure out of structured settlements.

In such a factoring transaction, the injured victim who is receiving periodic payments of damages for physical injuries under a structured settlement sells his or her rights to future periodic payments to a secondary market company. In exchange, the injured victim receives from the secondary market company a sharply discounted lump sum payment.

This is a transaction that the injured victim enters into with a third party, completely outside of the structured settlement and generally without even the knowledge of the other parties to the structured settlement. The secondary market company is not in the structured settlement business.

In an effort to avoid the anti-assignment provisions in the structured settlement agreements, the secondary market companies typically have the injured victim simply present the structured settlement company with a change of address to a post office box under the control of the secondary market company to accomplish the redirection of payments to the secondary market company. Thus, the structured settlement company obligated to make the periodic payment damages under the structured settlement is not a party to the factoring transaction and most often has no notice of it at all.

### *B. Rapid Growth in Secondary Market Purchases of Structured Settlement Payments*

Secondary market companies use extensive advertising and telemarketing, as well as direct appeals to plaintiffs' lawyers coupled with a finder's fee, to solicit new business. For example, one major secondary market company, J.G. Wentworth, stated in a recent SEC filing that during the first 9 months of 1997 alone, it ran 56,000 television commercials. Wentworth runs a telemarketing call center with 200 telemarketing stations operating 24 hours a day, 6 days a week.

The secondary market companies direct considerable advertising at the plaintiffs' bar, promising the injured victim's lawyer a second fee on the same case—this time by unwinding the structured settlement. For example, an ad by Stone Street Capital states:

"You helped your clients once by winning them a structured settlement. Now you can help them again by showing them how to convert all or a portion of their settlement to a lump-sum payment.

"For each of your clients who exercise this exciting new option, your firm will be compensated for legal fees by facilitating the standardized processing of an annuity purchase agreement. *On average, these fees amount to about $2,000 per conversion*. [Emphasis in original]."

The secondary market business is a rapidly growing one. According to SEC filings, during the first 9 months of 1997 J.G. Wentworth alone undertook 3,759 structured settlement purchase transactions. These purchased structured settlement payments had a total undiscounted maturity value of $163.6 million and were purchased for $74.4 million. Blocks of purchased structured settlement payments are now being "securitized" by the secondary market companies and marketed on Wall Street.

### *C. Public Policy Concerns Created by Secondary Market Transactions*

Secondary market purchases of structured settlement payments create serious problems affecting all participants in structured settlements.

• Secondary market purchases of structured settlement payments trigger the very same dissipation risks that structured settlements are designed to avoid

By selling future structured settlement payments to the secondary market companies, the injured victim receives an immediate lump sum payment. Just as lump sum tort recoveries are frequently dissipated, all too often this lump sum from the secondary market company can be quickly dissipated, and the injured person finds himself or herself in the very predicament which the structured settlement was intended to avoid.

Having factored away their only assured source of future financial support and then dissipating the cash received, these injured victims may face the prospect of public assistance to cover their future medical expenses and basic living needs.

• Secondary market purchases often are made at sharp discounts

In many cases the injured victim's dissipation risks are magnified because the lump sum payment that the injured victim receives in the factoring transaction is so sharply discounted. While factoring transactions apparently reflect a range of discounts, it is not uncommon for an injured victim to receive a lump sum payment of less than 50 percent of the present value of the structured settlement payments being sold.

In one recent case, a 20-year-old structured settlement recipient who was receiving monthly payments from a tort action when she was a child was persuaded to sell a series of her future payments for approximately 36 percent of their present discounted value. A few months later, she was persuaded to sell additional future payments for approximately 15 percent of their discounted present value.

Based on this case and many similar examples, it is clear that in secondary market transactions structured settlement recipients often are persuaded to sell future payments for far less than the payments are worth.

• Secondary market transactions create serious Federal income tax uncertainties for the original parties to the structured settlement

The structured settlement tax rules require that the periodic payments constitute tax-free damages on account of personal physical injuries in the hands of the recipient of those payments. (I.R.C. § § 130(c)(2)(D); 104(a)(2)). Following the factoring away by the injured victim, the periodic payments now would be received by the secondary market company and its investors and would not constitute tax-free damages in their hands. This creates serious Federal income tax uncertainties under the structured settlement tax rules for both the victim and the company funding the structured settlement.

*Injured victim*

• The injured victim not only loses the benefit of the future tax-free damage payments, but also runs a risk of being taxed on the lump sum received from the secondary market company if such payment is treated as received on account of the sale of the victim's future payment rights and not on account of the original injury.

• If the structured settlement payments were freely assignable by the injured victim and a ready market of financial institutions was available to acquire such payments, the victim might be deemed in constructive receipt of the present value of the future payments just as if the payments could be accelerated. In that case, from the outset of the settlement a portion of each periodic payment would be treated as taxable earnings, rather than tax-free damages.

*Company funding the structured settlement.*—Under the structured settlement tax rules, the settling defendant (or its liability insurer) assigns its periodic payment liability to a structured settlement company in exchange for a payment which is excluded from the structured settlement company's income if the structured settlement tax rules under I.R.C. § 130 are satisfied and such payment is reinvested in either an annuity or U.S. Treasury obligations precisely matched in amount and timing to the periodic payment obligation to the injured victim. The structured settlement company's income from the payments under the annuity or Treasuries is matched by an offsetting deduction for the damage payment to the victim.

• The factoring transaction raises the concern that the structured settlement tax rules no longer may be satisfied and the risk that the structured settlement company may be required to recognize and pay tax on amounts previously excluded from its income or to pay tax on the "inside build-up" under the annuity, for which there is no cash distribution to pay the tax.

• The structured settlement company may face an obligation to report the payments made to the secondary market company as taxable income even though in many cases the identity of the purchaser or even the existence of the factoring transaction itself is unknown.

• Secondary market transactions create risks of double liability for the structured settlement companies

While factoring transactions normally involve only the injured victim and the secondary market company, the underlying structured settlements typically involve multiple parties such as family members, defendants, liability insurers, and state workers' compensation authorities in workers' compensation cases. Because structured settlement agreements prohibit transfers of payments, if the structured settlement company makes the payments—even unwittingly—to the secondary market company, the structured settlement company may become subject to later claims that it paid the wrong party and could still be required to make the payments as originally required under the settlement.

In many cases this risk of double liability is magnified by state statutes that (i) in more than 20 states give statutory effect to contract provisions prohibiting transfers of annuity benefits and (ii) in nearly all States directly restrict or prohibit transfers of recoveries in various types of cases (e.g., workers' compensation, wrongful death, medical malpractice).

• The uncertainties created by secondary market transactions may discourage future use of structured settlements

These tax risks and double liability risks raised by the factoring transaction are risks that the structured settlement company specifically sought to avoid through the anti-assignment provisions in the structured settlement agreement and is not in a financial position to absorb, years after the original structured settlement transaction was entered into.

These uncertainties and unforeseen risks could jeopardize the continued ability of structured settlement companies to fund settlements in the future. The structured settlement company's participation is necessary to enable structured settlements to be undertaken in the first instance by satisfying the objectives of both sides to the claim: the injured victim needs the long-term financial protection that the structured settlement company's funding arrangement provides, and the settling defendant wishes to close its books on the liability rather than bearing an ongoing payment obligation decades into the future.

## III. A Stringent Excise Tax on Secondary Market Purchasers, Subject to a Limited Exception for Genuine, Court-Approved Hardship, Protects Structured Settlements, the Injured Recipients, and the Congressional Policy Underlying Structured Settlements

### *A. Gravity of Problem Requires Strong Action by Congress*

In acting to address the concerns over secondary market companies that purchase structured settlement payments from injured victims the Treasury Department noted that: "Congress enacted favorable tax rules intended to encourage the use of structured settlements—and conditioned such tax treatment on the injured person's inability to accelerate, defer, increase or decrease the periodic payments—because recipients of structured settlements are less likely than recipients of lump sum awards to consume their awards too quickly and require public assistance." (U.S. Department of the Treasury, General Explanations of the Administration's Revenue Proposals (Feb. 1998), p. 122).

Treasury then observed that by enticing injured victims to sell off their future structured settlement payments in exchange for a heavily discounted lump sum that may then be dissipated: *"These 'factoring transactions' directly undermine the Congressional objective to create an incentive for injured persons to receive periodic payments as settlements of personal injury claims."* (Id., at p. 122 [emphasis added].)

The Joint Tax Committee's analysis of the issue echoes these concerns: "Transfer of the payment stream under a structured settlement arrangement arguably subverts the purpose of the Code to promote structured settlements for injured persons. (Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 1999 Budget Proposal (JCS–4–98), (February 24, 1998), p. 223).

While noting that the States traditionally have been the province of consumer protection, the Joint Committee's analysis reasons that there is a clear role for the Federal tax law to address the policy concerns raised by sales of structured settlement payments: "On the other hand, the tax law already provides an incentive for structured settlement arrangements, and if practices have evolved that are inconsistent with its purpose, addressing them should be viewed as proper." (Joint Committee Description, supra, at p. 223).

### *B. Administration Proposal*

The Treasury Department in the Administration's FY 1999 Budget has proposed a 20-percent excise tax on secondary market companies that purchase structured settlement payments from injured victims.

Under the Administration's proposal, "any person purchasing (or otherwise acquiring for consideration) a structured settlement payment stream would be subject to a 20 percent excise tax on the purchase price, unless such purchase is pursuant to a court order finding that the extraordinary and unanticipated needs of the original recipient render such a transaction desirable." (Treasury General Explanation, at p. 122). The proposal would apply to transfers of structured settlement payments made after date of enactment.

The Administration's proposal represents a serious, constructive step to address the policy concerns raised by the purchases of structured settlement payments and to protect injured victims.

*C. An Even Stronger Solution Is Necessary to Fully Protect Structured Settlements and Injured Victims: A Stringent Excise Tax Rate on the Discount Subject Only To a Limited Exception for a Genuine, Court-Approved Hardship*

1. Stringent excise tax to address serious public policy *concerns raised by factoring transactions*

In its analysis of the Administration's proposal, the Joint Committee notes the potential concern that in some cases the imposition of a 20-percent excise tax may result in the secondary market company reducing even further the already-heavily discounted lump sum paid to the injured victim for his or her structured settlement payments. The Joint Committee notes that "[o]ne possible response to the concern relating to excessively discounted payments might be to raise the excise tax to a level that is certain to stop the transfers (perhaps 100 percent) . . . ." (Joint Committee Description, supra, at p. 223).

Secondary market purchases of structured settlement payments so directly subvert the Congressional policy underlying structured settlements and raise such serious concerns for structured settlements and the injured victims that it is appropriate to impose on the secondary market company a more stringent excise tax rate on the amount of the discount reflected in the secondary market purchase. Thus, unlike the Administration's proposed tax imposed on the purchase price, this excise tax imposed on the secondary market company would use a more stringent tax rate and would apply to the difference between the total face amount of the structured settlement payments purchased by the secondary market company and the heavily discounted lump sum paid to the injured victim. As a possible alternative, the more stringent excise tax rate could be applied against a tax base that is the greater of (i) the amount of the discount (the difference between the total face amount of payments purchased by the secondary market company and the lump sum paid to the victim), or (ii) the present value as determined under I.R.C. § 7520 (interest rate for annuity valuation for estate tax purposes) of the face amount of the payments being purchased by the secondary market company.

2. *Limited exception for genuine, court-approved hardship*

This stringent excise tax would be coupled with a limited exception for genuine, court-approved financial hardship situations. Drawing upon the hardship standard enunciated in the Treasury proposal, the excise tax would apply to secondary market companies in all structured settlement purchase transactions except in the case of a transaction that is pursuant to a court order finding that "the extraordinary, imminent, and unanticipated needs of the structured settlement recipient or his or her dependents render such a transaction appropriate and a further finding that the proposed transfer is not expected to subject the structured settlement recipient or his or her dependents to undue financial hardship in the future."

This exception is intended to apply only to a limited number of cases in which a genuinely "extraordinary, imminent, and unanticipated" hardship actually has arisen (e.g., serious medical emergency for a family member) has been demonstrated to the satisfaction of a court, as well as a showing that transferring away such payments will not leave the injured victim and his or her family exposed to undue financial hardship in the future when the structured settlement payments no longer are available.

3. Need to protect the tax treatment of the *original structured settlement*

In the limited instances of extraordinary and unanticipated hardship determined by court order to warrant relief, adverse tax consequences should not be visited upon the claimant or the other parties to the original structured settlement. Accordingly, the proposal would clarify in the statute or the legislative history that in those limited instances in which the extraordinary, imminent, and unanticipated hardship standard is found to be met by a court, the original tax treatment of the structured settlement under I.R.C. § § 104, 130, 72, and 461(h) would be left undisturbed.

That is, the periodic payments already received by the claimant prior to any factoring transaction would remain tax-free damages under Code section 104. The assignee's exclusion of income under Code section 130 arising from satisfaction of all of the section 130 qualified assignment rules at the time the structured settlement was entered into years earlier would not be challenged. Similarly, the settling defendant's deduction under Code section 461(h) of the amount paid to the assignee to assume the liability would not be challenged. Finally, the status under Code section 72 of the annuity being used to fund the periodic payments would remain undisturbed.

Despite the anti-assignment provisions included in the structured settlement agreements and the applicability of a stringent excise tax on the secondary market company, there may be a limited number of non-hardship factoring transactions that still go forward. If the structured settlement tax rules under I.R.C. § § 130, 72, and 461(h) had been satisfied at the time of the structured settlement and the applicable structured settlement agreements included an anti-assignment provision, the original tax treatment of the other parties to the settlement—i.e., the settling defendant and the Code section 130 assignee—should not be jeopardized by a third party transaction that occurs years later and likely unbeknownst to these other parties to the original settlement.

Accordingly, the proposal also would clarify in the case of a non-hardship factoring transaction, that if the structured settlement tax rules under I.R.C. § § 130, 72, and 461(h) had been satisfied at the time of the structured settlement and the applicable structured settlement agreements included an anti-assignment provision, the section 130 exclusion of the assignee, the section 461(h) deduction of the settling defendant, and the Code section 72 status of the annuity being used to fund the periodic payments would remain undisturbed.

Finally, the proposal would clarify the tax reporting obligations of the annuity issuer and section 130 assignee in the event of a factoring transaction. In the case of a factoring transaction, either on a court-approved hardship basis or a non-hardship basis, of which the annuity issuer has actual notice and knowledge, assuming that a tax reporting obligation otherwise would be applicable, the annuity issuer would be obligated to file an information report with the I.R.S. noting the fact of the transfer, the identity of the original payee, and the identity where known of the new recipient of the factored payments. No reporting obligation would exist where the annuity issuer (or section 130 assignee) had no knowledge of the factoring transaction.

## CONCLUSION

The imposition on secondary market companies of a stringent excise tax on the amount of the discount reflected in the purchase of structured settlement payments, subject to a limited exception for "extraordinary, imminent, and unanticipated" hardship, fully protects structured settlements, the injured victims, and the Congressional policy underlying structured settlements. The proposal should be enacted as part of any tax legislation considered by Congress this year.

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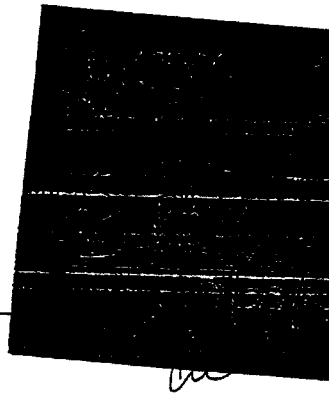

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# Lure of quick cash de-structures some settlements

By MARTHA NEIL
Law Bulletin staff writer

**Part One**

*Tuesday: A look at a new state law requiring court approval for sale of a structured settlement.*

Need money right away? Dial 1-888-WHY-WAIT.

That was the pitch being made recently on one Chicago cable television system by Stone Street Capital, part of a controversial industry that offers recipients of structured settlements a chance to trade future income for immediate lump-sum payments.

Advertisements like this — which appear on radio, television and the Internet, with some offering inducements such as a trip to the Bahamas to enter into a deal using a particular funding company or broker — are becoming commonplace.

But companies participating in the structured settlement resale market may find the business climate in Illinois got a bit chillier on Jan. 1. That was the effective date of a new state law requiring recipients to get court approval before selling structured settlements in the so-called secondary market.

Some opponents of the practice say the statute amounts to a swan song for the settlement purchasers, but industry representatives say the law won't close down their business, only make it more expensive and time-consuming for beneficiaries to sell.

Structured settlements are used in tort cases as a means of providing a series of payments over a period of time to claimants or their survivors, either instead of or in addition to a lump-sum payment. Generally, the defendants who offer structured settlements are insurance companies rather than individuals.

Over the last decade or so, a "secondary market" has developed in which companies — also known as "factors" — purchase the future income for a fraction of its present value.

The settlement purchasers, as they prefer to call themselves, got their start buying the installment payments due to lottery winners.

To make a transaction work, the industry employs such creative methods as having the beneficiary file a "change of address" notice and establish a power of attorney allowing the funding company to cash the checks when they arrive.

Critics say settlement purchasers frequently take advantage of vulnerable, financially unsophisticated beneficiaries, paying them far less than their future income stream is worth. Lured by what seems like a lot of immediate cash, payees swap the security of long-term income for a chance to go on a spending spree, opponents contend.

"Some of the stories you hear about discount rates cause you to lie awake at night. We have seen documented cases in which factoring companies paid 50 percent, 30 percent, or even 20 percent or less of the present value of the payments," said Craig H. Ulman.

A partner at the Washington, D.C., law firm of Hogan & Hartson, Ulman represents the National Structured Settlements Trade Association, comprised of insurers who fund and administer struc-

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# Lump sum

Continued from page 1

tured settlements.

Concern over the possible consequences of such practices is not new. Even before the Illinois legislation requiring court approval was adopted, the contracts establishing structured settlements generally prohibited subsequent sale of the income stream. But this has not prevented funding companies from plying their trade.

Indeed, the Stone Street commercial offering quick cash assured listeners that "you have the right to change your mind at any time" and accept a one-time outlay rather than payments over time.

Industry representatives say settlement purchasing serves people who need cash for legitimate reasons. Circumstances change, unanticipated expenses arise, and payees should have the right to set their own financial course without government interference, they say.

"We're a release valve for situations that don't work anymore," said Edward S. Stone. An attorney practicing in New York City and Connecticut, he is a director and part owner of Philadelphia-based J.G. Wentworth & Co., one of the industry leaders, and is treasurer of the National Association of Settlement Purchasers, whose member companies fund or broker structured settlement purchases.

But "release valve" isn't quite how Ulman, the structured settlement association counsel, perceives the sale of a structured settlement.

He cites the example of one beneficiary who recently sold 10 years' worth of $250-per-month payments, which would have amounted to a total of $30,000 over the decade-long payment schedule.

The present value of the payments was calculated by an actuary at about $22,000, Ulman said, but the funding company paid the beneficiary only about $8,050.

"They paid 36.6 percent of present value," Ulman said.

And regardless of whether the price is fair, said noted personal-injury lawyer Philip H. Corboy, the sale of a structured settlement defeats the purpose of the instrument: to prevent an accident victim who may be unable to work from throwing away money intended to last a lifetime on impulse purchases.

"These people who are in this business are preying on the most seriously vulnerable people in the world," Corboy said. "If they were not vulnerable, their lawyer would not have recommended a structured settlement. It's really like a spendthrift provision in a will."

Tactics used by the industry to persuade beneficiaries to sell structured settlements have also raised questions, critics say.

Stone Street, for instance, has on its Internet Web site a "sample" letter lawyers can use to tell clients that it "would seem prudent at least to receive a free quote on the total amount you could receive as a lump sum" from Stone Street.

The sample letter doesn't mention the Maryland-based settlement purchaser's "fee reimbursement program" which compensates attorneys "for legal fees incurred in connection with concluding the transaction ... at the time of closing." But the Web site does.

