1993

Miscellaneous Revenue Issues: Hearings before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, House of Representatives, One Hundred Third Congress, First Session

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CONTENTS

Part 1 (June 17, 22, 24; and July 13, 1993) ........................................................................ 1
Part 2 (September 8, 21, and 23, 1993) ........................................................................... 1055
Part 3 (Submissions for the Record—Revenue losers and revenue raisers) .................. 1787

Press releases announcing the hearings ................................................................. 2

WITNESSES

U.S. Department of the Treasury, Hon. Leslie B. Samuels, Assistant Secretary for Tax Policy:
June 22, 1993 ........................................................................................................ 299
September 21, 1993 ............................................................................................ 1397

U.S. Department of Commerce, Diana H. Josephson, Deputy Under Secretary for Oceans and Atmosphere, National Oceanic and Atmospheric Administration ............ 353

U.S. General Accounting Office, Natwar M. Gandhi, Associate Director, Tax Policy and Administration Issues, General Government Division, Tom Short, Assignment Manager, and David Pasquarello, Evaluator, Philadelphia GAO ..... 1421

Abrahamson, Gen. James A., Oracle Corp., and FSC Software Coalition 638
Actors' Equity Association, Ron Silver and Mark J. Weinstein 1121
Ad Hoc Group to Preserve Deduction for Advertising, Mark McConaghy 1171
Advanced Micro Devices, Cliff Jernigan 265
Advertising Tax Coalition
Timothy White 1179
Dewitt P. Helm, Jr. 1184
Aerospace Industries Association, Douglas C. McPherson 666
Aerospace States Association (see listing for Hon. C. Michael Callihan) 676
Air Transport Association of America, Edward A. Merlis 1303
Allers, Stephen D., Mineral Resources Alliance 1265
Alliance for Collaborative Research, Larry W. Sumney 371
Alliance for Responsible CFC Policy, Kevin J. Fay 1709
Alliance of American Insurers, Robert Jarratt 1488
Alliance to Save Energy, Mary Beth Zimmerman 699
Allis, John E., Houston, Tex 1536
American Agriculture Movement, Inc., Harvey Joe Sanner 1740
American Bankers Association, Taxation Committee, Lynda A. Kern 192
American Bar Association, Section of Taxation, Committee on S Corporations, Jordan P. Rose 434
American Express Travel Related Services, Co., Richard P. Romeo 1153
American Farmland Trust, Edward Thompson, Jr. 801
American Federation of Television & Radio Artists, Ron Silver and Mark Weinstein 1121
American Financial Services Association, Richard P. Romeo 1153
American Football Coaches Association, Charles McClendon 91
American Institute of Certified Public Accountants:
   Gerald W. Padwe 466
   Pamela J. Pecarich 1454
American Insurance Association, Robert Rahn 1500

(III)
V

Cianbro Corp., Robert J. Desjardins:
July 13, 1993 .......................................................... 1030
September 21, 1993 .................................................. 1553
City National Bank of Newark, Sharnia "Tab" Buford ........................................ 233
Cleveland-Cliffs, Inc., John L. Kelly .......................................................... 1275
Coalition for Asset Backed Securities, Donald J. Susswein ............................... 214
Coalition for the Fair Treatment of Environmental Cleanup Costs, Wayne Robinson ......................................................... 1626
Coalition on Energy Taxes, R. David Damron ............................................... 1254
Coalition to Eliminate Tax Barriers to Environmental Cleanup, Fred J. Gentile .......................................................... 1632
Coalition to Preserve the Current Deductibility of Environmental Remediation Costs, Roy E. Hock ........................................... 1604
Cohber Press, Inc., Howard C. Webber, Jr ..................................................... 1209
Cohen, Sheldon S., Leadership Council on Advertising Issues ........................ 1192
Colorado, State of (see listing for Hon. C. Michael Callihan) .......................... 1563
Commercial Finance Association, Louis Eliasberg, Jr .................................... 201
Committee for Competition Through Advertising, Gerald Z. Gibian .............. 1164
Community Bankers Association of Illinois, David E. Manning ....................... 208
Computer & Business Equipment Manufacturers Association, Robert Mattson ................................................................................. 645
Conference of Chief Justices, and Conference of State Court Administrators, Hon. Thomas R. Phillips, Chief Justice ........................................... 71
Construction Financial Management Association, Gerald J. Herr ...................... 1558
Contos, Larry, National Grocers Association, and Pay Less Supermarkets, Inc .......................................................................................... 523
Coopers & Lybrand, Ronald T. Maheu ............................................................. 1754
Cornell, Frederic G., Sullivan & Worcester .................................................... 479
Costello, Hon. Jerry F., a Representative in Congress from the State of Illinois ................................................................................. 64
Council for Rural Housing and Development, Pamela K. Borton ...................... 902
Cox, Dale, Independent Bakers Association ...................................................... 1094
Crispin, Robert W., Travelers Corp ................................................................. 180
Crop Protection Coalition, Richard Douglas .................................................... 1745
Dakin, William G., National Association of Manufacturers, and Mobil Corp .... 1431
Daley, Hon. Richard M., Mayor, City of Chicago ............................................. 830
Damron, R. David, Petrochemical Energy Group, Coalition on Energy Taxes, and Hoechst Celanese Corp ...................................................... 1254
DeFazio, Hon. Peter A., a Representative in Congress from the State of Oregon ................................................................................. 59
Desjardins, Robert J., Associated General Contractors of America, and
Cianbro Corp.:
July 13, 1993 ......................................................................................... 1030
September 21, 1993 ............................................................................. 1553
Destec Energy, Inc., Tom Remar .................................................................. 677
Dineen, Thomas C., Building Owners & Managers Association International ............................................................................. 1738
Disabled American Veterans, John F. Heilman ................................................. 120
Douglas, Richard, Crop Protection Coalition, and Sun-Diamond Growers of California ............................................................................. 1745
Dyer, Randy (see listing for National Structured Settlement Trade Association) ..................................................................................... 1136
Ege, Karl J., Frank Russell Co. and Frank Russell Investment Management Co .......................................................... 593
Electronic Industries Association, Peter F. McCloskey:
July 13, 1993 ......................................................................................... 622
September 21, 1993 ............................................................................. 1464
Eliasberg, Louis, Jr., Commercial Finance Association, and Finance Company of America .......................................................... 201
Elliott, Gary, National Wood Energy Association ............................................ 751
Emergency Committee for American Trade, Raymond J. Wlacak ...................... 1528
Emil Buchler Perpetual Trust, Ira J. Kaltman .................................................. 420
Erfandson, Dawn, Friends of the Earth ............................................................. 1284
Estee Lauder Co., Gerald Z. Gibian ............................................................... 1184
Farren, Michael J., Xerox Corp .................................................................... 681
Fay, Kevin J., Alliance for Responsible CFC Policy ............................................. 1709
Feeney, David L., National Retail Federation, and R.H. Macy & Co., Inc .......... 1203