Corboy, who said he was incensed to see a settlement purchaser among the advertisers at a recent trade show for East Coast personal-injury attorneys, contends that reputable lawyers will not cooperate in soliciting clients as potential clients for the so-called secondary market.

Some companies in the industry probably are "gouging people" on occasion, concedes Gregory J. Cipriano, general counsel for Montclair Financial Group, a New Jersey-based broker.

But instead of forbidding beneficiaries to make their own financial decisions, regulation should be employed to educate potential sellers about the advantages of shopping around for the best deal, Cipriano said. "This is America."

With cash in hand, payees can buy something of long-term value, such as a home, a car or a business, or use the money to reduce debt or make an investment, Cipriano said.

Those who don't sell often dissipate relatively small sums on trivial purchases, he contends: "A lot of people get these monthly payments and then never see anything from it."

Opponents wrongly portray sellers as uniformly vulnerable and financially unsophisticated, Cipriano and others say.

"We just did a transaction the other day with a gentleman who is an attorney," said Earl S. Nesbitt, general counsel for Dallas-based Settlement Capital Corp. "The reason he wanted to liquidate his structured settlement was so that he could pay some taxes he owes. I think that is a very good reason."

And this is typical, said Kiplund R. Kollmeier, a Sidley & Austin partner and who lobbies on behalf of Wentworth in Springfield.

Some 20 percent of all structured settlement purchases are from the original payee's estate, and another 20 percent are from beneficiaries of a wrongful-death claim, Kollmeier said. Hence, a seller isn't necessarily disabled, unable to work, or irresponsible with money, he contended.

At least a few payees are in fact quite sophisticated in matters financial, according to Cipriano: the secondary market had to set up a national listing of sellers to prevent some of the industry's so-called victims from repeatedly cashing out the same future income stream with different settlement purchasers.

Settlement purchasers apply a discount rate — between 14 percent and 25 percent probably is a "typical range" — to determine how much to pay beneficiaries for their future income, said David M. Lewis. He is a partner with Lewis, Goldberg & Bell in McLean, Va., which acts as general counsel for Stone Street.

Using these discount rates and the example provided by Ulman, in which a beneficiary sells 10 years' worth of $250-per-month payments, a typical funding company would likely offer to pay a beneficiary little more than half, at most, of the $30,000 total future income, according to Nesbitt. At a discount rate of 14 percent, the present value of the $30,000 future income would be about $16,100, and at a 25 percent discount rate it would be about $11,000.

To value the $30,000 future income around $22,000, as Ulman said an actuary did, it would be necessary to apply a discount rate of about 6.5 percent, according to Nesbitt.

The 6.5 percent discount rate is in line with the interest rate being paid on 10-year Treasury notes, which Ulman said is considered to be an appropriate measure of present value for structured settlements extending a decade into the future. But that is significantly less than the discount rate a funding company ordinarily would use to determine the present value of a structured settlement, Nesbitt said.

At double-digit discount rates, selling a structured settlement is similar, in terms of the cost of the cash to the selling beneficiary, to taking out a loan against a credit card, Lewis and other funding company representatives agreed. But "these people, mostly, cannot even do that," Lewis said of the beneficiaries who sell structured settlements. "They've already maxed out on their credit cards."

Plus, compared to borrowing against a credit card, selling a structured settlement offers one big advantage to the seller, Lewis said. By accepting a cash offer at a high discount rate, "they've given something up, but they don't owe anything back."

Some $3 to $5 billion annually is spent by insurance companies on premiums to fund 40,000 to 50,000 structured settlements, according to Stone, the lawyer involved in J.G. Wentworth & Co. No one knows with certainty how many of these structured settlements are bought from beneficiaries each year, Stone said, but he estimates perhaps one percent. Although structured settlements were first purchased in the secondary market in about 1989, he said, Wentworth began buying a substantial number only in 1995.

Now recognized by the industry as the biggest settlement purchaser in the business, Wentworth recently filed a registration statement with the Securities and Exchange Commission seeking permission to make an initial public offering of its stock.

The funding company has had enough receivables from its purchases of structured settlements to make it worthwhile to pool them in several securitized private placements of investment-grade notes, according to Stone.

"All of our buyers are insurance companies," he noted.

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Pro Bono: Volunteer lawyers aid immigrants, juveniles. **Pages C13–C14**

# Selling Out Structured Settlements

Abuses in secondary market lead to reform legislation.

BY GAIL DIANE COX
NATIONAL LAW JOURNAL STAFF REPORTER

CRYSTAL A. DAY recalls her excitement when she saw a commercial for a company offering to buy out annuity contracts.

The Westwego, La., woman is raising two children on $472 a month from Supplemental Security Income plus a twice-a-year, $4,123 check she receives under a 1991 structured settlement of her personal injury lawsuit. According to correspondence she sent last May to Continental Casualty Co., the insurance company that mails her periodic payments to her, a one-time buyout from a settlement-purchasing company sounded good because the ready cash would let her get ahead of her bills.

She expected to lose money in the deal—papers from the would-be purchaser indicated that she would have gotten a lump sum of $8,155 in return for signing over the three remaining $4,123 settlement checks.

But it wasn't the purchase price that scotched the deal. As Ms. Day tells it, what was initially presented as a routine procedure became increasingly "under-

# Critics Want Rules For Structured Settlements

['SETTLEMENTS' FROM PAGE 81]
plaining to her they "had to figure out a way to fool my insurance company." She says the woman she dealt with "exploded" when she said she'd already called Continental Casualty, and later Ms. Day was dropped with the explanation "that I messed up not only my chance of receiving a pay-off, but that I also messed up other people's chances as well."

Ms. Day's account—as well as the stories of others—illustrates a predatory trend that cries out for regulation, argued Randy Dyer, executive director of the National Structured Settlement Trade Association, or NSSTA. "Structured settlement payments are intended to compensate physically injured people for loss of earnings, medical expenses, physical and occupational therapy and the like," said Mr. Dyer, noting that many of the settlement purchasing companies that offer to "unwind" periodic payments got their start buying lottery winners' periodic payments.

Randy Dyer

But "unlike lottery winnings, structured settlement payments are not found money," Mr. Dyer continued, and the risk that some might squander lump-sum court awards prompted Congress to amend the Internal Revenue Code in 1982 to encourage structured settlements. Mr. Dyer suggested that the tax benefits of structured settlements could be forfeited if they go through a repurchase but acknowledged that guidelines to cover such sales have never been issued.

Widespread publicity—advertising as well as news of default judgments and garnishments when deals went sour—have made the gray market in settlements less secretive, said Craig Ulman, a contracts specialist and partner at Washington, D.C.'s Hogan & Hartson L.L.P. who sometimes advises the NSSTA.

He explained that, as with Ms. Day's proposed transaction, the deal is typically presented as a purchase rather than a loan to avoid laws against usury. In addition, some deals may require the seller to confirm that he or she is not dependent on the payments, in order to avoid criticism that sales may deprive sellers of their livelihoods, Mr. Ulman said.

The companies that purchase structured settlements, however, claim they are merely enlarging the options for former plaintiffs and that selling settlement income rights on the secondary market can be cheaper and faster than going back to court to reconstruct a settlement that has become unsatisfactory.

"We offer a way for them to cash in on their income stream," said Dean Schiernbeck, chief executive of Mutual Funding Group of San Diego, which had a kiosk at this month's American Bar Association convention in San Francisco. He describes Mutual Funding as the biggest buyer of settlement annuities in the country, even though it only entered the field in 1994.

Earl Nesbitt, counsel to Settlement Capital Corp., a Dallas company that has been buying structured settlements since 1989, added that it's not realistic to assume that some recipients don't simply "outgrow" their structure.

David Lewis, spokesman for another purchaser, Stone Street Capital of Bethesda, Md., agreed. His company can help former plaintiffs cope with college bills, mortgage down payments and other expenses not anticipated when the structure was created, he said. And if discounts appear high, he added, it may be because a lack of cooperation from annuity issuers can make his company's job labor-intensive.

Cash-flow purchasers noted that they also have a stake in maintaining the reputation of their industry. In mid-1996, the president of Stone Street Capital was among the founders of a new trade association, the National Structured Settlement Purchase Association (later changed to National Association of Settlement Purchasers, or NASP).

NASP's code of ethics includes observing "high standards of commercial honor and just and equitable principles of trade." Last month, Mr. Nesbitt was quoted in the newsletter National Underwriter as predicting that by summer's end, NASP would represent some 100 purchasing consultants as well as seven major companies.

In the continuing debate, the critics at the NSSTA can count several recent victories. On Aug. 1, Illinois Gov. Jim Edgar signed into law H.B. 1410, amending the state insurance code to state that no one who is a beneficiary of a structured settlement for personal injury "may assign in any manner the payments without prior approval of the circuit court." The law also bars companies holding settlement annuities from making payments to anyone other than the designated recipient without court approval.

The Texas Legislature also recently voted down a bill that would have explicitly allowed such settlement sales if they were designated as "voluntary."

As part of its lobbying against H.B. 923, the NSSTA gave Texas lawmakers an account of a parent of an injured child who allegedly conspired with a settlement-purchasing company to divert payments slated to be held in trust.

## Statement of Nationwide Insurance Enterprise

The Nationwide Insurance Enterprise, headquartered in Columbus, Ohio, is a group of insurance companies providing a wide range of insurance products from personal automobile and homeowners insurance, to commercial coverage for small and large businesses, to health insurance, life insurance and annuities. Our companies are licensed to engage in the business of insurance in all 50 states. We are deeply concerned about the heavy tax increases on insurance contained in President Clinton's Budget Proposal for Fiscal Year 1999, and we submit this statement in opposition to these proposals.

The Administration singles out for punitive tax increases both the insurance industry and those who acquire its vital products for their retirement savings and for protection of their assets and lives. We strongly urge that the Congress reject these misguided proposals.

These proposals, and their anticipated revenue effects as determined by Joint Committee on Taxation for the years 1998–08, are as follows:

| | |
|---|---|
| Increase taxes on annuities by decreasing annuity tax reserve deductions | $ 8,532,000,000 |
| Penalize corporate-owned life insurance by reducing interest deductions | $ 4,821,000,000 |
| Tax exchanges of variable annuity contracts and reallocations between investment options | $ 3,982,000,000 |
| Increase property and casualty insurance company taxes for companies that buy municipal bonds | $ 1,274,000,000 |
| Increase taxes of life insurance and annuity policyholders by disallowing part of their cost basis | $ 442,000,000 |
| Raise taxes on insurance companies that issue credit life insurance contracts by requiring such companies to capitalize 7.7% of net premiums | $ 198,000,000 |
| Total | $19,249,000,000 |

In addition to the above proposals that directly hit insurance companies, their policyholders, or both, the Administration would discourage sales of life insurance by eliminating the "Crummey" rule which for many years has prevented the imposition of transfer taxes upon gifts of $10,000 a year or less if the donee were given a right to withdraw the amount transferred. Joint Committee on Taxation estimates that this proposal would increase revenues by $555 million over a 10-year period.

Our specific comments on the more significant proposals follow.

### Increase Taxes on Annuities by Decreasing Annuity Tax Reserve Deductions

The Administration proposal would curtail the tax deduction for annuity contract reserves by limiting reserves to the lesser of (1) the present reserve, based on a state-law reserve method (CARVM), or (2) the contract's net cash surrender value plus a declining small percentage. In order to examine the impact of this change and why it should be rejected, it is important to understand the purpose of reserving, the requirements of state insurance laws to insure solvency, and the misunderstandings of the Administration about recent changes made by the National Association of Insurance Commissioners.

Reserves are used to pay policyholders the benefits for which they contracted. Thus, an annuity reserve is the amount of money an insurer must set aside in escrow today to meet its obligations to contractholders, both today and in the future. Reserving at adequate levels is necessary to protect contractholders and to protect insurers against insolvency. Maintaining sufficient annuity reserves is even more necessary now that individuals live longer and the insurer's obligation is correspondingly greater.

A tax deduction is allowed for reserves. Basically, a life insurance company pays taxes on its gross income less the amount used for reserves. The current deduction for annuity reserves is provided by Section 807 of the Internal Revenue Code. It is based on the minimum reserves state insurance regulators require companies to hold to meet their obligations to policyholders. As such, current law permits state regulators, rather than the IRS, to provide the basic method for determining reserves. The Administration's proposal is an unprecedented and inappropriate attempt to supplant the professional expertise and judgment of state insurance regulators over the reserves necessary to fulfill policyholder obligations.

Under the current Code reserves for any annuity contract are the greater of the net surrender value of the contract or the reserve determined using the Commis-

sioner's Annuities Reserve Valuation Method (CARVM) prescribed by the National Association of Insurance Commissioners (NAIC), but not more than the annual statement reserve. The Administration's proposal would change this calculation by making it the lesser of the net surrender value of the contract or the reserve as determined by CARVM.

The Administration attempts to justify this change by noting that the NAIC adjusted its guidelines for calculating CARVM reserves for annuity contracts in 1997, characterizing the NAIC actions as "conservative" and as an inaccurate measurement of income. However, the NAIC made these adjustments to recognize all future benefits in computing reserves and to address minimum death benefits under deferred annuity contracts. The NAIC should be commended for trying to make sure that the reserves set aside to pay obligations to policyholders are sufficient to meet such obligations. This change in calculation by the NAIC was not intended to create excessive reserves for federal tax purposes, but instead to reflect proper reserving for future benefits due to policyholders.

The Administration's proposal is both bad law and bad policy. Annuities are the only investment that assure individuals that they will not outlive their income. Raising taxes on reserves which are used to make payments under annuities will inevitably lead to higher prices for these essential products and thus undermine Americans' private retirement savings efforts.

### PENALIZE CORPORATE-OWNED LIFE INSURANCE BY REDUCING INTEREST DEDUCTIONS

Another misguided Administration proposal would place an additional tax on companies that borrow for any purpose if those companies also own life insurance, including key employee insurance. This proposal is anti-business and fails to recognize the vital role of insurance in fostering the survival and growth of small and closely-held businesses.

Under the proposal, the mere ownership of a whole life insurance policy on the president of a company could result in a tax penalty on unrelated borrowing. This additional tax would be imposed against loans that bear no relation to any borrowing from a life insurance policy but instead result from normal business borrowing for expansion and other fundamental purposes.

In 1996 Congress reviewed the taxation of policy loans borrowed directly from life insurance policies and placed substantial restrictions on this type of borrowing, limiting it to coverage on key employees. The new proposal ignores this history and would craft a new and more draconian limitation. No principle supports this abandonment of the key person exception.

Employers purchase life insurance for the same reason individuals purchase life insurance—to protect against the untimely loss of an income earner and to provide for long term financial needs. Just as businesses rely on insurance to protect against the loss of property, they need life insurance to minimize the cost of losing other valuable assets such as key employees, those responsible for the survival and success of the enterprise.

Also corporate-owned life insurance helps employers finance employee benefits of all types. Corporations frequently use life insurance to fund various employee benefits, such as retiree health care and deferred compensation plans. The loss of interest deductions for unrelated borrowing would likely force many companies to reduce employee and retiree benefits currently funded through business life insurance.

In short, this proposal would hurt small businesses and their employees, disrupt financial plans, impair employee benefits and should be rejected.

### TAX EXCHANGES OF VARIABLE ANNUITY CONTRACTS AND REALLOCATIONS BETWEEN INVESTMENT OPTIONS

Under Section 1035 of the Internal Revenue Code, a policyholder can exchange without any tax any life insurance contract for another life insurance contract, a life insurance contract for an annuity, and an annuity for another annuity. This long-established rule is based on sound public policy: individuals should be able to take changed circumstances into account in their insurance and annuity programs but should not be taxed until they take their money out of their insurance or annuity.

The current treatment of life insurance and annuity product exchanges rests on the basic proposition that the policyholder has continued his or her interest in one insurance product through the use of a new insurance product better suited for his or her current needs. Variable insurance products offer life insurance and annuity benefits which reflect the performance of financial markets, and thus are able to keep pace with inflation. Policyholders need to be able to modify their contracts in order to shift more conservative investment options as they grow older, accommodate to changes in their retirement and insurance protection needs, and respond to

changes in the financial markets. The Administration's proposal is to treat such exchanges and reallocations as if the individuals sold all of these assets and withdrew from their plans in total. This is simply wrong.

The Administration appears to believe that variable annuities are simply a type of mutual fund. This is far from the truth. Annuities are subject to severe tax restrictions under current law that mutual funds escape. These include penalties on early distribution, no basis step-up at death, severe diversification restrictions, and, most significant, taxation at full, rather than capital gains, rates.

Suppose a worker contributed $5,000 to a variable annuity plan when he is 40 years old and chose a particular stock fund option. Supposed 10 years later his fund has grown to $12,000 and he wants to switch to a bond fund option in the same annuity because he feared a stock market decline. The Administration would tax the entire accumulation above the original $5,000,1 which is $7,000, as ordinary income. The tax, at full rates, would be taken out of the worker's $12,000 in retirement funds simply because he shifted his investment option.

It is ironic that these tax increases would fall on middle income households, especially on women. Recent surveys have shown that over 80% of deferred annuity contract policyholders, and 74% of variable annuity contract policyholders, have total household incomes under $75,000. Many of these policyholders work for employers who do not offer, or who have terminated, qualified retirement plans. Particularly, for such policyholders, annuities are the essential source of retirement savings.

Annuity tax legislation was first enacted in the late 1930s to allow individuals to provide for themselves needed retirement income above that obtained through social security. The Administration's proposal would strike a heavy blow against that sound policy.

### Increase Taxes of Insurance and Annuity Policyholders by Disallowing Part of Their Cost Basis

The Administration proposes to increase taxes on individually-owned life insurance and annuities by reducing the tax basis of these contracts. Specifically, the proposal would require policyholders to reduce their investment in the contract (premiums paid) by the amount of mortality or expense charges deemed to be associated with the contract. Under current law, policyholders pay tax on any gain in a life insurance or annuity contract if the contract is surrendered or amounts are distributed (other than at death under a life insurance contract). The amount of gain traditionally has been the excess of the amount received over the total premiums paid in (investment in the contract). There has never been a statutory or regulatory requirement that the investment in the contract must be reduced by the amount of contract mortality and expense charges. Current law for life insurance and annuities is consistent with the treatment of other assets, such as homes, cars, mutual funds and bank accounts, where no reduction is required for benefits resulting from ownership, e.g., the imputed rental value of a car or house.

Apparently, the theory behind the proposed reduction in basis is that since the policyholder is obtaining the insurance coverage, its cost must be a benefit and should therefore reduce basis like any other benefit, such as partial withdrawals and policyholder dividends. However, using as a mortality charge the maximum permitted under Section 7702 is not justified. Also, it creates questions for contracts qualifying as life insurance under the cash value test. For annuities, reducing tax basis by a mortality charge makes even less sense. Except for guaranteed minimum death benefits, the only mortality component of these contracts is associated with payout and, unlike life insurance, is not actually realized by policyholders until annuity payments actually occur. In addition, the higher the worth of the guarantee, the higher the eventual payments. Since higher payments generate higher potential tax, reducing the basis for the underlying guarantee that produces such income appears to tax the same thing.

In the case of expenses, expenses or costs of maintaining investments are generally added to basis if paid by investors. Since expense charges on life and annuity contracts are typically not paid in cash, they should not increase basis—however, neither should they decrease it. If this treatment is adopted, logic would seem to require that it apply to expenses associated with any investment. If so, mutual fund management fees should reduce basis of such investments.

Also, this ill-advised proposal would confuse policyholders and significantly increase their costs and time in maintaining correct information about the investment in their life insurance and annuity contracts. Life insurance companies would be required to keep two sets of books for cash value life insurance and annuity contracts, requiring extensive systems changes.

Since mortality costs increase as an insured ages, this proposal would particularly harm older policyholders, some of whom plan to surrender their policies as their needs for life insurance death protection decreases. Since life insurance and annuities promote family financial security, it is irresponsible to enact a penalty on what the nation should encourage.

INCREASING PROPERTY AND CASUALTY INSURANCE COMPANY TAXES FOR COMPANIES THAT BUY MUNICIPAL BONDS

By doubling present law's curtailment of deductions for loss reserves, the Administration proposes to extract an additional $400 million in income taxes from property and casualty insurance companies that invest in municipal bonds. This blow against an essential industry that is already fully taxed would harm insurers and their policyholders and would also force insurers to desert the market for tax exempt bonds. Serious damage to states and municipalities could result. As the Bond Market Association has pointed out, the exodus of the property/casualty industry from the municipal bond market would drive up borrowing costs for states and localities. Property/casualty companies routinely purchase the majority of new issues of government grade bonds, bonds with maturities of 10–20 years, general obligation and government revenue bonds, and municipal securities that help states and localities meet such vital needs as school construction, water, sewer facilities, roads and other projects. Higher borrowing costs for these infrastructure and governmental uses would either be passed on to state and local taxpayers, or would prevent certain needs from being met at all.

INCREASE GIFT TAXES BY ELIMINATING "CRUMMEY" RULE

Current gift tax law permits a donor to transfer up to $10,000 per year to another person without any gift tax if the gift is of a present interest. Since the 1968 decision of Crummey v. Commissioner, the gift could be placed in a trust and still qualify as long as the donee had the right to withdraw the transferred amount. Thus, under a Crummey trust, a parent is able to transfer funds for the benefit of a child or grandchild in a responsible manner without the imposition of a gift tax.

The Administration proposes to repeal the Crummey trust rule and limit the gift tax exemption to only outright transfers. This would hurt many parents who wish to establish trusts for specific needs of their children, such as home education, home purchases and future security.

This proposal discourages responsible gifts and increases gift taxes. It marches backward from last year's determination by Congress that gift and estate taxes should be decreased and transfers of property from one generation to another should be encouraged.

## Statement of Washington Counsel, P.C., Attorneys-at-Law, and Ernst & Young LLP, on behalf of the Notice 98–11 Coalition

INTRODUCTION

The Administration's FY99 Budget Proposal ("Budget Proposal") includes an exceedingly broad request for regulatory authority to prescribe the "appropriate tax results" of "hybrid transactions." Hybrid transactions are defined to include entities that are treated as corporations under one country's tax system and as branches or partnerships in another, as well as securities that are treated as debt or royalties in one country and as equity in another. Treasury's "General Explanation" cites regulations to be issued pursuant to Notice 98–11 and Notice 98–5 (the "Notices") as areas in which the Treasury would be expected to use the requested regulatory authority.

The Notice 98–11 Coalition (the "Coalition") is concerned that, under the guise of the Notices and the Budget Proposal, Treasury is seeking to launch a major new initiative in the international tax area that will undermine the ability of U.S. multinationals to compete in the global marketplace. In requesting the ability to unilaterally define "appropriate results," Treasury is seeking the authority to make fundamental changes in existing law, a prerogative of the Congress. Moreover, the Notices and the Budget Proposals have created a chilling effect on the ability of U.S. multinationals to enter into transactions in the ordinary course of business.

THE ISSUES RAISED BY THE ADMINISTRATION'S PROPOSAL ON HYBRIDS RAISE FUNDAMENTAL TAX POLICY CONCERNS THAT SHOULD BE ADDRESSED BY THE CONGRESS.

As recognized by the Internal Revenue Service ("IRS") in describing the background of Notice 98–11, "U.S. international tax policy seeks to balance the objective of neutrality of taxation as between domestic and foreign business enterprises (seeking neither to encourage nor to discourage one over the other, [referred to as "capital export neutrality"]) with the need to keep U.S. business competitive." The legislative history of Subpart F[1] is clear that capital export neutrality is not the only policy goal, but the IRS has only paid lip service to that fact. In reality, the Administration's position (as evidenced by the Notices and the Budget Proposal) would elevate the policy of capital export neutrality over international competitiveness. Even if capital export neutrality were the only consideration, it is questionable whether the expansion of Subpart F as envisioned by Notice 98–11 is consistent with capital export neutrality.

The basic structure of the U.S. international tax regime dates from the early 1960s when the U.S. economy was so dominant that it accounted for over half of all multinational investment in the world. The decades that followed saw a migration from domestically-based to globally-competitive markets. With this transformation comes new challenges for Congressional policy makers interested in helping U.S. companies remain competitive. Indeed, the Congress has adopted trade laws that recognize both the need for expanded markets and the reduction of trade barriers. In like manner, it is for the Congress to determine whether to alter the extent to which international tax rules bolster or hinder the competitiveness of U.S. companies in global markets.

The Congress is the only proper forum for determining whether to revisit the balance that has been struck between the competing U.S. tax goals of international competitiveness versus capital export neutrality. Further, by raising this issue by Notices and proposed legislation that grant Treasury open-ended authority to prescribe rules, Treasury is seeking to usurp the legislative process. Any change in law should be made through substantive statutes enacted prospectively by the Congress, not Notices issued retroactively by Treasury.

NOTICE 98–11 AND NOTICE 98–5 REPRESENT ATTEMPTS BY TREASURY TO "LEGISLATE BY NOTICE," REGULATING WELL BEYOND THE INTERPRETIVE AUTHORITY GRANTED BY THE CONGRESS.

As an example, many taxpayers in good faith structured specific foreign operations to take into account the final regulations issued on December 17, 1996, for the elective entity classification regime referred to as "check-the-box." The check-the-box regulations sanctioned the creation of hybrid branches that are respected as separate entities for purposes of foreign tax law but not U.S. purposes. In Notice 98–11, however, Treasury indicates that regulations will prevent the use of check-the-box to create "hybrid branches" in the international context where the result "is contrary to the policies and rules of Subpart F...." Although an IRS "Notice" does not involve the same depth of consideration as temporary or proposed regulations, the issuance of Notice 98–11 had an immediate "chilling effect" by casting doubt on the ability of taxpayers to rely with certainty on their check-the-box elections and the IRS's own check-the-box regulations, as well as the viability of structures that were put in place before the check-the-box regulations were finalized.

The fundamental change announced in Notice 98–11 (that is, the treatment of hybrid branches for purposes of Subpart F) should be the prerogative of the Congress not the IRS. The check-the-box regulations did not enlarge Treasury's general interpretive authority. Treasury itself recognized that "there [was] considerable flexibility under the [old] rules to effectively change the classification of an organization at will." Notice 95–14, 1995–1 C.B. 297, 298. The final check-the-box regulations simply replaced the "increasingly formalistic rules under the [old] regulations with a much simpler approach that generally is elective." P–S–43–95, 1996–1 Adv. Sh. Ed. C.B. 937, 938. Similarly, as described by the staff of the Joint Committee on Taxation, the "major change made by the check-the-box regulations is to allow tax classification ... to be explicitly elective...." Joint Committee on Taxation, Review of Selected Entity Classification and Partnership Tax Issues (JCS–6–97), April 8, 1997, page 11. The Budget Proposal would, in effect, authorize Treasury to issue any regu-

[1] "Subpart F" refers to the anti-deferral regime prescribed by Sections 951–964 of the Internal Revenue Code of 1986, as amended (the "Code"); all references to "Sections" hereinafter are to the Code.

lations it believes are appropriate to prevent results that it deems to be inconsistent with Subpart F or any other provision of U.S. tax law. Accordingly, the combined effect of the Notices and the Budget Proposal is to prevent taxpayers from structuring many transactions that were clearly permitted before and after publication of the check-the-box regulations.

Neither the Notices nor the Budget Proposal sets forth the expected content or scope of proposed regulations. Thus, taxpayers will not even know what the law actually is until regulations are written.[2] The practical effect of the Administration's Budget Proposal would be to sanction "legislation by notice." Moreover, publication of vague Notices violates the spirit of the Taxpayer Bill of Rights 2 ("TBOR2") requirement that regulations generally be effective only on a date that a notice "substantially describing the expected contents" of regulations is released to the public.[3]

THE BUDGET PROPOSAL ON HYBRIDS AND THE RELATED NOTICES HAVE A WIDESPREAD IMPACT ON LEGITIMATE U.S. ECONOMIC ACTIVITY.

The Coalition includes over thirty U.S. multinationals that are greatly concerned about the Treasury's position as evidenced by the Budget Proposal and the Related Notices. Because the Administration failed to articulate a comprehensive analytical framework for the results foreshadowed by the Notices, these companies have no way of determining the tax treatment of ongoing international operations that occur in the ordinary course of business (including transactions and structures that relied on the rules in effect prior to check-the-box).

The most immediate examples of this activity occurs in Europe. Consistent with the implementation of European Union ("EU") directives, U.S. multinationals are reorganizing their European operations from what had been a country-by-country subsidiary model to a regionally focused cross-border business. This involves shifts of activities to better manage capacity, centralization of distribution activities and consolidation of regional support centers for functions such as cash management, billing, quality control, etc.. The move to a single European currency is further accelerating the trend and compelling additional consolidation of activity.

Hybrid treatment for U.S. tax purposes of European subsidiaries is consistent with the manner in which companies are reorganizing their operations in Europe. The ability to elect hybrid treatment facilitates U.S. companies in achieving their desired regional operating structures, by allowing such conversions to be done free of U.S. tax consequences. It also enables U.S. companies to accomplish such reorganizations in a manner that is most tax effective in the foreign countries involved.

The Notices seem to be grounded in the notion that U.S. multinationals should be penalized for employing tax planning strategies that reduce foreign income taxes. The result obtained in each of the examples described in the Notices is to impose a U.S. "Soak Up Tax," whenever a U.S. taxpayer manages to reduce a foreign tax payment by use of hybrids. The rationale for this result is unclear, unless one believes that the United States should be the "Tax Police" for the world. There is no (apparent) overriding policy reason for inhibiting the ability of U.S. businesses to compete in foreign markets against foreign competitors, especially where there is no cost to the U.S. fisc (and potentially increased U.S. tax revenues, over time, due to reductions in foreign tax credits).

UNLESS THE CONGRESS ACTS, TAXPAYERS WILL FACE ECONOMIC LOSSES ARISING FROM THEIR DETRIMENTAL RELIANCE ON EXPRESS PROVISIONS OF CURRENT LAW.

Regulations to be issued pursuant to Notice 98–5 would be effective for taxes paid or accrued on or after December 23, 1997. The general effective date stated in Notice 98–11 is January 16, 1998, with a June 30, 1998 effective date for hybrid branches that were in existence on January 16th.

The relevant Notices place taxpayers in the untenable position of having to determine the tax treatment of transactions pursued in the ordinary course of business, in advance of receiving any specific guidance, and before having any opportunity to comment on (as yet undefined) proposals. Taxpayers who acted in reliance on exist-

[2] Pending the issuance of regulations, taxpayers will not even be able to query the IRS on the possible consequences of a hybrid transaction—the IRS recently revised it's "no rulings" list to specifically include (1) the issue "whether an entity is treated as fiscally transparent by a foreign jurisdiction for purposes of Section 894," "to reflect the fact that the [IRS] is studying the issue....;" and (2) "any transaction or series of transactions that is designed to achieve inconsistent tax consequences or classifications under the tax laws of the U.S. and the tax laws of a treaty partner." Rev. Proc. 98–7, 1998–1 I.R.B. 222.

[3] This prohibition, which is found in Section 7805(b)(1), only applies to regulations issued pursuant to statutes enacted after the 1996 enactment of TBOR2.

ing law will suffer economic losses due to the perceived need to react to Treasury's stated intention to issue retroactive regulations.

THE ADMINISTRATION'S PROPOSAL WILL ADD COMPLEXITY TO THE TAX LAW IN THE INTERNATIONAL AREA, CONTRARY TO RECENT CONGRESSIONAL SIMPLIFICATION EFFORTS.

While the Administration itself touted the check-the-box regulations as a major simplification initiative, the issuance of regulations pursuant to Notice 98–11 would add additional complexity because it would appear that foreign entities would be treated as branches for some purposes but not for others. As a result, taxpayers would be required to maintain two sets of U.S. tax books to account for the international operations of hybrid branches both as corporations for some U.S. tax purposes and as branches for others.

The Notices and the Budget Proposal are contrary to recent Congressional efforts to simplify the anti-deferral provisions of the Code. For example, the Congress reduced complexity by repealing the Section 956A tax on excess passive earnings in 1996. Again, in 1997, the Congress repealed the application of the Passive Foreign Investment Company regime to U.S. shareholders of Controlled Foreign Corporations because of the complexity involved in applying both regimes. Additionally, the Congress passed a host of other foreign tax simplifications in 1997, including, as previously proposed by Ways and Means Committee members Houghton and Levin in H.R. 1783, provisions to reduce a buyer's Subpart F income by the amount of a seller's deemed dividend under Section 1248, repeal the separate foreign tax credit limitations for Section 902 noncontrolled foreign corporations, and prevent the creation of deemed dividends under Subpart F on account of specified ordinary course transactions of securities dealers.

## CONCLUSION

The Notices and the Budget Proposal represent an attempt by Treasury to "legislate by notice," violating the spirit of TBOR 2. The Notices and the Budget Proposal squarely present the issue whether the Congress or the Treasury should be the arbiter of U.S. tax policy in the international arena. The Congress should prevent Treasury from issuing broad Notices that have immediate effective dates, without articulating with any specificity the content of future regulations. Whether to change the application of Subpart F and other international tax rules to hybrids and other transactions goes to the heart of the competing considerations underlying the current international tax regime. The Congress is the proper forum for making such policy decisions.

*This statement is presented by LaBrenda Garrett-Nelson and Mark Weinberger on behalf of Washington Counsel, P.C., and David Benson and Henry Ruempler on behalf of Ernst & Young LLP. The Coalition consists of over 30 U.S. multinational corporations representing a broad cross-section of American industries.*

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## Statement of Jared O. Blum, President, Polyisocyanurate Insulation Manufacturers Association

The Polyisocyanurate Insulation Manufacturers Association (PIMA) is pleased to submit these written comments on the revenue provisions in the President's fiscal year 1999 Budget. PIMA is the trade association of the rigid polyiso foam insulation industry, a product that is used in over 60 percent of new commercial roof construction, in 40 percent of new residential construction, and in most re-insulation of existing commercial building roofs.

## I. INTRODUCTION

We support efforts to improve the energy efficiency of new buildings. Currently, residential and commercial buildings represent more than a third of the total U.S. energy consumption, and account for two thirds of all electricity used in the country. In addition, the energy consumed in buildings is responsible for 35 percent of total U.S. carbon dioxide ($CO_2$) emissions (our most significant greenhouse gas) and substantial amounts of other pollutants as well (e.g., sulfur dioxide, nitrogen oxides, and particulate matter). Improving the energy efficiency of buildings is a cost effective strategy for reducing emissions of greenhouse gases and other harmful air pollutants and for improving the our country's energy security. The President's pro-

posed energy tax credits are a step in the right direction, but we believe changes could be made that would significantly increase their impact.

## II. Tax Credit for the Purchase of New Energy Efficient Homes

A tax credit for purchasing new energy efficient homes is an effective way to attract energy-efficient technologies and building practices into the market-place. However, we believe that requiring new homes to be at least 50 percent more efficient than the Model Energy Code (MEC) is a threshold that is too high and would undermine the intent of the credit. Few homes can be built to this standard cost-effectively, and those that are built would be expensive "showcase" homes. This outcome would have only a minor impact on changing long-term construction practices in the home building industry.

Putting cutting-edge technology in a few showcase homes will do little to address the most important obstacle to building energy-efficient homes: market barriers to common, every day energy-efficient technologies. There are a wide array of energy-efficient technologies currently available on the market. However, a number of market barriers discourage the use of these technologies. One of these is the problem of split incentives where landlords have little reason to invest in efficiency measures when the energy bill is passed on to tenants, whereas tenants rarely make such investments because their tenure in the building is typically uncertain. Likewise, given far-from-perfect information among consumers, speculative builders are less likely to invest up front in premium-cost, high-efficiency measures because the builder will not pay for energy use in the building after its purchase. As a result, for both commercial and residential construction, the overriding incentive is to reduce up-front costs with little regard for operating costs. Tax incentives would help overcome these market barriers, but they need to be structured in a way that will attract less esoteric building technologies that will have greater market penetration and can be sustained after the tax credit has ended.

A more realistic and achievable threshold would be a 30 percent improvement over MEC. In addition, meeting this threshold, although lower than the 50 percent threshold, still represents a significant improvement over current building practices. Currently, there are several market programs intended to encourage the purchase of homes that are 30 percent more efficient than MEC, such as EPA's Energy Star Homes program and several utility programs. Even with these programs in place, however, fewer than 2 percent of the new homes built each year meet the 30 percent threshold. A tax credit for homes that are 30 percent more efficient than the MEC would complement EPA's Energy Star program, resulting in a greater market penetration of homes with superior energy-efficiency and achieving greater environmental benefits compared to a credit that uses a 50 percent threshold.

Using a 30 percent threshold would have the practical effect of providing a tax cut for lower and middle income families, whereas the 50 percent threshold would effect only higher income families. This is because achieving a 50 percent increase in energy-efficiency would be common only in more expensive homes, whereas the technology required to achieve a 30 percent improvement, such as better insulation, tighter ducts, high-efficiency heating and air conditioning, and high performance windows, can be used in homes in every price range. In addition, a tax credit for homes meeting the 30 percent threshold is more likely to make housing more affordable for middle and lower income families. Not only do these houses cost less to operate, but the additional upfront cost of the increased energy-efficiency will be offset by the tax credit.

## III. Tax Credits for Energy-Efficient Building Equipment

The President has proposed tax credits to encourage the purchase of certain high-efficiency building technologies, many of which are used to heat or cool buildings. We are surprised that with this emphasis on the heating and cooling of buildings there was no consideration given to insulation. To achieve the full potential of these technologies, the building envelope must be adequately insulated. Providing a tax credit for the use of superior levels of insulation would help to achieve the greatest environmental benefit from the President's proposed policies.

Currently, a large percentage of new commercial and residential buildings fail to comply with even the minimum state and local building energy codes, an important component of which is insulation. A 1995 study by the American Council for an Energy-Efficient Economy that reviewed code compliance studies performed by state and local jurisdictions, as well as by electric utilities, concluded that compliance rates are typically on the order of 50 to 80 percent. The Department of Energy's Pacific Northwest National Laboratory estimates an even lower rate of compliance of about 40 percent for both residential and commercial buildings. A tax credit for

insulation would be a very effective incentive for builders not only to comply with building energy codes, but also to surpass the minimum standards for installing insulation.

According to the Pacific Northwest National Laboratory, if compliance with state and local building energy codes were improved ten percent over what it would otherwise be, 41 trillion Btus would be saved annually and carbon emissions would be reduced 900,000 tons per year by 2010. It is hoped that the effect of an insulation tax credit would do more than simply encourage builders to comply with state and local building energy codes, but these figures provide an idea of the magnitude of the benefits that could result from such a tax credit.

**Statement of Protective Life Insurance Company**

In accordance with the provisions of a February 18, 1998 advisory from the Committee on Ways and Means of the United States House of Representatives, Protective Life Insurance Company ("Protective Life") submits this written statement for the Committee's consideration in conjunction with its review of President Clinton's Fiscal Year 1999 Budget. This statement is limited in scope to a single topic concerning capitalization of policy acquisition expenses as applied to group credit life insurance. The Clinton Administration has proposed an amendment to section 848 of the Internal Revenue Code that would increase, from 2.05 to 7.7 percent of net premiums, the amount of group credit life policy acquisition expenses subject to the capitalization requirement. Protective Life opposes this proposal and offers the following comments for your consideration.

Protective Life is the primary operating subsidiary of Protective Life Corporation ("PLC") PLC is a publicly held holding company whose shares are registered with the New York Stock Exchange. At December 31, 1997, its assets were $10.5 billion. PLC is headquartered in Birmingham, Alabama. PLC and its subsidiaries have offices in several other states, including California, Illinois, Ohio, Indiana, North Carolina, Tennessee and Alabama.