Page
Page

Feulner, Edwin J., Jr. (see listing for Heritage Foundation) ................................................. 201
Finance Company of America, Louis Eliasberg, Jr ................................................................. 105
Fink, Matthew P., Investment Company Institute ............................................................... 372
Firemen's Association of the State of New York, Kenneth E. Newton ................................. 105
First Colony Life Insurance Co., Andrew Larsen ............................................................... 174
First Federal Savings, E. Lee Beard ......................................................................................... 1328
Florida Clinical Practice Association, Inc., Stanley W. Rosenkranz ....................................... 1106
Florida Farm Bureau Casualty Insurance Co., Robert Jarratt .............................................. 1488
Florida Farm Bureau General Insurance Co., Robert Jarratt ............................................... 1488
Forest Industries Council on Taxation, Bartow S. Shanks .................................................... 682
Frank Russell Co., and Frank Russell Investment Management Co., Karl J. Ege, and Warren Thompson .......................................................... 593
Friends of the Earth, Darl Erdlandson ..................................................................................... 1284
FSC Software Coalition, Gen. James A. Abrahamson ................................................................ 638
Gackenbach, Julie Leigh, U.S. Chamber of Commerce ............................................................ 1444
Gentile, Fred ......................................................... 262
Gentile, Peter A., North American Reinsurance Corp ............................................................ 1480
Geothermal Resources Association, Thomas C. Hinrichs ..................................................... 766
Gibian, Gerald Z., Estee Lauder Co., and Committee for Competition Through Advertising .............. 1164
Gill, Charles B., National Rural Utilities Cooperative Finance Corp ...................................... 1346
Glunt, Roger C., (see listing for National Association of Home Builders) ............................... 187
Golden State Mutual Life Insurance Co., Larkin Teasley ....................................................... 187
Graphic Arts Legislative Council, Howard C. Webber, Jr ..................................................... 1209
Great Western Financial Corp., Michael Palko (see listing for Savings & Community Bankers of America) ................................................................. 496
Harman, Hon. Jane, a Representative in Congress from the State of California ................. 1073
Harper, Edwin L., Association of American Railroads ............................................................ 514
Hartzell, Robert P., California Association of Wine Grape Growers .................................... 1648
Hecht, Marjorie Mazel, 21st Century Science & Technology .................................................. 1730
Heffley, Hon. Joel, a Representative in Congress from the State of Colorado (see listing for Hon. C. Michael Calihan) ................................................................. 120
Hellman, John F., Disabled American Veterans ....................................................................... 120
Helm, Dewitt F., Jr., Advertising Tax Coalition, and Association of National Advertisers, Inc ............................................................................................................... 1184
Henderson, Robert E., South Carolina Research Authority .................................................... 973
Heritage Foundation, William J. Lehrfeld (on behalf of Edwin J. Pauker, Jr.) ......................... 1331
Herr, Gerald J., Construction Financial Management Association, and Bryn Awel Corp .................................................................................................................. 1558