Protective Life was founded in 1907 and is now a Tennessee domestic insurance company. Protective Life produces, distributes and administers various insurance products either directly or through its subsidiaries. Among these are life insurance products, including group credit life insurance. Group credit life products are generally offered to consumers who receive credit from facilities such as financial institutions and automobile dealers. The credit facilities generally purchase group credit life insurance from insurers such as Protective Life. At the same time, individuals associated with the credit facilities function as agents who enroll individual debtors i premiums received.

Policy acquisition expenses arising from the sale of group credit life insurance are currently subject to a capitalization requirement that was instituted in 1990. The tax effect resulting from this requirement is commonly called the deferred acquisition cost, or DAC, tax. The DAC tax provisions require a ten-year amortization for policy acquisition expenses above the first $5 million in a taxable year. The first $5 million may be amortized over five years.

Currently, the DAC tax applies to acquisition expenses up to 2.05 percent of the net premiums from the sale of group credit life insurance. This 2.05 percent level applies for all group life insurance contracts, which is defined to include group credit life insurance. Thus, the DAC tax requirement for group credit life insurance is currently capped at an amount equivalent to 2.05 percent of net premiums.

As noted above, the Administration has proposed an amendment to the Code that would subject a greater proportion of group credit life policy acquisition expenses to the DAC tax capitalization requirement. This would be accomplished by shifting the cap from 2.05 to 7.7 percent of net premiums. This 7.7 percent level is one that currently applies to all insurance contracts not falling with the definitions of either group life insurance or annuities. This includes individual life insurance.

Protective Life understands that the Administration has based its proposal upon the fact that acquisition expenses for group credit life insurance are higher than most other group life insurance products and are comparable to the acquisition expenses for individual life insurance. This suggests a belief that group credit life insurance should not be treated as the group insurance that it is because it resembles individual life insurance in one respect. Protective Life respectfully submits that this reasoning fails to consider the several respects in which group credit life insurance differs from individual life insurance.

State regulations effectively place a cap on credit insurance premium rates. Most states utilize so-called prima facie rate provisions that grant blanket approval for

rates that do not exceed a certain level. Notably, these rates were established prior to the 1990 institution of the current 2.05 percent DAC tax, which insurers were forced to absorb. Although an insurer can apply for approval to charge a higher rate, most state regulators restrict premium increases to those justified by an insurer's increased loss ratios, not increased expenses. Thus, premium revenues from the sale of credit insurance are effectively capped at the prima facie rates. Whereas sellers of individual life insurance products can adjust premiums to account for changes in the tax laws, sellers of group credit life insurance cannot. These sellers have already been forced to accept the 2.05 percent DAC tax, and are now faced with the possibility of having to absorb an increase up to a level equivalent to 7.7 percent of net premiums.

For legislators seeking a politically acceptable source of increased tax revenues, the box into which the sellers of group credit life insurance have been placed could be viewed as a positive. Absent a change in state regulations increasing the prima facie rates, these insurers would effectively be barred from passing along to consumers the proposed increase in the DAC tax. This restriction, however, merely creates pressures in other respects, and thus threatens the continued marketability of quality group credit insurance products to all consumers. This is particularly significant in light of an important distinction between group credit life insurance and individual life insurance.

Unlike most individual life insurance products, group credit life insurance tends to serve demographically lower income consumers. It provides an important source of protection against financial risks for individuals who are generally not in a position to purchase individual life insurance coverage. Obviously, if the prima facie rate structure were to change to account for the this tax would be felt primarily by these lower income consumers through an increase in the cost of group credit insurance.

Alternatively, if group credit life insurers are forced to do business under the current rate structures, the proposed DAC tax increase might have a different adverse effect on these lower income consumers through limiting the quality or availability of this type of insurance. Unless insurers were to decrease the commissions paid to credit facilities functioning as agents, which is a highly unlikely scenario in the current competitive marketplace, these insurers would have to suffer further erosion of what are already thin margins of return. Several measures could be instituted to minimize the effects of this erosion, but none would benefit the consumer.

Insurers would be pressured to decrease claims expenses through such mechanisms as greater reliance on restrictions for coverage or on policy exclusions. This would diminish the availability and quality of the products now offered to a wide range of lower income consumers. To maximize per-policy premiums, some insurers might shift the marketing of this product away from insurance sold in connection with smaller loans. Used automobile dealers and other credit facilities that routinely finance smaller dollar purchases might not be able to offer group credit life insurance. This would result in group credit life insurance becoming less available to the lowest of lower income consumers and those in the greatest financial need of this product. Finally, some insurers would simply discontinue the marketing of group credit insurance. This would likely limit the availability of the product or have other anti-competitive effects that could adversely affect lower income consumers.

Despite policy acquisition expense data that have apparently caused the Administration to regard group credit life insurance as may more closely resembling individual life insurance than other group insurance, group credit life insurance cannot appropriately be regarded as comparable to individual life insurance. In Protective Life's experience, the average term of group credit life is significantly shorter than that of individual life insurance and may even be sorter than many other forms of group life insurance. Indeed, it is shorter than the five-year amortization period that applies under the DAC tax for the first $5 million in acquisition expenses incurred in a taxable year, and much shorter than the ten-year period that applies thereafter. Under these circumstances, there is no justification in the tax laws for requiring any group credit life acquisition expenses to be capitalized over a five-year period, much less over a ten-year period.

Protective Life could mount an argument that the current 2.05 percent DAC tax is unfair in light of the existing amortization periods and the average term of group credit life insurance, but it will save that argument for another day. For the present, it is sufficient to state that an increase in the DAC tax level from 2.05 to 7.7 percent is unjustified. Such an increase would have an undue, adverse effect on the continued availability of quality group credit life products to lower income con-

sumers. Accordingly, the Administration's proposed change in the tax laws should be rejected.

Respectfully submitted,

DRAYTON NABERS, JR.
*Chairman of the Board*

**Statement of Hon. Jim Ramstad, a Representative in Congress from the State of Minnesota**

Mr. Chairman, thank you for convening this hearing to examine the revenue provisions in the President's proposed FY99 budget.

I must say I'm concerned by some of the so-called "unwarranted benefits" targeted by the Administration. Some are recycled from past years, and some are new surprises.

I'm troubled by the conflicting messages some of these proposals are sending. At at a time the Administration claims it wants to encourage long-term savings and retirement security, the very businesses and products that provide long-term savings opportunities are being attacked. At a time we should be encouraging exports and improving the balance of trade, American businesses that export are being penalized. And at a time of devolution when we are asking more from state and local governments, we have a proposal that would likely raise their borrowing costs.

Because I am so troubled by the inconsistencies, I'm grateful for this opportunity to hear from Mr. Summers about the Administration's proposals.

Again, Mr. Chairman, thank you for providing us this forum to explore the Administration's budget proposals in detail.

**Statement of Grace Chen, Chief Executive Officer, e-CommLink, Inc., Houston, Texas, on behalf of the R&D Credit Coalition**

Mr. Chairman and members of the Committee, my name is Grace Chen, and I am the Chief Executive Officer of e-CommLink, Inc. of Houston, Texas. I thank you for the opportunity to submit this statement on behalf of the R&D Credit Coalition on the importance of making permanent the research and experimentation tax credit (commonly referred to as the "R&D" credit). The R&D Credit Coalition is a broad-based coalition of 30 trade associations and approximately 750 small, medium and large companies, all united in seeking the permanent extension of the R&D credit. The members of the R&D Credit Coalition represent many of the most dynamic and fastest growing companies in the nation and include the entire spectrum of R&D intensive industries: aerospace, biotechnology, chemicals, electronics, information technology, manufacturing, pharmaceuticals and software. (I have attached to this statement a letter from the members of the R&D Credit Coalition to President Clinton concerning including the R&D credit in the Administration's FY 1999 Budget.)

e-CommLink, Inc., founded in 1996, is a privately owned high technology company located in Houston, Texas. The company has developed a pioneering technology using Web-enabled middle processing applications to facilitate on-line information management and dynamic interactivity between vendors, customers, and business partners. This technology offers an economical and scaleable connectivity solution. Rapid new product development is essential to success in our industry. The company has grown to 45 employees and anticipates substantial growth in the future.

I want to commend Representatives Nancy Johnson and Bob Matsui, and the original cosponsors of H.R. 2819, and Senators Hatch and Baucus, and the original cosponsors of S. 1464, for introducing legislation to permanently extend the R&D credit. I also want to commend President Clinton for including, and funding, an extension of the R&D tax credit in the Administration's FY 1999 Budget.

This year the accounting firm of Coopers & Lybrand has completed a new study, *Economic Benefits of the R&D Tax Credit*, (January 1998), that dramatically illustrates the significant economic benefits provided by the credit and further reinforces the need to make the credit permanent. According to the study (executive summary attached) making the R&D credit permanent would stimulate substantial amounts of additional R&D, increase national productivity and economic growth almost immediately, and provide U.S. workers with higher wages and after-tax income. I hope the Congress will take swift action to permanently extend the R&D credit by enact-

ing the provisions of H.R. 2819—S. 1464 before the credit expires once again on June 30, 1998.

## I. R&D Credit Legislative History

The R&D credit was enacted in 1981 to provide an incentive for companies to increase their U.S. R&D activities. As originally passed, the R&D credit was to expire at the end of 1985. Recognizing the importance and effectiveness of the provision, Congress decided to extend it. In fact, since 1981 the credit has been extended eight times. In addition, the credit's focus has been sharpened by limiting both qualifying activities and eligible expenditures. With each extension, the Congress indicated its strong bipartisan support for the R&D credit.

In 1986, the credit lapsed, but was retroactively extended and the rate cut from 25 percent to 20 percent. In 1988, the credit was extended for one year. However, the credit's effectiveness was further reduced by decreasing the deduction for R&D expenditures by 50% of the credit. In 1989, Congress extended the credit for another year and made changes that were intended to increase the incentive effect for established as well as start-up companies. In the 1990 Budget Reconciliation Act, the credit was extended again for 15 months through the end of 1991. The credit was again extended through June 30, 1992, by the Tax Extension Act of 1991. In OBRA 1993, the credit was retroactively extended through June 30, 1995.

In 1996, as part of the Small Business Job Protection Act of 1996, the credit was extended for eleven months, through May 31, 1997, but was not extended to provide continuity over the period July 1, 1995 to June 30, 1996. This one-year period, July 1, 1995 to June 30, 1996, was the first gap in the credit's availability since its enactment in 1981.

In 1996, the elective Alternative Incremental Research Credit ("AIRC") was added to the credit, expanding the availability of the credit to R&D intensive industries which could not qualify for the credit under the regular criteria. The AIRC adds flexibility to the credit to address changes in business models and R&D spending patterns which are a normal part of a company's life cycle. The sponsors of H.R. 2819 and S. 1464 recognize the importance of the AIRC. Their legislation, in addition to making the credit permanent, provides for a modest increase in the AIRC rates that will bring the AIRC's incentive effect more into line with the incentive provided by the regular credit to other research-intensive companies.

Most recently, the Congress approved a thirteen month extension of the R&D credit that was enacted into law as part of the Taxpayer Relief Act of 1997. The credit was made available for expenditures incurred from June 1, 1997 through June 30, 1998, with no gap between this and the previous extension.

According to the Tax Reform Act of 1986, the R&D credit was originally limited to a five-year term in order "to enable the Congress to evaluate the operation of the credit." While it is understandable that the Congress in 1981 would want to adopt this new credit on a trial basis, the credit has long since proven over the sixteen years of its existence to be an excellent investment of government resources to provide an effective incentive for companies to increase their U.S.-based R&D.

The historical pattern of temporarily extending the credit, combined with the first gap in the credit's availability, works to reduce the incentive effect of the credit. The U.S. research community needs a stable, consistent R&D policy in order to maximize its incentive value and its contribution to the nation's economic growth and sustain the basis for ongoing technology competitiveness in the global arena.

## II. Why Do We Need A R&D Credit?

### *A. Credit offsets the tendency for under investment in R&D*

The single biggest factor driving productivity growth is innovation. As stated by the Office of Technology Assessment in 1995: "Much of the growth in national productivity ultimately derives from research and development conducted in private industry." Sixty-six to eighty percent of productivity growth since the Great Depression is attributable to innovation. In an industrialized society R&D is the primary means by which technological innovation is generated.

Companies cannot capture fully the rewards of their innovations because they cannot control the indirect benefits of their technology on the economy. As a result, the rate of return to society from innovation is twice that which accrues to the individual company. This situation is aggravated by the high risk associated with R&D expenditures. As many as eighty percent of such projects are believed to be economic failures.

Therefore, economists and technicians who have studied the issue are nearly unanimous that the government should intervene to increase R&D investment. The

most recent study, conducted by the Tax Policy Economics Group of Coopers & Lybrand, concluded that "absent the R&D credit, the marketplace, which normally dictates the correct allocation of resources among different economic activities, would fail to capture the extensive spillover benefits of R&D spending that raise productivity, lower prices, and improve international trade for all sectors of the economy." Stimulating private sector R&D is particularly critical in light of the decline in government funded R&D over the years. Direct government R&D funding has declined from 57% to 36% of total R&D spending in the U.S. from 1970 to 1994. Over this same period, the private sector has become the dominant source of R&D funding, increasing from 40% to 60%.

*B. The credit helps U.S. business remain competitive in a world marketplace*

The R&D credit has played a significant role in placing American businesses ahead of their international competition in developing and marketing new products. It has assisted in the development of new and innovative products; providing technological advancement, more and better U.S. jobs, and increased domestic productivity and economic growth. This is increasingly true in our knowledge and information-driven world marketplace.

Research and development must meet the pace of competition. In many instances, the life cycle of new products is continually shrinking. As a result, the pressure of getting new products to market is intense. Without robust R&D incentives encouraging these efforts, the ability to compete in world markets is diminished.

Continued private sector R&D is critical to the technological innovation and productivity advances that will maintain U.S. leadership in the world marketplace. Since 1981, when the credit was first adopted, there have been dramatic gains in R&D spending. Unfortunately, our nation's private sector investment in R&D (as a percentage of GDP) lags far below many of our major foreign competitors. For example, U.S. firms spend (as a percentage of GDP) only one-third as much as their German counterparts on R&D, and only about two-thirds as much as Japanese firms. This trend must not be allowed to continue if our nation is to remain competitive in the world marketplace.

Moreover, we can no longer assume that American companies will automatically choose to site their R&D functions in the United States. Foreign governments are competing intensely for U.S. research investments by offering substantial tax and other financial incentives. Even without these tax incentives, the cost of performing R&D in many foreign jurisdictions is lower than the cost to perform equivalent R&D in the U.S.

An OECD survey of sixteen member countries found that thirteen offer R&D tax incentives. Of the sixteen OECD nations surveyed, twelve provide a R&D tax credit or allow a deduction for more than 100% of R&D expenses. Six OECD nations provide accelerated depreciation for R&D capital. According to the OECD survey, the U.S. R&D tax credit as a percentage of industry-funded R&D was *third lowest* among nine countries analyzed.

Making the U.S. R&D credit permanent, however, would markedly improve U.S. competitiveness in world markets. The 1998 Coopers & Lybrand study found that, with a permanent credit, annual exports of goods manufactured here would increase by more than $6 billion, and imports of goods manufactured elsewhere would decrease by nearly $3 billion. Congress and the Administration must make a strong and permanent commitment to attracting and retaining R&D investment in the United States. The best way to do that is to permanently extend the R&D credit.

*C. The credit provides a targeted incentive for additional R&D investment, increasing the amount of capital available for innovative and risky ventures.*

The R&D credit reduces the cost of capital for businesses that increase their R&D spending, thus increasing capital available for risky research ventures.

Products resulting from R&D must be evaluated for their financial viability. Market factors are providing increasing incentives for controlling the costs of business, including R&D. Based on the cost of R&D, the threshold for acceptable risk either rises or falls. By reducing the costs of R&D, you make it possible to increase R&D efforts. In most situations, the greater the scope of R&D activities, or risk, the greater the potential for return to investors, employees and society at large.

The R&D credit is a vital tool to keep U.S. industry competitive because it frees-up capital to invest in leading edge technology and innovation. It makes available additional financial resources to companies seeking to accelerate research efforts. It lowers the economic risk to companies seeking to initiate new research, which will potentially lead to enhanced productivity and overall economic growth.

*D. Private industrial R&D spending is very responsive to the R&D credit, making the credit a cost effective tool to encourage economic growth*

Economic studies of the credit, including the Coopers & Lybrand 1998 study, the KPMG Peat Marwick 1994 study, and the article by B. Hall entitled: "R&D Tax Policy in the 1980s: Success or Failure?" *Tax Policy and the Economy* (1993), have found that a one-dollar reduction in the after-tax price of R&D stimulates approximately one dollar of additional private R&D spending in the short-run, and about two dollars of additional R&D in the long run. The Coopers & Lybrand study predicts that a permanent R&D credit would lead U.S. companies to spend $41 billion more (1998 dollars) on R&D for the period 1998–2010 than they would in the absence of the credit. This increase in private U.S. R&D spending, the 1998 study found, would produce substantial and tangible benefits to the U.S. economy.

Coopers & Lybrand estimated that this permanent extension would create nearly $58 billion of economic growth over the same 1998–2010 period, including $33 billion of additional domestic consumption and $12 billion of additional business investment. These benefits, the 1998 study found, stemmed from substantial productivity increases that could add more than $13 billion per year of increased productive capacity to the U.S. economy. Enacting a permanent R&D credit would lead U.S. companies to perform significantly more R&D, substantially increase U.S. workers' productivity, and dramatically grow the domestic economy.

*E. Research and Development is About Jobs and People*

Investment in R&D is ultimately an investment in people, their education, their jobs, their economic security, and their standard of living. Dollars spent on R&D are primarily spent on salaries for engineers, researchers and technicians.

When taken to market as new products, incentives that support R&D translate to salaries of employees in manufacturing, administration and sales. Of exceptional importance to e-CommLink, Inc. and the other members of the R&D Credit Coalition, R&D success also means salaries to the people in our distribution channels who bring our products to our customers as well as service providers and developers of complementary products. And, our customers ultimately drive the entire process by the value they put on the benefit to them of advances in technology. Benefits that often translate into improving their ability to compete. By making other industries more competitive, research within one industry contributes to preserving and creating jobs across the entire economy.

My experience has been that more than 75 percent of expenses qualifying for the R&D credit go to salaries for researchers and technicians, providing high-skilled, high-wage jobs to U.S. workers. Investment in R&D, in people working to develop new ideas, is one of the most effective strategies for U.S. economic growth and competitive vitality. Indeed, the 1998 Coopers & Lybrand study shows improved worker productivity throughout the economy and the resulting wage gains going to hi-tech and low-tech workers alike. U.S. workers' personal income over the 1998–2010 period, the 1998 study predicts, would increase by more than $61 billion if the credit were permanently extended.

*F. The R&D credit is a market driven incentive*

The R&D credit is a meaningful, market-driven tool to encourage private sector investment in research and development expenditures. Any taxpayer that increases their R&D spending and meets the technical requirements provided in the law can qualify for the credit. Instead of relying on government-directed and controlled R&D spending, businesses of all sizes, and in all industries, can best determine what types of products and technology to invest in so that they can ensure their competitiveness in the world marketplace.

## III. The R&D Credit Should Be Made Permanent To Have Maximum Incentive Effect

Research projects cannot be turned off and on like a light switch. If corporate managers are going to take the benefits of the R&D credit into account in planning future research projects, they need to know that the credit will be available to their companies for the years in which the research is to be performed. Research projects have long horizons and long gestation periods. Furthermore, firms generally face longer lags in adjusting their R&D investments compared, for example, to adjusting their investments in physical capital.