Hinely, J. Vernon, Carbonic Industries Corp ........................................................................... 1760
Hinrichs, Thomas C., Geothermal Resources Association, and Magma Power Co .............. 766
Hock, Roy E., Coalition to Preserve Deductibility of Environmental Remediation Costs, and Technotrel, Inc .................................................................................. 1604
Hoechst Celanese Corp., R. David Damron ............................................................................ 1254
Holmes, John C., Association of Christian Schools International ........................................... 1082
Home Health Services and Staffing Association, James C. Pyles ......................................... 1574
Hood, John A., National Assisted Management Association, and Volunteers of America ...................................................................................................................... 940
Horn, Hon. Stephen, a Representative in Congress from the State of California ................. 1074
Houck, Donald L., National Association of Water Cos., and California Water Service Co 132
<table>
<thead>
<tr>
<th>Name and Organization</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lockhart, Joseph, Rache A., National Congress of American Indians</td>
<td>887</td>
</tr>
<tr>
<td>Lewis, Teny, Jung, Paul, Student Loan Interest Deduction Restoration Coalition</td>
<td>126</td>
</tr>
<tr>
<td>Jernigan, Cliff, Semiconductor Industry Association, and Advanced Micro Devices</td>
<td>1094</td>
</tr>
<tr>
<td>John D. and Catherine T. MacArthur Foundation, James T. Griffin</td>
<td>428</td>
</tr>
<tr>
<td>Johnson, Hon. Nancy L., a Representative in Congress from the State of Connecticut</td>
<td>402</td>
</tr>
<tr>
<td>Johnson, Stephen F., American Public Power Association, and Washington Public Utility Districts' Association</td>
<td>770</td>
</tr>
<tr>
<td>Joseph, Rachel A., National Congress of American Indians</td>
<td>557</td>
</tr>
<tr>
<td>Jung, Paul, Student Loan Interest Deduction Restoration Coalition</td>
<td>1016</td>
</tr>
<tr>
<td>Kalish, Mark, National Association of Home Builders</td>
<td>1436</td>
</tr>
<tr>
<td>Kaltman, Ira J., Emil Buehler Perpetual Trust</td>
<td>420</td>
</tr>
<tr>
<td>Kaman Corp., Glenn M. Messmer</td>
<td>277</td>
</tr>
<tr>
<td>Kelly, John L., American Iron Ore Association and Cleveland-Cliffs, Inc</td>
<td>1275</td>
</tr>
<tr>
<td>Kern, Lynda A., American Bankers Association, Taxation Committee; and AmSouth Bank N.A</td>
<td>192</td>
</tr>
<tr>
<td>Kies, Kenneth J., North American Reinsurance Corp</td>
<td>1480</td>
</tr>
<tr>
<td>Kilpatrick Life Insurance Co., Virginia Kilpatrick Shehee</td>
<td>158</td>
</tr>
<tr>
<td>Kleccka, Hon. Gerald D., a Representative in Congress from the State of Wisconsin</td>
<td>1372</td>
</tr>
<tr>
<td>Kmart Corp., James P. Sheridan</td>
<td>258</td>
</tr>
<tr>
<td>Knox, James E., Itel Corp</td>
<td>585</td>
</tr>
<tr>
<td>Land Insurance Title Co., Irving Morgenroth</td>
<td>1037</td>
</tr>
<tr>
<td>Lange, Robert T., Malvern, Pa</td>
<td>811</td>
</tr>
<tr>
<td>Larsen, Andrew, National Structured Settlement Trade Association, and First Colony Life Insurance Co</td>
<td>174</td>
</tr>
<tr>
<td>Lazarus, Fred, IV, Association of Independent Colleges of Art and Design</td>
<td>1103</td>
</tr>
<tr>
<td>Lazeny, Virginia: Independent Petroleum Association of America, and Bretagne Corp</td>
<td>691</td>
</tr>
<tr>
<td>Independent Petroleum Association of America, Bretagne Corp, and National Stripper Well Association</td>
<td>1242</td>
</tr>
<tr>
<td>Leadership Council on Advertising Issues, Sheldon S. Cohen</td>
<td>1192</td>
</tr>
<tr>
<td>Lee, John W., College of William and Mary, Marshall-Wythe School of Law</td>
<td>1687</td>
</tr>
<tr>
<td>Leeper, Stephen G., Association of Local Housing Finance Agencies; and Housing, Urban Redevelopment Authority of Pittsburgh</td>
<td>887</td>
</tr>
<tr>