In order to increase their R&D efforts, businesses must search for, hire, and train scientists, engineers and support staff. They must often invest in new physical plant and equipment. There is little doubt that a portion of the incentive effect of the

credit has been lost over the past seventeen years as a result of the constant uncertainty over the continued availability of the credit.

If the credit is to provide its maximum potential incentive for increased R&D activity, the practice of periodically extending the credit for short periods, and allowing it to lapse, must be eliminated, and the credit must be made permanent. Only then will the full potential of its incentive effect be felt across all the sectors of our economy.

## IV. Conclusion

Making the existing R&D credit permanent best serves the country's long term economic interests as it will eliminate the uncertainty over the credit's future and allow R&D performing businesses to make important long-term business decisions regarding research spending and investment. Private sector R&D stimulates investment in innovative products and processes that greatly contribute to overall economic growth, increased productivity, new and better U.S. jobs, and higher standards of living in the United States. Moreover, by creating an environment favorable to private sector R&D investment, jobs will remain in the United States. Investment in R&D is an investment in people. A permanent R&D credit is essential for the United States economy in order for its industries to compete globally, as international competitors have chosen to offer direct financial subsidies and reduced capital cost incentives to "key" industries. The R&D Credit Coalition strongly supports the permanent extension of the R&D credit and urges Congress to enact the provisions of H.R. 2819—S. 1464 before the credit expires on June 30, 1998.

Attachments: Letter from members of R&D Credit Coalition to President Clinton
Executive Summary of 1998 Coopers & Lybrand study "Economic Benefits of the R&D Tax Credit"

*Aerospace Industries Association*
*American Association of Engineering Societies*
*American Automobile Manufacturers Association*
*American Council on Education*
*American Electronics Association*
*American Institute of Chemical Engineers*
*Biotechnology Industry Organization*
*Business Software Alliance*
*Chemical Manufacturers Association*
*Chicago Software Association*
*Computing Technology Industry Association*
*Electronic Industries Association*
*Emergency Committee for American Trade*
*Information Technology Association of America*
*Massachusetts Software Council*
*Information Technology Industry Council*
*Interactive Digital Software Association*
*National Association of Manufacturers*
*National Electrical Manufacturers Association*
*National Foreign Trade Council*
*North Carolina Electronics and Information Technologies Association*
*Pharmaceutical Research and Manufacturers Association*
*Semiconductor Equipment and Materials International*
*Semiconductor Industry Association*
*Software Publishers Association*
*Telecommunications Industry Association*
*United States Chamber of Commerce*
*United States Telephone Association*

December 15, 1997

The Honorable William Jefferson Clinton
President of the United States
The White House
1600 Pennsylvania Avenue, N.W.
Washington, D.C. 20500

Dear Mr. President:

We urge you to include a permanent extension of the Research and Experimentation tax credit (commonly referred to as the R&D credit), as contained in H.R. 2819 and S. 1464, in your Fiscal Year 1999 Budget. Your leadership in including, and funding, an extension of the R&D credit in your FY 1998 Budget was instrumental in achieving the recent extension of the credit in the Taxpayers Relief Act of 1997.

As you know, the R&D credit continues to enjoy broad, bipartisan congressional support. The credit provides companies a critical, effective and proven incentive to maintain and increase their investment in U.S.-based research and development. The continued encouragement of private sector R&D in the United States is particularly important in light of the substantial tax and other financial incentives offered by many of our major foreign trade competitors. Moreover, targeted primarily at salaries and wages paid to employees in U.S.-based R&D activities, the credit supports the creation of valuable new, high-skilled jobs for American workers.

For these reasons, we strongly urge you to make an investment in the future economic growth of our country by funding a permanent extension of the R&D credit in your FY 1999 Budget.

We thank you for your consideration of our strong interest in a permanent R&D credit and look forward to working with you toward achieving this goal.

Sincerely,

(Signatories)

cc: The Honorable Albert Gore, Jr.
The Honorable Robert E. Rubin
The Honorable Franklin D. Raines
The Honorable Erskine Bowles

Applied Digital Access

Applied Materials, Inc

Applix

Aries Electronics Inc

ARKSYS

Ascend Communications, Inc

Ascent Pediatrics

ASM America

Aspect Systems, Inc

Astar, Inc

Asyst Technologies, Inc

AT & T

ATL Ultrasound, Inc

Atrium Medical

Attachmate

Audio Precision, Inc

Aupperle Associates, Inc

Ausimont USA

Autodesk, Inc

Automation Modules, Inc

AutoSimulations, Inc

Award Software International, Inc

Axelgaard Manufacturing Co, Ltd

Axic, Inc

Axiohm Translation Solutions, Inc

Aztek Engineering, Inc

Bachow & Associates, Inc, and Affiliates

Bayer Corp

Bell Atlantic

Bio-logic Systems Corp

Boehringer Ingelheim Corp

Boeing

Boekeker Plastics, Inc

Branden Technologies, Inc

Bristol-Myers Squibb Company

Broadband Communications Products, Inc

Brookhaven Instruments Corporation

Brooks Automation

Burleigh Instruments

Burton Corp

C&D Technologies, Inc

C&D Technologies, Inc: The Power Electronics Division

Cabot

Caere Corp

Cambridge Technology Partners

Canary Technology, Inc

Candescent Technologies Corp

Candle Corp.

Cascade Microtech, Inc

Cayenne Information

CECO Filter, Inc

Cegelec ESCA Corp

Cerion Technologies, Inc

Cerprobe Corp

CFM Technologies, Inc

Cherry Semiconductor Corp

3Com Corp
AAF International
Abbott Laboratories
Ablestik Laboratories
Absolute Time Corp
Accel Technologies, Inc
AccSys Technology, Inc
Accurate Automation Corp
Accurel Systems International Corp.
ACSI Inc
ACT Networks, Inc
Active Power
Adaptec, Inc
Adastra Systems Corp
ADE Corporation
Adflex Solutions
Adrenaline Research
Advanced Ceramics Corporation
Advanced Energy Industries Inc
Advanced Hardware Architectures, Inc
Advanced Input Devices
Advanced Micro Devices (AMD)
Advanced Pressure Technology
Advent Software, Inc
AEHR Test Systems
Aera Corporation
Aeroflex Laboratories, Inc
Aerotech, Inc
AeroVironment, Inc
Air Products and Chemicals, Inc
Alcatel
Alcatel Comptech, Inc
Alfa Laval Cardinal
Align Rite International Inc
Alliant Techsystems, Inc
AlliedSignal
Alpha Industries, Inc
Alpha Innotech Corp.
ALZA
Amarel
American Computer Hardware Corp
American Home Products Corp
American Internet
Ameritec Corporation
Amgen
AMP Incorporated
AmPro Corp
AMRAY, Inc
Analogics, Inc
Ancot Corp
Anorad Corporation
Anritsu Company
Anza Technology, Inc
Apex Microtechnology

Chromatic Research, Inc
Chrysalis Symbolics
Chrysler Corp
Cisco Systems, Inc
Citrix Systems, Inc
Clariant Corporation
Claris Corporation
Clippard Instrument Lab, Inc
Cognex Corp
Cohu, Inc
Comdisco Electronics Group
Communication Coil, Inc
Communication Techniques, Inc
Compaq Computer Corp
COMSYS Information Technology Services
Concept Systems Design, Inc
Conductive Rubber Technology, Inc
Control Resources Corp
Control Systems International, Inc
Control Technology
Cool Fog Systems Inc
Corcom, Inc
Core Systems
Corel
Corfin Industries, LLC
Corporate Research and Technology
CPU Technology, Inc
CR Technology
Creative Computer Applications, Inc
Creative Computer Solutions, Inc
Creative Pathways, Inc
Credence Systems Corp
CSM Industries, Inc
CTG, Inc
CUI Laser
CyberOptics Corp
Cyborg Systems
D.N.B. Capital Management, Inc
Daihen Advanced Component, Inc
Data General Corp
Data I/O
Data Instruments, Inc
Data Race, Inc
Datamatic, Inc
Decision Point Data
Decisioneering, Inc
Dell Computer Corp
Detek Industries
Dexter Electronic Materials
Diamond Multimedia
Digimarc Corp
Digital Instruments, Inc
Digital Lightwave, Inc
Digital Link Corp
Digital Microwave Corp.
Digital Wireless Corp

Dionex Corp

DNE Technologies

Doctor Design Inc

Donaldson Company, Inc

Dorsey Gage Co., Inc

Dover Technologies

Dryden Engineering Company, Inc

DS Technologies, Inc

DSC Communications Corp

DSP Technology, Inc

DuPont

Dupont Merck Pharmaceutical Co

DYM

E & S Technologies, Inc

E. Villages, LLC

Eastman Kodak Co

Eaton Corporation

Eccs, Inc

Edify Corp

EDS

Eikon Strategies, Inc

Electro Scientific Industries, Inc

Electrophysics

Eli Lilly and Company

Elpac Electronics, Inc

Emar, Inc

EMC Corp

Epichem Inc

EPiCON, Inc

Epson Portland, Inc

Epson Research and Development, Inc

ERC Technology Inc

Ernst & Young LLP

ESC

Esco Electronics Corp

Etec Systems, Inc

EXA Corporation

Extensis Corp

F & K Delvotec, Inc

Fablink Corporation

Fastech Integration

FaxTrieve, Inc

FileNET Corp

First Virtual Holding, Inc

Fisher-Rosemount

Flexhead Industries, Inc

FlipChip Technologies, LLC

Fluent Inc

Fluidix, Inc

Fluoroware, Inc

Ford Motor Company

Fortrend

Four Dimensions, Inc

Frequency Devices, Inc

Frye Electronics, Inc

FSI International, Inc

FTP Software, Inc

Future Automation

G L Automation Inc

G.D. Searle & Co

Gaertner Scientific Corporation

Gamma Precision Technology, Inc

GemStone Systems, Inc

Genedax

Genentech, Inc

General DataComm Industries, Inc

General Motors Corp

General Scanning, Inc

General Semiconductor, Inc

Genus

Genzyme Corp

GeoTel Communications

Giga Info Group

GlaxoWellcome, Inc

GOW-MAC Instrument Company

Gradient Point Corp.

Greenbrier & Russell, Inc

Group Olivey, LLC

H.T. Components USA, Inc

Handy & Harman Tube Co.

Harrington Industrial Plastics, Inc

Helix

Helmig Engineering

Heraeus Amersil, Inc

Hewlett-Packard Corp

Hi Rel Labs

Hibbing Electronics Corp

Highground Systems

Hitachi Data Systems

HM Electronics, Inc

HNC Software, Inc

Hologic Inc

HSQ Technology, Corp

Hughes Electronics

Hypervision, Inc

IBM

Identix Incorporated

I-Kinetics, Inc

Ikos Systems, Inc

ImageLabs, Inc

Imaging Technology

Implant Center

In Focus Systems, Inc

Individual Inc

Industrial Dynamics

Indyme Electronics, Inc

Inflorescence, Inc

INPUT

Inso Corp

Inspex, Inc

Institute for Interconnecting & Packaging Electronic Circuits (IPC)

Instron Corporation

Instrumentation Technology Systems

Insync Systems, Inc

Integrated Circuit Development Corp.

Integrated Control Concepts, Inc

Integrated Measurement Systems, Inc (IMS)

Integrated Systems, Inc

Integrated Technology Corporation

Intel Corp

Intelligent Reasoning Systems, Inc

Interfet Corp

Interlink Electronics, Inc

Intermetrics, Inc

International Data Group

Interneuron Pharmaceutical

Intersol

inTEST Corporation

Intuit, Inc

Ion Systems, Inc

Ion Tech, Inc

Ionics

Itron, Inc

ITT Industries, Inc

J.A. Woollam Co., Inc

J.D. Edwards & Company

Jaco Electronics, Inc

Janco Corp

Johnson & Johnson

Johnstech International Corp.

Jon Goldman Associates

Jones & Jones

JST Custom Fabrication, Inc

Jtech

Julaba USA, Inc

Kaon Interactive

Kaydon Corporation

KAYEX

Keane, Inc

Kent Technical Applications, Inc

Kentek Information Systems

KLA Tencor Corporation

Knights Technology, Inc

Kofax Image Products, Inc

Kollmorgen Motion Technologies Group

Komag, Inc

Kovo Corporation of USA

KPMG Peat Marwick

Kreativ, Inc

Kulicke & Soffa Industries, Inc

Kyocera America, Inc

Kyzen Corporation

Label Graphics, Inc

Lam Research Corp

Lan SuperVision, Ind

LANart Corp

Lattice Semiconductor Corp

Laurier Inc

Leupold & Stevens, Inc

Lewtan Technology

Lexmark International, Inc

Leybold Intercon, Inc

Leybold Materials, Inc

Leybold Semiconductor Vacuum Solutions

Liant

Liconix

Lightware

LoDan Electronics, Inc

Logical Services Inc

LTX Corporation

Lucas/Signatone Corp.

Lucent Technologies

Lufran, Inc

Lumisys Inc

Lumonics

LUXTRON Corporation

Lynx Real-Time Systems, Inc

Marlow Industries, Inc

Materials Research Corporation

Mathworks

Maxrad, Inc

Maxstrat Corp

Maxwell Technologies

MCI Communications

MCT, Inc

MDC Vacuum Products Corp.

Measurement Systems International

MediaMap

MEECO, Inc

MEGA Systems & Chemicals, Inc

MEMC Electronic Materials, Inc

Mentor Graphics, Corp

Mercer Computer Systems

Methode Electronics, Inc

MetroLine

Metron Technology

MFM Technology Inc

Micrion Corp

Micro Encoder, Inc

Microbar Inc

Micro-E Co.

MicroScan Systems

MicroSim Corporation

Microsoft Corp

Microsource, Inc

Mikron Instrument Co., Inc

Mitron

Mitsubishi Silicon America

Modcomp, Inc

Modern Age Books

Molectron Detector, Inc

Morris, Manning, & Martin LLP

Motion Engineering, Inc

Mott Corporation

MPM Corporation

MRS Technology

MTM Engineering, Inc

MTS Systems Corp

Nalco Chemical Co

Napersoft

National Semiconductor

Natural MicroSystems

NCR

Netcom On-Line Communication Services, Inc

Netegrity, Inc

Netscape Communications, Inc.

New Wave Research, Inc

Newbridge Networks, Inc

Newport Corporation

Nissei Sangyo America

Nissene Technology Group

Nitto Denko America, Inc

Nor-Cal Products, Inc

Nortel (Northern Telecom)

Northrop Grumman

Novartis Corp

Novell (3)

Novellus Systems, Inc

Novtek Test Systems

Novus Corporation

Nuera Communications, Inc

Number Ninie

Object Design

Objective Communication

OHKA America, Inc

Oliver Design, Inc

Omniview Design, Inc

OnTrak Systems, Inc

Opmaxx, Inc

Optelecom, Inc

Optical Coating Laboratory Inc

Oracle Corp

OraVax, Inc

OrCAD, Inc

Oregon Medical Systems, Inc

Orthodyne Electronics Corp

Orthopedic Systems, Inc

ORYX Instruments and Materials

Osicom Technologies, Inc

OSTI Inc

Pacific Pac International Inc

Pall Corporation

Parable Corp

Parametric Technology, Inc

Pasco Scientific

Pasteur Merieux Connaught

Pearson Electronics

PeopleSoft, Inc

Pericom Semiconductor Corp

Pervasive Software, Inc

Pfizer, Inc

Phase Metrics, Inc

Philips Electronics

Philips Electronics N.A. Corp

Philips Semiconductors

Phoenix Technologies, Inc

Photronics Inc

Physical Electronics, Inc

Picturetel

Pioneer Hi-Bred International, Inc

PixTech

Plantinum Technologies, Inc

Planview, Inc

Plast-O-Matic Valves, Inc

PLATINUM Technology

Plymouth Tube Co.

Polyfibron

Poly-Flow Engineering, Inc

Potomac Photonics, Inc

Powerquest

Praegitzer Industries, Inc

Precise Sensors, Inc

Precision Filters, Inc

PRI Automation, Inc

PrimeYield Systems, Inc

Process Software

Procter & Gamble

Prodigy

Progressive Technology, Inc

Project Software and Development

Proscript, Inc

Prosys Inc

Proteon, Inc

Protocol Systems, Inc

QEI, Inc

QLP Laminates (Division of AMP)

QUALCOMM, Inc

Quality Assurance Management, Inc

Qualix Group

Qualmark Corp

Quantum Corp

Quantum Design, Inc

Radiotherapeutics Corp

Radnet, Inc

Rainbow Technologies, Inc

RAM Software Systems, Inc

Ramco Electric Co.

Ramtron International Corp

Raytheon Company

RDB Marketing Associates, Inc

Read-Rite Corp

Reflective Technology

Reliability Incorporated

Research, Inc

RF Monolithics, Inc

RF Power Products, Inc

Rhone-Poulenc Rorer

Rigaku/USA, Inc

Rincon Research Corp

RMB Products, Inc

RO Associates, Inc

RockShox, Inc

Rockwell International Corp

Rodel, Inc

Rohm & Hans Company

Roos Instruments, Inc

RoweCom

RSF Electronics

Rudolph Technologies, Inc

Samsung Austin Semiconductor

Saphikon, Inc

Sarnoff Digital

Satcon Technology

SCC Communications Corp

Schweitzer Engineering Laboratories, Inc

Science Applications International Corporation (SAIC)

Scientific Sealing Technology

Scientific Technologies, Inc

Scientific-Atlanta

Scitex

SCP Global Technologies

Seattle Silicon Corp

Security Dynamics Technologies, Inc

Semi-Alloys Co.

Semiconductor Diagnostics, Inc

Semiconductor Equipment Technology

Semiconductor Systems, Inc

Semitool, Inc

Semy Engineering, Inc

Sensys Instruments

Sentient Networks, Inc

Sequent Computer Systems, Inc

Servicor, Inc

Shannon Electronics

Sharp Microelectrions Technology

Shionogi Biores

Sierra Design Labs

Sierra Instruments, Inc

Sight Systems, Inc

Silent Systems

Silicon Graphics

Silicon Storage Technology, Inc

Silicon Valley Group, Inc

Silicon Valley Microelectronics, Inc

Simulation Sciences, In

SKF Motion Technologies

SL Industries, Inc

Smart Corp

Smart Machines, Inc

Smart Modular Technologies, Inc

Smart Storage

Smartrunk Systems, Inc

SmithKline Beecham

Software Association of Oregon

Soletek Corp

Solid State Measurements, Inc

Solvay Pharmaceuticals, Inc

Sonix, Inc

Spectron Glass & Electronics Inc

SpeedFam International, Inc

SPI/Semicon Products, Inc

Splash Technology, Inc

SPSS

Sputtered Films, Inc

SRC Vision, Inc

Stanford Telecommunication, Inc

STB Systems, Inc

Steag Microtech, Inc

Steller, Inc

Storage Concepts, Inc

Storage Technology Corp

Storm Technology, Inc

Stratus Computer, Inc

Submicron Systems Corporation

Sumitoto Sitix Silicon, Inc

Summa Four

Summit Technology

SunGard Data Systems

Supertex, Inc

Symantec

Symetrics Industries, Inc

Synergetics

System Soft

Talon Engineering Corp.

TCI International, Inc

TEAL Electronics

Teal Electronics Corp

Technologic Software Concepts, Inc

Technology Modeling Associates

Tekelec

Tektronix, Inc

Telecscan Systems, Inc

Telect, Inc

Telescan Systems

Temp Electronics

Temptronic Corporation

The Cherry Corp

The Comdys Group

The Dow Chemical Comp

The Dun & Bradstreet Corp

The Goss and DeLeeuw Machine Company

The Lee Company

The Logic Works, Inc

The Micromanipulator Co., Inc

The Texwipe Company

The Timken Company

Thermoset Plastics, Inc

Thermotek, Inc

Thiokol Corp

Thomson Corporation of America

Thornton Associates, Inc

Thrustmaster, Inc

TMT, Inc

Tone Commander Systems

Tracor, Inc

Trek, Inc

Tri Tool, Inc

Trilogy Development, Inc

Trimble Navigation Limited

TRW, Inc

TSI TelSys, Inc

TSK/STC Silicon Technology Corporation

Tyco

Ultra Fab Technology, Inc

Ultratech Stepper, Inc

ULVAC Technologies, Inc

Uniax Corp

Uniden America Corporation, Inc

Union Carbide Corp

United Technologies Corp

Unitek Miyachi Corp

Unitrode Corp

Universal Instruments Corporation

Universal Photonics, Inc

Utel, Inc

Utracision, Inc

Varian Associates, Inc

Vectis

Vector Consulting, Inc

Venture Management Associates

Venture Tech 2000, Inc.

Veriflo Corporation

Vernitron

Verteq, Inc

VIASOFT

VideoServer, Inc

Virtual Music Entertainment, Inc

Visio Corp

Vitech Corp

Vitronics Corp

Vivid Technologies, Inc

Vodavi Technology, Inc

Voyan Technology

VTC, Inc

VTEL Corp

Warner-Lambert Co

Watkins-Johnson Company

Webline

Wells Lamont Corp.

WESGO, Inc

WESTT, Inc

White Microelectronics

Wildfire Communication

Will Vinton Studios

Williams

WorldCare, Limited

Xerox Corp

Xilinx, Inc

Yamaichi Electronics USA, Inc

Zero Defects

Zitel Corp

# ECONOMIC BENEFITS OF THE R&D TAX CREDIT

## A Study
## Prepared by the Coopers & Lybrand
## Tax Policy Economics Group
## for the R&D Credit Coalition

### EXECUTIVE SUMMARY

This new study of the Research and Experimentation tax credit (commonly known as the "R&D credit") shows the credit's significant positive stimulus to U.S. investment, innovation, wage growth, consumption, and exports, all contributing to a stronger economy and a higher standard of living for American workers. The study reports new findings from the Coopers & Lybrand Dynamic Economic Model that highlight the beneficial macroeconomic impact and industry-specific productivity gains caused by the credit. Importantly, the study concludes that the R&D tax credit is such a powerful incentive that it will ultimately pay for itself due to its impact on productivity gains and economic growth, which increase federal revenue. The principal findings of the study are as follows:

- **Making the R&D credit permanent will stimulate additional R&D.** Over the 1998-2010 period, U.S. companies would spend $41 billion more (in 1998 dollars) on R&D as a result of permanently extending the credit.

- **Additional R&D spending raises productivity.** Innovations from additional R&D investment would begin to increase productivity almost immediately, adding more than $13 billion a year to the economy's productive capacity by the year 2010.

- **Increased productivity from additional R&D generates a 31 percent return.** Additional output capacity from gains in productivity produces a 31 percent annualized rate of return to R&D — more than twice the typical rate of return to investments in plant and equipment.

- **The R&D credit increases economic growth.** Higher productivity stimulated by the R&D credit would cause the economy to produce nearly $58 billion more (in 1998 dollars) of goods and services during the 1998-2010 period, including $33 billion of additional domestic consumption, $3 billion of additional residential construction, $12 billion of additional business investment, and $10 billion of additional net exports.

- **The R&D credit benefits the entire economy.** Gains in productivity are not limited to sectors where investments in R&D take place. The gains would spill over to all sectors of the economy — to agriculture, mining, basic manufacturing, and high-tech services. Technological innovations improve productivity in industries that make innovations *and* in industries that make use of those innovations.

- **Increased productivity from additional R&D would provide U.S. workers with higher wages and families with more after-tax income.** By facilitating the expansion of opportunities in high-tech industries, the R&D credit would directly promote high-wage employment. Moreover, by improving productivity throughout the economy, the credit would boost wages in low-tech as well as high-tech industries.

- **The R&D credit raises personal income.** As a result of productivity gains, personal income over the 1998-2010 period would be $61 billion higher; by 2010, personal income would be $11 billion higher per year. The after-tax benefit of this increase in income to U.S. taxpayers is equivalent to a $5 billion tax cut over 5 years and a $25 billion tax cut over 10 years.

- **The R&D credit allows economic growth with more output per worker, helping to ease the financial strain on federal entitlement programs caused by the aging of the baby boomers.** Productivity gains would allow greater output with more efficiency, which is essential to ensure a strong and growing economy as America grays and its workforce shrinks. Such gains will help resolve the looming financial strain on federal retirement and health care programs without large increases in payroll taxes or sharp reductions in benefits.

- **The R&D credit would ultimately pay for itself.** A permanent R&D credit would be an excellent *investment* for the government to make because it would raise taxable incomes enough to more than pay for itself. In the long run, $1.75 of additional tax revenue (on a present value basis) would be generated for each $1 the government spends on the credit, creating a win-win situation for both taxpayers and the government.

- **The R&D credit lowers costs and prices.** Higher productivity tied to the R&D credit's availability would significantly lower industry production costs. The annual cost savings for manufacturing industries alone would be nearly $5 billion annually by 2010. Those savings would result in significantly lower U.S. producer prices and consumer costs, especially for pharmaceuticals, communications equipment, chemicals, aircraft, and computers.

- **The R&D credit improves trade and international competition.** Lower producer prices would make U.S. industries more competitive in world markets. Exports of goods and services would increase, thereby improving the overall balance of trade. By 2010, annual exports of manufactured goods would be more than $6 billion higher, while imports of manufactured goods would be nearly $3 billion lower.

January 1998

For a complete description of the Coopers & Lybrand Dynamic Economic Model, which was used to produce this study, see the Joint Committee on Taxation publication, *Joint Committee on Taxation Tax Modeling Project and 1997 Symposium Papers*, November 20, 1997.

For more information about this study, contact Mark Weinberger, Washington Counsel P.C., Washington, D.C. (202) 293-7474. Mr. Weinberger serves as counsel to the R&D Credit Coalition.

## Statement of Tax Council

### INTRODUCTION

Mr. Chairman and Members of the Committee:

The Tax Council is pleased to present its views on the Administration's Budget proposals and their impact on the international competitiveness of U.S. businesses and workers. The Tax Council is an association of senior level tax professionals rep-

resenting over one hundred of the largest corporations in the United States, including companies involved in manufacturing, mining, energy, electronics, transportation, public utilities, consumer products and services, retailing, accounting, banking, and insurance. We are a nonprofit, business supported organization that has been active since 1967. We are one of the few professional organizations that focus exclusively on federal tax policy issues for businesses, including sound federal tax policies that encourage both capital formation and capital preservation in order to increase the real productivity of the nation.

The Tax Council applauds the House Ways & Means Committee for scheduling these hearings on the Administration's budget proposals involving taxes. We do not disagree with all of these proposals, for example, we support extension of the tax credit for research, as well as accelerating the effective date of the rules regarding look-through treatment for dividends received from "10/50 Companies." These provisions will go a long way toward increasing our declining savings rate and improving the competitive position of U.S. multinational companies. However, in devising many of its other tax proposals, the Administration replaced sound tax policy with a short sighted call for more revenue.

Many of the revenue raisers found in the latest Budget proposals introduced by the Administration lack a sound policy foundation. Although they may be successful in raising revenue, they do nothing to achieve the objective of retaining U.S. jobs and making the U.S. economy stronger. For example, provisions are found in the Budget to (1) extend Superfund taxes without attempting to improve the cleanup programs, (2) repeal the use of "lower of cost or market" inventory accounting, (3) arbitrarily change the sourcing of income rules on export sales by U.S. based manufacturers, (4) provide the Treasury Secretary with blanket authority to issue regulations in the international area that could conceivably allow it to attack legitimate tax planning by U.S. companies, for example, by severely restricting the ordinary business operations of foreign affiliates by no longer allowing a U.S. company to characterize its foreign affiliate as a branch for U.S. tax purposes, (5) inequitably limit the ability of so-called "dual capacity taxpayers" (i.e., multinationals engaged in vital petroleum exploration and production overseas) to take credit for certain taxes paid to foreign countries, and (6) restrict taxpayers from having the ability to mark-to-market certain customer trade receivables.

In its efforts to balance the budget, the Administration is unwise to target publicly held U.S. multinationals doing business overseas, and the Tax Council urges that such proposals be seriously reconsidered. The predominant reason that businesses establish foreign operations is to serve local overseas markets so they are able to compete more efficiently. Investments abroad provide a platform for the growth of exports and indirectly create jobs in the U.S., along with improving the U.S. balance of payments. The creditability of foreign income taxes has existed in the Internal Revenue Code for over 70 years as a way to help alleviate the double taxation of foreign income. Replacing such credits with less valuable deductions will greatly increase the costs of doing business overseas, resulting in a competitive disadvantage to U.S. multinationals versus foreign-based companies.

In order that U.S. companies can better compete with foreign-based multinationals, the Administration should instead do all it can to make the U.S. tax code more friendly and consistent with the Administration's more enlightened trade policy. Rather than engaging in gimmicks that reward some industries and penalize others, the Administration's budget should be written with the goal of reintegrating sounder tax policy into decisions about the revenue needs of the government. Provisions that merely increase business taxes by eliminating legitimate business deductions should be avoided. Ordinary and necessary business expenses are integral to our current income based system, and arbitrarily denying a deduction for such expenses will only distort that system. Higher business taxes impact all Americans, directly or indirectly. For example, they result in higher prices for goods and services, stagnant or lower wages paid to employees in those businesses, and smaller returns to shareholders. Those shareholders may be the company's employees, or the pension plans of other middle class workers.

Corporate tax incentives like the research tax credit have allowed companies to remain strong economic engines for our country, and have enabled them to fill even larger roles in the health and well being of their employees. For these reasons, sound and justifiable tax policy should be paramount when deciding on taxation of business—not mere revenue needs.

## POSITIVE TAX PROPOSALS

The Administration has proposed several tax provisions that will have a positive impact on the economy. Three good examples are:

### ACCELERATING EFFECTIVE DATE OF 10/50 COMPANY CHANGE

One proposal would accelerate the effective date of a tax change made in the 1997 Tax Relief Act affecting foreign joint ventures owned between ten and fifty percent by U.S. parents (so-called "10/50 Companies"). This change will allow 10/50 Companies to be treated just like controlled foreign corporations by allowing "look-through" treatment for foreign tax credit purposes for dividends from such joint ventures. The 1997 Act, however, did not make the change effective for such dividends unless they were received after the year 2003 and, even then, required two sets of rules to apply for dividends from earnings and profits ("E&P") generated before the year 2003, and dividends from E&P accumulated after the year 2002. The Administration's proposal will, instead, apply the look-through rules to all dividends received in tax years after 1997, no matter when the E&P constituting the makeup of the dividend was accumulated.

This change will result in a tremendous reduction in complexity and compliance burdens for U.S. multinationals doing business overseas through foreign joint ventures. It will also reduce the competitive bias against U.S. participation in such ventures by placing U.S. companies on a much more level playing field from a corporate tax standpoint. This proposal epitomizes the favored policy goal of simplicity in the tax laws, and will go a long way toward helping the U.S. economy by strengthening the competitive position of U.S. based multinationals.

### EXTENDING THE RESEARCH TAX CREDIT

The proposal to extend the research tax credit for another year is also to be applauded. The credit, which applies to amounts of qualified research in excess of a company's base amount, has served to promote research that otherwise may never have occurred. The buildup of "knowledge capital" is absolutely essential to enhance the competitive position of the U.S. in international markets—especially in what some refer to as the "Information Age." Encouraging private sector research work through a tax credit has the decided advantage of keeping the government out of the business of picking specific winners or losers in providing direct research incentives. Nevertheless, The Tax Council recommends that both the Administration and Congress work together to make the research tax credit a more permanent part of the tax laws.

### NETTING OF UNDERPAYMENTS AND OVERPAYMENTS

The proposal to require the IRS to net overpayments and underpayments for purposes of calculating interest (commonly referred to as "global interest netting") is a large step forward towards fairness and equity. A new interest rate would be added to Code § 6621 that equalizes interest in cases of overlapping periods of mutual indebtedness for tax periods not barred by an expiring statute of limitations. In other words, no interest would accrue on a deficiency to the extent that a taxpayer is owed a refund in the same amount, during periods that both are outstanding. This proposal would apply only prospectively, to periods of overlapping mutual indebtedness occurring after the enactment date. We suggest that this change also be made effective retroactively, to apply to all open tax years, consistent with Congress' long-stated position on this issue.

### PROVISIONS THAT SHOULD BE RECONSIDERED

The Tax Council offers the following comments on certain specific tax increase proposals set forth in the Administration's budget:

### FOREIGN OIL AND GAS INCOME TAX CREDITS

The Tax Council's policy position on foreign source income is clear—A full, effective foreign tax credit should be restored and the complexities of current law, particularly the multiplicity of separate "baskets," should be eliminated.

The President's budget proposal dealing with foreign oil and gas income moves in the opposite direction by limiting use of the foreign tax credit on such income. This selective attack on a single industry's utilization of the foreign tax credit is not justified. U.S. based oil companies are already at a competitive disadvantage under current law since most of their foreign based competition pay little or no home country tax on foreign oil and gas income. The proposal increases the risk of foreign oil and gas income being subject to double taxation which will severely hinder U.S. oil companies in the global oil and gas exploration, production, refining and marketing arena.

## REPEAL OF THE EXPORT SOURCE RULE

Since 1922, regulations under Code § 863(b) and its predecessors have contained a rule which allows the income from goods that are manufactured in the U.S. and sold abroad (with title passing outside the U.S.) to be treated as 50% U.S. source income and 50% foreign source income. This export source rule has been beneficial to companies who manufacture in the U.S. and export abroad because it increases their foreign source income and thereby increases their ability to utilize foreign tax credits more effectively. Because the U.S. tax law restricts the ability of companies to get credit for the foreign taxes which they pay (e.g., through the interest and R&D allocations), many multinational companies face double taxation on their overseas operations, i.e., taxation by both the U.S. and the foreign jurisdiction. The export source rule helps alleviate this double taxation burden and thereby encourages U.S.-based manufacturing by multinational exporters.

The President proposes to eliminate the 50/50 rule and replace it with an "activities based" test, which would require exporters to allocate income from exports to foreign or domestic sources based upon how much of the activity producing the income takes place in the U.S. and how much takes place abroad. The justification given for eliminating the 50/50 rule is that it provides U.S. multinational exporters operating in high tax foreign countries a competitive advantage over U.S. exporters that conduct all their business activities in the U.S. The Administration also notes that the U.S. tax treaty network protects export sales from foreign taxation in countries where we have treaties, thereby reducing the need for the export source rule. Both of these arguments are seriously flawed.

The export source rule does not provide a competitive advantage to multinational exporters vis-a-vis exporters with "domestic-only" operations. Exporters with only domestic operations never incur foreign taxes and, thus, are not even subjected to the onerous penalty of double taxation. Also, domestic-only exporters are able to claim the full benefit of deductions for U.S. tax purposes for all their U.S. expenses, e.g., interest on borrowings and R&D costs, because they do not have to allocate any of those expenses against foreign source income. Thus, the export source rule does not create a competitive advantage; rather, it helps to "level the playing field" for U.S.-based multinational exporters. Our tax treaty network is certainly no substitute for the export source rule since it is not income from export sales, but rather foreign earnings, that are the main cause of the double taxation described above. To the extend the treaty system lowers foreign taxation, it can help to alleviate the double tax problem, but only with countries with which we have treaties, which tend to be the most highly industrialized nations of the world. We have few treaties with most of the developing nations, which are the primary targets for our export growth in the future.

Exports are fundamental to our economic growth and our future standard of living. Over the past three years, exports have accounted for about one-third of total U.S. economic growth. The export source rule also operates to encourage companies to produce their goods in their U.S. plants rather than in their foreign facilities. Repeal on cutbacks in the export source rule will reduce exports and jeopardize high paying jobs in the United States. Given the danger that the current Asian crisis poses to our exports, repeal of the rule would be especially unwise and counterproductive.

## LIMITING USE OF "HYBRID" ENTITIES

It is troubling that the Administration (i.e., Treasury) feels compelled to request congressional authority to issue potentially sweeping legislative regulations after non-specific tax guidance has been given. If Treasury has specific issues to address, it should do so through specific legislative proposals. This would permit normal congressional consideration, including hearings on such proposals.

One such proposal would limit the ability of certain foreign and U.S. persons to enter into transactions that utilize so-called "hybrid entities," which are entities that are treated as corporations in one jurisdiction, but, as branches or partnerships in another jurisdiction. Although most hybrid transactions do not attempt to generate tax results that are "inconsistent with the purposes of U.S. tax law," the Administration feels that there are enough taxpayers taking unfair advantage of the current rules that it is necessary to codify and extend the earlier government issued tax guidance (Notices 98–5 and 98–11) on this subject.

U.S. multinationals compete in an environment wherein foreign competitors use tax planning techniques to reduce foreign taxes without incurring home country tax. The use of "hybrid entities" allows U.S. Multinationals to compete on a level playing field and promotes additional U.S. exports. The use of hybrids is consistent with the initial balance between competitiveness and export neutrality that was intended by

Congress in enacting the "Subpart F" rules. Although Congress specifically enacted a branch rule for foreign base company sales under Code § 954(d)(3), similar rules were not enacted for foreign personal holding company income. If enacted, these proposals would represent an unwarranted extension of legislative authority by Congress to the Executive Branch to impose new rules by regulation without Congressional debate.

Notices 98–5 and 98–11 have a chilling effect on the ability of U.S. companies to structure their foreign operations consistent with the commercial objective of regionalizing their businesses. They also adversely impact companies' abilities to effectively reduce their overall costs by reducing local taxes in their overseas operations. The Notices are drafted so broadly and so vaguely that they confuse U.S. taxpayers and their advisors, and introduce a compelling need to seek clarification as to whether taxpayers can continue to rely on the simple "check-the-box" regulations issued just last year. All these effects are exacerbated by the Notices' immediate effective dates.

The world has changed dramatically since enactment of the Subpart F rules in 1962. We feel that it would be more appropriate for Congress to request a study regarding the trade and tax policy issues associated with Notices 98–5 and 98–11. In this regard, a moratorium on further regulatory action by Treasury should be imposed until enactment of specific legislative proposals resulting from well reasoned analysis and debate.

### Foreign Built-In Losses

Another proposal would require the Treasury to issue regulations to prevent taxpayers from "importing built-in losses incurred outside U.S. taxing jurisdictions to offset income or gain that would otherwise be subject to U.S. tax." The administration argues that although there are rules in the Code that limit a U.S. taxpayer's ability to avoid paying U.S. tax on built-in gain (e.g., Code § § 367(a), 864(c)(7), and 877), similar rules do not exist that prevent built-in losses from being used to shelter income otherwise subject to U.S. tax and, as a result, taxpayers are avoiding Subpart F income inclusions or capital gains tax. We believe that this directive, which is written extremely broadly, is unnecessary due to the existence of rules already available in the Code, e.g., the anti-abuse provisions of Code § § 269, 382, 446(b), and 482. Both this proposal, and the one immediately above regarding the use of hybrid entities, would severely impact the ability of U.S. multinationals to compete on an equal footing against foreign-based companies.

### Payments to 80/20 Companies

Currently, a portion of interest or dividends paid by a domestic corporation to a foreign entity may be exempt from U.S. withholding tax provided the payor corporation is a so-called "80/20 Company," i.e., at least eighty percent of its gross income for the preceding three years is foreign source income attributable to the active conduct of a foreign trade or business. The Administration believes that the testing period is subject to manipulation and allows certain companies to improperly avoid U.S. withholding tax on certain distributions attributable to a U.S. subsidiary's U.S. source earnings. As a result, it proposes to arbitrarily change the 80/20 rules by applying the test on a group-wide (as opposed to individual company) basis. However, there is little evidence that these rules have been manipulated on a broad scale in the past and we do not believe such a drastic change is needed at this time.

### Superfund Taxes

The three taxes that fund Superfund (corporate environmental tax, petroleum excise tax, and chemical feed stock tax) all expired on December 31, 1995. The President's budget would reinstate the two excise taxes at their previous levels for the period after the date of enactment through September 30, 2008. The corporate environmental tax would be reinstated at its previous level for taxable years beginning after December 31, 1997 and before January 1, 2009. Moreover, the funding cap for the Oil Spill Tax would be increased from the current $1 Billion amount to the *obscenely* high level of $5 Billion.

These taxes, which were previously dedicated to Superfund, would instead be used to generate revenue to balance the budget. This use of taxes for deficit reduction purposes, when historically dedicated to funding specific programs should be rejected. The decision whether to re-impose these taxes dedicated to financing Superfund should instead be made as part of a comprehensive examination of reforming the entire Superfund program.

### MODIFYING THE "SUBSTANTIAL UNDERSTATEMENT" PENALTY

The Administration proposes to make any tax deficiency greater than $10 million "substantial" for purpose of the Code § 6662 substantial understatement penalty, rather than applying the existing test that such tax deficiency must exceed ten percent of the taxpayer's liability for the year. The penalty is twenty percent of the tax underpayment, unless the taxpayer had "substantial authority" for the position producing the underpayment, or the relevant facts are disclosed on the return and there is a reasonable basis for the position.

There is no basis for the Administration's assertion that large corporate taxpayers are "playing the audit lottery" because of the purportedly high threshold amount at which the substantial understatement penalty applies. Large publicly-held corporations spend enormous amounts on tax related advice and, for security law and other reasons, generally document the basis for every major tax return position. Unfortunately, because of the complexity of both modern business transactions and the tax laws, as well as the relative dearth of regulatory or other guidance, the proper tax treatment of many items in a large corporation's return is far from clear. Also unclear is whether the "substantial authority" standard is met where a position is supported by well-reasoned legal analysis but there are no relevant cases, rulings, or other precedents, a situation encountered all too frequently by the corporate taxpayers targeted by this proposal. Indeed, the standard's vagueness is apparently evidenced by the continuing failure of Treasury to comply with the mandate of Code § 6662(d)(2)(D), requiring it to publish and periodically update a list of positions for which it is believes substantial authority is lacking.

We believe that the ultimate impact of this proposal to expand the substantial understatement penalty will be an expansion of lengthy and costly litigation to properly interpret the substantial authority standard. Taxpayers seeking protection from this penalty by disclosing uncertain positions will face almost certain proposed adjustments from IRS agents, no matter how reasonable their position, resulting in lengthy administrative controversy and litigation. Moreover, there is no evidence that the existing penalty and interest provisions are inadequate, so we strongly urge Congress to reject this ill-advised proposal.

### INCREASED PENALTIES FOR FAILURE TO FILE RETURNS

The Administration proposes to increase penalties for failure to file information returns, including all standard 1099 forms. IRS statistics bear out the fact that compliance levels for such returns are already extremely high. Any failures to file on a timely basis generally are due to the late reporting of year-end information or to other unavoidable problems. Under these circumstances, an increase in the penalty for failure to timely file returns would be unfair and would fail to recognize the substantial compliance efforts already made by American business.

### LIMITING MARK-TO-MARKET ACCOUNTING

Certain trade receivables would no longer be eligible for treatment under the mark-to-market accounting rules. Under those rules, certain taxpayers who purchase and sell their own trade receivables are exempt from the mark-to-market method of accounting unless they elect to be included. If they do, those taxpayers can currently write-off certain non-interest bearing receivables, and account, note, and trade receivables unrelated to the active business of a security dealer. There appear to be no tax policy reasons for prohibiting taxpayers from accelerating their bad debt deductions for these trade receivables, only government revenue considerations.

### REPEALING LOWER OF COST OR MARKET INVENTORY METHOD

Certain taxpayers can currently determine their inventory values by applying the lower of cost or market method, or by writing down the cost of goods that are not salable at normal prices, or not usable because of damage or other causes. The Administration is proposing to repeal these options and force taxpayers to recognize income from changing their method of accounting, on the specious grounds that writing down unusable or non-salable goods somehow "understates taxable income." We strongly disagree with this unwarranted proposal. In addition, we believe that in the least, the lower of cost or market method should continue to be permissible when used for financial accounting purposes, to avoid the complexity of maintaining separate inventory accounting systems.

### MODIFYING CORPORATE-OWNED LIFE INSURANCE ("COLI") RULES

The Administration proposes to substantially change the taxation of business-owned life insurance by disallowing a pro-rata portion of a business' general deduction for interest expense. Moreover, the Administration has proposed retroactive application of the new tax to existing life insurance contracts. This proposal should not be adopted.

Life insurance has long been used by businesses to protect against financial loss caused by the death of key employees and to finance the soaring cost of employee benefits, especially post-retirement health benefits. Life insurance provides a secure and stable source of financing for such employee benefits, and it is particularly well suited to this purpose because its long-term nature matches the correspondingly long-term nature of the liabilities. The Administration's proposal would have a devastating effect on employee benefit programs and key-person protection by effectively taxing life insurance contracts out of existence. Businesses should not be discouraged from providing employee health benefits or from seeking to protect themselves from key-person losses.

Moreover, the Administration's proposal would apply retroactively to existing life insurance contracts that were purchased by businesses in good faith, based on existing law. There can be no question of abuse: business use of life insurance is well known and the taxation of insurance contracts has been settled for many years. In addition, Congress has reviewed the taxation of business-owned life insurance in each of the last two years and, in each case, has carefully preserved the existing taxation of business-owned life insurance on the lives of employees. The Administration's proposal represents the worst kind of retroactive tax—it would not only cause the termination of most or all existing contracts, but, would also have the effect of taxing past earnings under those contracts.

### DEFERRAL OF OID ON CONVERTIBLE DEBT

The Administration has included a number of past proposals aimed at financial instruments and the capital markets, which were fully rejected during the last session of Congress. These reintroduced proposals should again be rejected out of hand. One proposal would defer deductions by corporate issuers for interest accrued on convertible debt instruments with original issue discount ("OID") until interest is paid in cash. The proposal would completely deny the corporation an interest deduction unless the investors are paid in cash (e.g., no deduction would be allowed if the investors convert their bonds into stock). Investors in such instruments would still be required to pay income tax currently on the accrued interest. In effect, the proposal defers or denies an interest deduction to the issuer, while requiring the holder to pay tax on the interest currently.

The Tax Council opposes this proposal because it is contrary to sound tax policy and symmetry that matches accrual of interest income by holders of OID instruments with the ability of issuers to deduct accrued interest. There is no justifiable reason for treating the securities as debt for one side of the transaction and as equity for the other side. There is also no reason, economic or otherwise, to distinguish a settlement in cash from a settlement in stock.

Moreover, the instruments in question are truly debt rather than equity. Recent statistics show that over 70 percent of all zero-coupon convertible debt instruments were retired with cash, while only 30 percent of these instruments were convertible to common stock. Re-characterizing these instruments as equity for some purposes is fundamentally incorrect and will put American companies at a distinct disadvantage to their foreign competitors, who are not bound by such restrictions. These hybrid instruments and convertible OID bond instruments have allowed many U.S. companies to raise tens of billions of dollars of investment capital used to stimulate the economy. Introducing this imbalance and complexity into the tax code will discourage the use of such instruments, limit capital raising options, and increase borrowing costs for corporations.

### ELIMINATING THE "DRD" FOR CERTAIN PREFERRED STOCK

Another proposal would deny the dividend received deduction ("DRD") for certain types of preferred stock, which the Administration believes are more like debt than equity. Although concerned that dividend payments from such preferred stock more closely resembles interest payments than dividends, the proposal does not simultaneously propose to allow issuers of such securities to take interest expense deductions on such payments. Again, the Administration violates sound tax policy and, in this proposal, would deny these instruments the tax benefits of both equity and debt.

The Tax Council opposes this proposal as not being in the best interests of either tax or public policy. Currently, the U.S. is the only major western industrialized nation that subjects corporate income to multiple levels of taxation. Over the years, the DRD has been decreased from 100% for dividends received by corporations that own over 80 percent of other corporations, to the current 70% for less than 20 percent owned corporations. As a result, corporate earnings have become subject to multiple levels of taxation, thus driving up the cost of doing business in the U.S. To further decrease the DRD would be another move in the wrong direction.

### PRO RATA DISALLOWANCE

Another proposal is also somewhat similar to the "pro rata" budget proposal that was rejected by Congress last year. It would effectively eliminate the "two-percent de minimis rule" and disallow a portion of interest expense deductions for certain entities that earn tax-exempt interest. While last year's proposal was designed to apply to corporations generally, this year's proposal would apply only to "financial intermediaries." Under the proposal, financial intermediaries that earn tax-exempt interest would lose a portion of their interest expense deduction based on the ratio of average daily holdings of municipals to average daily total assets.

The Tax Council strongly opposes the Administration's proposal to extend the "pro rata" disallowance of tax-exempt interest expense to financial intermediaries. These companies play an important role in the markets for municipal leases, housing bonds, and student loan bonds. By eliminating this significant source of demand for municipal securities, the Administration's proposal would force state and local governments to pay higher interest rates on the bonds they issue, significantly increasing their costs of capital. The cost of public facilities, such as school construction and housing projects, would be increased. This proposal is entirely inconsistent with tax incentive programs for some of the same state and local projects. At a time when the state and local governments are asked to do more, Congress should not make it more costly for them to achieve their goals.

### INCREASING THE PRORATION PERCENTAGE FOR PROPERTY AND CASUALTY ("P&C") INSURANCE COMPANIES

In 1986, Congress enacted a provision taxing fifteen percent (the proration percentage) of otherwise tax exempt interest of P&C companies attributable to municipal obligations acquired after 1986. It is now proposed to increase this proration to thirty percent for obligations acquired after enactment. Although a number of specious arguments are made in support of this proposal, it appears to be primarily revenue driven. The Tax Council believes that States will continue to finance their activities through bonds, but this proposal will make it more costly for P&C companies to buy them. Thus, States must either raise their interest rates or find individuals to buy the bonds, resulting in an even greater revenue loss to the Treasury (individuals have no proration percentage).

### TAX INSURANCE CONTRACT EXCHANGES OR REALLOCATE ASSETS WITH VARIABLE INSURANCE CONTRACTS

Annuity contract investments are a valuable retirement and investment tool. Currently, owners of variable annuity contracts can allocate their investments in a contract among different investment options (e.g. a bond fund, a stock fund, and a balanced fund). Owners may reallocate their account values within the contract among the various options without incurring a current tax so long as the investment remains committed to a retirement annuity. This flexibility provides an important savings incentive for retirement. A taxable event does occur when funds are taken out of an annuity. The Administration proposes to tax any exchange of a life insurance, endowment, or annuity contract, for a variable contract, or vice versa. In addition, any reallocation among accounts within the same variable life or annuity contract would result in a taxable event, even though no funds were taken out of the contract.

The Tax Council adamantly opposes this provision as a tax increase on middle-class Americans and retirement savers. Moreover, this proposal completely contradicts the President's recent statements to "Save Social Security First." Any new tax on private retirement savings puts further strain on the overall private and public retirement system. Variable life and annuity contracts are used respectively to insure against premature death and for long-term retirement savings. Like other retirement saving vehicles, including defined contribution and defined benefit plans, annuities allow savings to grow tax-free until they are needed for retirement. All retirement savers periodically shift their savings among different options as they

grow older and more conservative, or as the market changes. Under this proposal, annuity owners who shift accounts would be taxed immediately, thereby forcing them to keep bad investments or pay a tax on undistributed funds.

Recent surveys have shown that more than 80 percent of the owners of deferred annuity contracts have total annual household incomes of under $75,000. Such middle income savers rely on these well-designed products to encourage them to commit funds to retirement. At a time when Congress and the President are concerned about saving Social Security, the last thing that they should do is tax private retirement savings options.

### REDUCTION IN BASIS ("INVESTMENT IN THE CONTRACT") FOR MORTALITY-RELATED CHARGES

The Administration's proposal would reduce a policyholder's tax basis in an insurance or annuity contract for certain charges under the contract by subtracting mortality and associated expense charges. In the case of life insurance contracts, these charges include the cost of the insurance and related expenses. For deferred annuity contracts, the assumed mortality and expenses charges, which must be subtracted, are deemed to equal the contract's average cash value during the year multiplied by 1.25 percent. This proposal is nothing but a tax on private retirement savings. Increasing the cost of such savings vehicles by reducing a product's tax basis creates a disincentive to use these important savings tools. Life insurance and annuity contracts are designed to both accumulate retirement savings and insure against premature death (e.g. mortality-related risks). Taxes on income from the savings element of such contracts should not be increased just because those contracts also provide insurance protection.

This provision will likewise result in a tax increase on middle-class Americans and retirement savers. In addition, the proposal is inconsistent with general tax rules relating to the determination of tax basis and will further increase the complexity of the tax code with no recognizable benefit. Under the proposal, life insurance companies would be required to maintain additional records to keep track of two different basis amounts for annuity contracts. This will undoubtedly result in increased administrative burdens and compliance costs, which most likely will be passed on to Americans trying to save for retirement.

### MODIFYING THE RESERVE RULES FOR ANNUITY CONTRACTS

Currently, reserves for annuity contracts equal the greater of the contract's net surrender value or an amount based on the Commissioner's Annuities Reserve Valuation Method ("CARVM"). Under the Administration's proposal, reserves for all annuity contracts with cash surrender values would equal the lesser of the amount computed under CARVM or the contract's "adjusted account value." The adjusted account value would equal the net cash surrender value plus a specified percent (e.g., plus 5.5% in the first year).

The Tax Council opposes this proposal as another attack on middle-class Americans and retirement savers who use annuity contracts as their preferred savings vehicle. The proposal would make it unduly expensive for insurance companies to administer an annuity contract in its early years. While aimed at accounting and reserve methods of insurers, the real targets are the users of these products who will eventually bear the increased costs and burdens resulting from such a change. By increasing the costs of annuity contracts, use of such vehicles will be reduced, thereby straining the entire public and private retirement system. At a time when Americans are trying to increase retirement savings, this proposal moves in the opposite direction and makes it more costly for them to achieve their goal.

### EFFECTIVE DATES

Before concluding, we would like to make one last comment regarding the effective dates of tax proposals. The Tax Council believes that it is bad tax policy to make significant tax changes in a retroactive manner that impose additional burdens on businesses. Businesses should be able to rely on the tax rules in place when making economic decisions, and expect that those rules will not change while their investments are still ongoing. It seems plainly unfair to encourage businesses to make economic decisions based on a certain set of rules, but then change those rules midstream after the taxpayer has made significant investments in reliance thereon.

CONCLUSION

The Tax Council strongly urges Congress not to adopt the provisions identified above when formulating its own proposals, since they are based on unsound tax policy. Congress, in considering the Administration's budget, should elevate sound and justifiable tax policy over mere revenue needs. Revenue can be generated consistent with sound tax policy, and that is the approach that should be followed as the budget process moves forward.

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**Statement of Martin A. Regalia, Ph.D., Vice President and Chief Economist, U.S. Chamber of Commerce**

The U.S. Chamber appreciates this opportunity to express our views on the revenue provisions in President Clinton's Fiscal Year 1999 budget proposal. The U.S. Chamber is the world's largest business federation, representing more than three million businesses and organizations of every size, sector and region. This breadth of membership places the U.S. Chamber in a unique position to speak for the business community.

THE PRESIDENT'S BUDGET WOULD INCREASE BUSINESS TAXES

President Clinton's budget proposal contains numerous new spending initiatives, and pays for them by increasing taxes on businesses. It would increase gross taxes on American businesses by $106 billion over five years (including $65.5 billion in receipts from tobacco legislation), and raise government receipts, as a percentage of GDP, from an already-high 19.8 percent to 20.1 percent.

The President's proposal contains dozens of provisions which would raise taxes on the business community. Many of these provisions were included in his earlier budget proposals and were summarily rejected by Congress, while others are being offered for the very first time.

The proposal also asserts that many of these provisions are needed to close unwarranted tax benefits or "loopholes." However, these so-called loopholes are, in fact, legitimate, equitable, and longstanding business tax provisions, and should remain in the Internal Revenue Code.

The most onerous provisions in the President's budget proposal would:

*Replace the Export Source Rule with an Activity-Based Rule*

Currently, U.S.-based multinational exporters can treat 50 percent of their export income as U.S. source income and 50 percent as foreign source income. This rule is beneficial to companies that manufacture products in the U.S. and export abroad because it increases their ability to utilize foreign tax credits and, therefore, alleviate double taxation.

The President's proposal would replace the existing export source rule with an economic activity-based rule. The proposed rule could increase U.S. taxes on these companies, and, therefore, encourage them to produce their goods overseas, rather than in this country. Since exports have played an important role in our nation's recent economic growth, any proposal weakening the longstanding export source rule could have a significant, negative effect on our economy.

*Convert Airport Trust Fund Taxes to a Cost-Based User Fee System*

Currently, excise taxes are imposed on commercial and noncommercial aviation to finance programs administered through the Airport and Airway Trust Fund. These taxes were modified and extended through September 30, 2007 by the Taxpayer Relief Act of 1997 ("1997 Act").

The President's proposal would phase-out these excise taxes beginning in Fiscal Year 1999 through Fiscal Year 2003, and replace them with cost-based user fees. While the proposal does not contain details of this provision, it is estimated to raise almost $6 billion over the next five years. A $6 billion tax increase on the business community and the public-at-large, especially before the issue of whether existing excise taxes should be replaced by cost-based user fees is fully debated, is unacceptable and should be thwarted immediately.

*Modify the Reserve Rules for Annuity Contracts*

Under current law, life insurance reserves for any annuity contract equal the greater of the contract's net surrender value or an amount determined using the Commissioner's Annuities Reserve Valuation Method ("CARVM"). Under the Presi-

dent's proposal, reserves for any annuity contract with a cash surrender value would equal the lesser of the amount computed under CARVM or the contract's "adjusted account value." The adjusted account value for a contract would equal the net cash surrender value of the contract, plus a percentage of the net cash surrender value of the contract (e.g., 5.5 percent in the first year, 5.0 percent in the second year).

This provision would make it unduly expensive for insurance companies to administer annuity contracts in their early years. Ultimately, individuals saving for retirement would have to absorb the increased costs and burdens associated with the proposed change in reserve rules. At a time when Americans need to increase retirement savings, this proposal moves in the opposite direction by making saving more costly and burdensome.

*Reinstate the Superfund Excise Taxes*

The four taxes that funded the Hazardous Substance Superfund Trust Fund ("Superfund") expired on December 31, 1995. The President's proposal would reinstate the three expired excise taxes from the date of enactment through September 30, 2008, and the expired corporate environmental income tax for tax years beginning after December 31, 1997, and before January 1, 2009.

The business community believes that the various Superfund taxes should be thoroughly examined and evaluated before they are reinstated. Furthermore, if these taxes are reinstated, they should be part of a comprehensive plan to reform the entire Superfund program.

*Modify the Corporate-Owned Life Insurance Rules*

The President's proposal would impose additional taxes on businesses that borrow for any purpose if they also own life insurance, including key employee life insurance. Specifically, the provision would eliminate the exception under the pro-rata-interest-disallowance rule for employees, officers and directors. The exception for 20-percent owners would be retained, however.

This provision could have a devastating effect on life insurance products that protect businesses, especially small businesses, against financial loss caused by the death of key employees and allows them to provide benefits, including retiree health benefits, to their employees. Furthermore, the provision would unfairly apply retroactively to existing life insurance contracts that were purchased under current law.

*Repeal the "Lower-of-Cost-or-Market" Inventory Accounting Method*

Currently, taxpayers that maintain their inventories under the "first-in-first-out" ("FIFO") method may determine the value of ending inventory under a "lower-cost-or-market" method. Under this method, the value of ending inventory is written down if its market value is less than its cost. Similarly, under the subnormal goods method, any goods that are unsalable at normal prices, or unusable because of damage or other causes, may be written down to reflect their lower market values.

The President's proposal would repeal these valuation methods for taxpayers whose average annual gross receipts over a three-year period exceed $5 million. This provision could increase taxes on those businesses that use FIFO, or cause them to switch to the "last-in-first-out" method of valuation for both tax and financial statement purposes.

*Eliminate Various Estate Tax Planning Techniques*

Instead of further reducing the estate and gift tax burden on Americans, as Congress did last year in the 1997 Act, the President's proposal would increase estate taxes on the middle-class by eliminating or curtailing the use of several popular estate tax planning devices.

Specifically, the proposal would: (1) repeal the "Crummey" rule which would stifle the use of insurance trusts; (2) eliminate "valuation discounts" for minority-owned interests of family limited partnerships (except for active businesses); and (3) reduce the attractiveness of "personal residence trusts" by requiring the trust to make certain payments to the homeowner or else value the retained interest at zero. If enacted, these provisions would make it more difficult for business owners to develop estate plans which would keep their businesses intact, and their employees working, after their deaths.

*Modify the Exchange Rules for Insurance and Annuity Contracts*

Life insurance and annuity contracts have proven to be valuable retirement and savings devices. Under current law, one can exchange a life insurance, endowment or annuity contract for a variable contract, or vice versa, without triggering tax. Likewise, one can reallocate investment assets within a variable life or annuity contract without incurring tax.

The President's proposal would repeal the tax-free status of the above-mentioned exchanges, even if no funds are actually withdrawn from the contracts. This provision would impose an additional tax on many Americans who are trying to save for retirement. The tax-free benefits of life insurance and annuity contracts should be maintained in order to encourage greater personal saving and responsibility.

*Eliminate the Dividends-Received Deduction for Certain Preferred Stock*

Currently, a corporation can deduct 100 percent of the "qualifying" dividends it receives from a domestic corporation if it owns over 80 percent of the stock of the dividend-paying corporation. The percentage is reduced to 80 percent if the corporation owns at least 20 percent, but no more than 80 percent, of the stock of the dividend-paying corporation, and to 70 percent if the corporation owns less than 20 percent of the stock of such corporation.

The President's proposal would eliminate the dividends-received deduction for certain types of preferred stock, subjecting corporate earnings to even higher amounts of tax. The dividends-received deduction should be increased, not decreased, in order to lessen the effects of multiple taxation on corporations and shareholders.

*Repeal Tax-Free Conversions of "Large" C Corporations to S Corporations*

Under current law, the "built-in" gains of assets of a C corporation that converts, or merges, into an S corporation is not subject to tax so long as such assets are not disposed of within 10 years after conversion. The President's proposal would repeal these tax-free conversions for "large" S corporations, defined as those corporations whose stock has a value of more than $5 million at the time of conversion.

As a result, this provision would require immediate gain recognition by such "large" corporations with respect to their appreciated assets, as well as by their shareholders with respect to their stock upon conversion to S-corporation status. If enacted, this provision would decrease the desirability of the Subchapter S election for those C corporations that are eligible to convert.

*Require Employers to Deposit Unemployment Taxes Monthly*

Generally, employers deposit their federal and state unemployment tax liabilities quarterly. The President's proposal would require that most employers, beginning in 2004, pay their federal and state unemployment taxes on a monthly basis. This provision would significantly increase the administrative burden on businesses by increasing the number of annual unemployment tax deposits from four to 12.

## MORE TAX RELIEF IS NEEDED FOR BUSINESSES

Instead of increasing taxes on the business community, the President's budget proposal should lead the way in reducing business taxes. The U.S. Chamber believes tax relief is needed in the following areas:

*Alternative Minimum Tax ("AMT")*

While the 1997 Act exempted "small" corporations from AMT and provided some relief for other corporations, repeal of the harmful corporate and individual AMT is needed. If repeal is not feasible, significant reforms should be enacted. Such reforms should include: providing a "small business" exemption for individuals; completely eliminating the depreciation adjustment; increasing the individual AMT exemption amounts; allowing taxpayers to offset their current year AMT liabilities with their accumulated minimum tax credits; and making the AMT system less complicated and easier to comply with.

*Capital Gains Tax*

While the 1997 Act reduced the maximum capital gains tax rate for individuals from 28 percent to 20 percent (10 percent for those in the 15-percent income-tax bracket), it also lengthened the holding period for long-term capital gains from 12 months to 18 months. This holding period should revert back to 12 months, and rates should be further reduced, if possible. In addition, capital gains tax relief is still needed for corporations, whose capital gains continue to be taxed at regular income tax rates.

*Equipment Expensing*

In 1998, businesses can generally expense up to $18,500 of equipment purchased. This amount will gradually increase to $25,000 by 2003. This expensing limit needs to be further increased, and at a faster pace, in order to promote capital investment, economic prosperity, and job growth.

*Estate and Gift Tax*

While the 1997 Act provided some estate tax relief, the federal estate tax should be completely repealed. If repeal is not feasible, significant reforms should be implemented. Such reforms include further increasing the unified credit, reducing overall tax rates, increasing and expanding the newly created "family-owned business interest" exclusion to encapsulate more businesses, and broadening the installment payment rules.

*Foreign Tax Rules*

While the 1997 Act included some foreign tax relief and simplification measures, our foreign tax rules need to be further simplified and reformed so American businesses can better compete in today's global marketplace.

*Individual Retirement Accounts ("IRAs")*

While the 1997 Act expanded deductible IRAs and creates nondeductible Roth IRAs, both types of IRAs need to be further expanded (e.g., increase contribution limits, eliminate phase-out ranges) in order to promote saving and personal responsibility.

*Internal Revenue Service ("IRS") Restructuring and Reform*

The overall management, oversight and culture at the IRS needs to be changed in order to make it a more efficient, accountable and taxpayer-friendly organization. We support legislation which the House overwhelmingly passed in November and look forward to working with Congress towards its enactment.

*Research and Experimentation Tax Credit*

While the 1997 Act extended this credit through June 30, 1998, it needs to be extended permanently, and further expanded, so businesses can better rely on and utilize the credit.

*S Corporation Reform*

While the Small Business Jobs Protection Act of 1996 contained many needed reforms for S corporations, such as increasing the maximum number of shareholders from 35 to 75, there are many other important reforms which still need to be enacted, such as allowing preferred stock to be issued and creating family attribution rules.

*Self-Employed Health Insurance Deduction*

This deduction is scheduled to increase from 40 percent in 1997 to 100 percent in 2007. We believe this timetable should be accelerated to give self-employed individuals a full deduction as soon as possible.

*Work Opportunity Tax Credit*

This credit, which encourages employers to hire individuals from several targeted groups, needs to be permanently extended beyond its June 30, 1998 sunset date.

*Worker Classification Rules*

The current worker classification rules are too subjective and restrictive, and need to be simplified and clarified. We support the creation of a more objective safe harbor for independent contractors, while leaving the current 20-factor test and Section 530 safe harbors intact.

## CONCLUSION

The revenue-raising provisions contained in President Clinton's Fiscal Year 1999 budget proposal would further increase taxes on businesses and reduce savings and investment. The U.S. Chamber urges that these provisions be rejected as bad tax policy, and not included in final budget legislation for Fiscal Year 1999.

Hidden among the dozens of tax increases in the President's proposal are a few provisions which would marginally benefit businesses. For example, the proposal would temporarily extend the research and experimentation tax credit, work opportunity tax credit and the employer-provided educational assistance exclusion, enhance taxpayers' rights, and extend and modify the Puerto Rico Tax Credit.

These provisions, however, would not provide businesses with significant or long-term tax relief. For example, the tax extender provisions would not be made permanent, and are overshadowed by the numerous tax increasing provisions. Furthermore, needed relief in other areas, such as the alternative minimum tax and the estate and gift tax, is not provided for anywhere in his proposal.

Our long-term economic health depends on sound economic and tax policies. The federal tax burden on American businesses is too high and needs to be significantly reduced. In addition, our tax code wrongly favors consumption over savings and investment. As we prepare for the economic challenges of the next century, we must orient our current tax policies in a way that encourages more savings, investment, productivity growth, and, ultimately, economic growth.

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**Statement of United States Council for International Business (USCIB)**

INTRODUCTION

The United States Council for International Business (USCIB) is pleased to take this opportunity to comment with respect to the international provisions included among the tax proposals offered in the Administration's budget statement.

The USCIB advances the global interest of American business both at home and abroad. It is the American affiliate of the International Chamber of commerce (ICC), the Business and Industry Advisory Committee (BIAC) to the OECD, and the International Organisation of Employers (IOE). As such, it officially represents U.S. business positions in the main intergovernmental bodies, and vis-à-vis foreign business and their governments.

We noted, and appreciate, in the international area the proposal to accelerate the implementation date of the "look-through" treatment for dividend from 10/50 companies. Too many of the international tax proposals, however, reflect a misguided emphasis on raising revenue at the expense of sound tax policy. Most of the revenue raisers found in the budget proposals which affect the international area lack a sound policy foundation. Although they may be successful in raising revenue, they do nothing to achieve the objective of expanding and/or retaining U.S. jobs to make the U.S. economy stronger. Examples, include the proposals (1) to arbitrarily change the sourcing of income rules on export sales by U.S. based manufacturers, (2) to provide the Treasury Secretary with blanket authority to issue regulations in the international area that could conceivably allow it to attack legitimate tax planning by U.S. companies, (for example, by severely restricting the ordinary business operations of foreign affiliates through no longer allowing a U.S. company to characterize its foreign affiliate as a branch for U.S. tax purposes), and (3) to limit the ability of so-called "dual capacity taxpayers" (i.e., multinationals engaged in vital petroleum exploration and production overseas) to take credit for certain taxes paid to foreign countries. These proposals, if enacted, would be totally counter productive.

The Administration is unwise, in its efforts to balance the budget, to target U.S. multinationals doing business overseas, and we urge that such proposals be reconsidered and withdrawn. The predominant reason that businesses establish overseas operations is to serve local markets to be able to compete more effectively. Investments abroad provide a platform for the growth of exports and, indirectly, create jobs in the U.S., not to mention improving the U.S. balance of payments. The creditability of foreign income taxes has existed in the Internal Revenue code for almost 80 years to alleviate the double taxation of foreign income. Replacing such credits with less valuable deductions will greatly increase the costs of doing business overseas, resulting in a competitive disadvantage to U.S. multinationals vis-a-vis foreign-based companies.

So that U.S. companies can better compete with foreign-based multinationals, the Administration should, instead, do all it can to make the U.S. tax law more user friendly, consistent with the Administration's more enlightened trade policy. Rather than engaging in gimmicks that reward some industries and penalize others, the Administration's budget should be written with the goal of reintegrating sounder tax policy into decisions regarding the revenue needs of the government. Provisions that merely increase business taxes by eliminating legitimate business deductions should be avoided. Ordinary and necessary business expenses are integral to our current income tax system, and arbitrarily denying a deduction for such an expense will only distort that system. Higher business taxes impact all Americans, directly or indirectly. For example, they result in higher prices for goods and services, stagnant or lower wages paid to employees in those businesses, and smaller returns to shareholders. Those shareholders may be the company's employees, or the pension plans of other workers. We comment below on the specific proposals impacting the international area.

ACCELERATING THE EFFECTIVE DATE OF 10/50 COMPANY CHANGE

We commend the Administration for its proposal to accelerate the effective date of a tax change made in the 1997 Tax Relief Act affecting foreign joint ventures owned between ten and fifty percent by U.S. parents (so-call "10/50 Companies"). This change will allow 10/50 Companies to be treated just like controlled foreign corporations, by allowing "look-through" treatment for foreign tax credit purposes for dividends from such joint ventures. The 1997 Act, however, did not make the change effective to dividends for such entities unless they were received after the year 2003 and, even then, required separate rules to apply, on the one hand, to dividends from earning and profits ("E&P") generated before the year 2003, and, on the other hand, to dividends from E&P accumulated after the year 2002. The Administration's proposal will, instead, apply the look-through rules to all dividends received in tax years after 1997, no matter when the E&P constituting the dividend was earned and accumulated.

This change will result in an enormous reduction in complexity and compliance burdens for U.S. multinationals doing business overseas through foreign joint ventures. It will also reduce the competitive bias against U.S. participation in such ventures by placing U.S. companies on a much more level playing field from a corporate tax standpoint. The proposal is the type of provision that promotes the desirable policy goal of simplicity in the tax law.

FOREIGN TAX CREDITS RELATING TO FOREIGN OIL AND GAS INCOME

The USCIB strongly believes that, in general, a full foreign tax credit should be restored and the complexities of current law, particularly the multiplicity of separate "baskets," should be eliminated.

Unfortunately, the proposal relating to foreign oil and gas income moves quite in the opposite direction, by limiting use of the foreign tax credit on foreign oil and gas income. This selective attack on a single industry's utilization of the foreign tax credit is not justified. U.S. based oil companies are already at a competitive disadvantage under current law since most of their foreign based competition pay little or no home country tax on foreign oil and gas income. The proposal increases the risk of foreign oil and gas income being subjected to double taxation which will severely hinder U.S. oil companies in their global oil and gas exploration, production, refining and marketing activities.

REPEAL OF THE EXPORT SOURCE RULE

The regulations under Code 863(b) (and its predecessors) have long contained a rule which allows the income from goods that are manufactured in the U.S. and sold abroad (with title passing outside the U.S.) to be treated as 50% U.S. source income and 50% foreign source income. This export source rule has been beneficial to companies who manufacture in the U.S. and export abroad because it increases their foreign source income and thereby increases their ability to utilize foreign tax credits. Because the U.S. tax law restricts the ability of companies to fully utilize credits for the foreign income taxes which they incur (e.g., through the interest and R&D allocations), many multinational companies face double taxation on their overseas operations. The export source rule helps alleviate this double taxation burden and thereby encourages U.S.-based manufacturing by multinational exporters.

The proposal would eliminate the 50/50 rule and replace it with an "activities based" test, which would require exporters to allocate income from exports to foreign or domestic sources based upon how much of the activity producing the income takes place in the U.S. and abroad, respectively. The justification given for eliminating the 50/50 rule is that it provides U.S. multinational exporters operating in high tax foreign countries a competitive advantage over U.S. exporters that conduct all their business activities in the U.S. The administration also notes that the U.S. tax treaty network protects export sales from foreign taxation in countries where we have treaties, thereby reducing the need for the export source rule. Both of these arguments are erroneous.

The export source rule does not provide a competitive advantage to multinational exporter vis-à-vis exporters with "domestic-only" operations. Exporters with only domestic operations never incur foreign taxes and, thus, are not subjected to the onerous penalty of double taxation. Also, domestic-only exporters are able to claim the full benefit of deductions for U.S. tax purposes for all their U.S. expenses, e.g., interest on borrowings and R&D costs, because they do not have to allocate any of those expenses against foreign source income. Thus, the export source rule does not create a competitive advantage; rather, it helps to "level the playing field" for U.S.-based multinational exporters. Our tax treaty network, although of great significance to

U.S. businesses operating abroad is certainly no substitute, for the export source rule since it is not earnings from export sales, but rather other foreign earnings, that are the main cause of the double taxation described above. To the extent that the treaty network lowers foreign taxes, it can help to alleviate the double tax problem, but only with countries with which we have treaties, which tends to be the other industrialized nations of the world. We have few treaties with the developing nations, which will undoubtedly be the primary targets areas for our export growth in the future.

Exports are fundamental to our economic growth and our future standard of living. Over the past three years, exports have accounted for about one-third of total U.S. economic growth. The export source rule also operates to encourage companies to produce their goods in their U.S. plants rather than in their foreign facilities. Repeal of, or a cutback in, the export source rule will reduce exports and jeopardize high paying jobs in the United States. Given the danger that the current Asian crisis poses to our exports, repeal of the rule would be especially unwise and counterproductive.

### LIMITING USE OF "HYBRID" ENTITIES

We deplore the fact that the Administration (i.e., Treasury) feels compelled to request congressional authority to issue potentially sweeping legislative regulations after non-specific tax guidance has been given. If Treasury has specific issues to address, it should do so through specific legislative proposals. This would permit normal congressional consideration, including hearings on such proposals.

We refer in particular to the proposal which would limit the ability of certain foreign and U.S. persons to enter into transactions that utilize so-called "hybrid entities," which are entities that are treated as corporations in one jurisdiction but as branches or partnerships in another jurisdiction. Although most hybrid transactions do not attempt to generate tax results that are "inconsistent with the purposes of U.S. tax law," the Administration feels that there are enough taxpayers taking unfair advantage of the current rules that it is necessary to codify and extend earlier government issued tax guidance on this subject (i.e., Notice 98–5 and 98–11).

U.S. multinationals compete in an environment in which foreign competitors use tax planning techniques to reduce foreign taxes without incurring home country tax. The use of "hybrid entities" allows U.S. multinationals to compete on a level playing field and, in fact, promotes additional U.S. exports. The use of hybrids is consistent with the initial balance between competitiveness and export neutrality that was intended by Congress in enacting the "Subpart F" rules. Although Congress specifically enacted a branch rule for foreign base company sales under Code 954(d)(3), similar rules were not enacted for foreign personal holding company income. If enacted, these proposals would represent an unwarranted extension of legislative authority by Congress to the Executive Branch to impose new rules by regulation without Congressional debate.

Notices 98–5 and 98–11 have chilling effect on the ability of U.S. companies to structure their foreign operations consistent with the commercial objective of regionalizing their businesses. They also adversely impact the ability of U.S. multinationals to effectively reduce their overall costs by reducing local taxes in their overseas operations. The Notices are drafted so broadly and so vaguely that they will confuse U.S. taxpayers and their advisors, and introduce a compelling need to seek clarification as to whether taxpayers can continue to rely on the simple "check-the-box" regulations issued just last year. All these effects are exacerbated by the Notices' immediate effective dates.

The world has changed dramatically since enactment of the Subpart F rules in 1962. We feel that it would be more appropriate for Congress to request a study regarding the trade and tax policy issues associated with Notices 98–5 and 98–11. In this regard, a moratorium on further regulatory action by Treasury should be imposed until enactment of specific legislative proposals resulting from a well reasoned analysis and debate.

### FOREIGN TAX CREDITS RELATING TO FOREIGN OIL AND GAS INCOME

Another proposal would require the Treasury to issue regulations to prevent taxpayers from "importing built-in losses incurred outside U.S. taxing jurisdictions to offset income or gain that would otherwise be subject to U.S. tax." The administration argues that although there are rules in the Code that limit a U.S. taxpayer's ability to avoid paying U.S. tax on built-in gains (e.g., Code 367(a), 8664(c)(7), and 877), similar rules do not exist that prevent built-in losses from being used to shelter income otherwise subject to U.S. tax, and, as a result, taxpayers are avoiding subpart F income inclusions or capital gains tax. We believe that this directive,

which is written extremely broadly, is unnecessary due to the existence of rules already available in the code, e.g., the anti-abuse provisions of Code 269, 382, 446(b), and 482. This is another example of the type of provision that would seriously erode U.S. competitiveness.

### PAYMENTS TO 80/20 COMPANIES

Under current rules, a portion of the interest or dividends paid by a domestic corporation to a foreign entity may be exempt from U.S. withholding tax provided the payor corporation is a so-called "80/20 Company," i.e., at least eighty percent of its gross income for the preceding three years is foreign source income generated in the active conduct of a foreign trade or business. The Administration believes that the testing period is subject to manipulation and allows certain companies to improperly avoid U.S. withholding tax on certain distributions attributable to a U.S. subsidiary's U.S. source earnings. As a result, it proposes to arbitrarily change the 80/20 rules by applying the test on a group-wide (as opposed to individual company) basis. However, there is little evidence that these rules have been manipulated on a broad scale in the past, and, accordingly, we do not believe such a drastic change is needed.