<td>Lehigh County Authority, Aurel M. Arndt</td>
<td>979</td>
</tr>
<tr>
<td>Lehman Brothers, Inc., R. Fenn Putnam</td>
<td>954</td>
</tr>
<tr>
<td>Lehrfeld, William J., Heritage Foundation</td>
<td>1331</td>
</tr>
<tr>
<td>Leibtag, Bernard, Associated Builders &amp; Contractors, Inc</td>
<td>427</td>
</tr>
<tr>
<td>Levin, Hon. Sander M., a Representative in Congress from the State of Michigan</td>
<td>30</td>
</tr>
<tr>
<td>Levine, Howard J., Roberts &amp; Holland</td>
<td>1680</td>
</tr>
<tr>
<td>Lewis, Terry, National Association of Housing Cooperatives</td>
<td>947</td>
</tr>
<tr>
<td>Lockhart, James H., Baptist Foundation of Oklahoma</td>
<td>1768</td>
</tr>
<tr>
<td>Longsworth, Nellie L., Preservation Action</td>
<td>929</td>
</tr>
<tr>
<td>Lorenson, Edward P., Savings &amp; Community Bankers of America, and Bristol Savings Bank of Connecticut</td>
<td>562</td>
</tr>
<tr>
<td>Page</td>
<td></td>
</tr>
<tr>
<td>------</td>
<td></td>
</tr>
<tr>
<td>Louisiana Insurers' Conference, Virginia Kilpatrick Shehee</td>
<td>168</td>
</tr>
<tr>
<td>Lovain, Timothy, Trade Taxes Group</td>
<td>507</td>
</tr>
<tr>
<td>MacIlvaine, Joseph C., Western Growers Association, Western Pistachio Association, California Pistachio Commission, and Paramount Farming Co</td>
<td>1555</td>
</tr>
<tr>
<td>MAERP Reinsurance Association, Robert Rahn</td>
<td>1500</td>
</tr>
<tr>
<td>Magill, James N., Veterans of Foreign Wars of the United States</td>
<td>123</td>
</tr>
<tr>
<td>Magma Power Co., Thomas C. Hinrichs</td>
<td>766</td>
</tr>
<tr>
<td>Maheu, Ronald T., Coopers &amp; Lybrand</td>
<td>1754</td>
</tr>
<tr>
<td>Mangis, Jon A., Oregon Department of Veterans' Affairs</td>
<td>990</td>
</tr>
<tr>
<td>Manning, David E., Community Bankers Association of Illinois</td>
<td>208</td>
</tr>
<tr>
<td>Martell, James G., Prime Group, Inc</td>
<td>838</td>
</tr>
<tr>
<td>Martello, Michael E., National Constructors Association, and Bechtel Construction Co</td>
<td>1043</td>
</tr>
<tr>
<td>Marvin, Michael L., American Wind Energy Association</td>
<td>758</td>
</tr>
<tr>
<td>Mattson, Robert, Computer &amp; Business Equipment Manufacturers Association, and IBM Corp</td>
<td>645</td>
</tr>
<tr>
<td>Mayer, Matthew, Times Square Center Associates, and Park Tower Realty Corp</td>
<td>362</td>
</tr>
<tr>
<td>McChesney, Thomas B., Building Owners &amp; Managers Association International, and Grubb &amp; Ellis Co</td>
<td>254</td>
</tr>
<tr>
<td>McClendon, Charles, American Football Coaches Association</td>
<td>91</td>
</tr>
<tr>
<td>McClosey, Peter F., Electronic Industries Association: June 21, 1993</td>
<td>622</td>
</tr>
<tr>
<td>September 21, 1993</td>
<td>1464</td>
</tr>
<tr>
<td>McDonagh, Mark, Ad Hoc Group to Preserve Deduction for Advertising</td>
<td>1171</td>
</tr>
<tr>
<td>McPherson, Douglas C., Aerospace Industries Association, and General Dynamics Corp</td>
<td>668</td>
</tr>
<tr>
<td>Meris, Edward, Air Transport Association of America</td>
<td>1303</td>
</tr>
<tr>
<td>Merrill Lynch &amp; Co., Inc., LaBrenda Garrett Stodghill</td>
<td>580</td>
</tr>
<tr>
<td>Merrill, Peter, U.S. Multinational Corporation Tax Policy Coalition</td>
<td>1516</td>
</tr>
<tr>
<td>Messner, Glenn M., Kaman Corp</td>
<td>277</td>
</tr>
<tr>
<td>Metzger, Philip C., New York State Office of Federal Affairs</td>
<td>788</td>
</tr>
<tr>
<td>Michigan State Hospital Finance Authority, and Michigan Higher Education Facilities Authority, Roy A. Pentilla</td>
<td>966</td>
</tr>
<tr>
<td>Millett, David G., IRBEO Inc/Dyno Nobel Inc</td>
<td>527</td>
</tr>
<tr>
<td>Mineral Resources Alliance, Stephen D. Alfers</td>
<td>1235</td>
</tr>
<tr>
<td>Mayl Corp., William G. Dakin</td>
<td>1431</td>
</tr>
<tr>
<td>Mohat, G. Mustafa, General Motors Corp</td>
<td>262</td>
</tr>
<tr>
<td>Montgomery, Hon. G.V. (Sonny), Chairman, Committee on Veterans' Affairs, and a Representative in Congress from the State of Mississippi</td>
<td>46</td>
</tr>
<tr>
<td>Morgenthau, Irving, American Land Title Association, and Land Insurance Title Co</td>
<td>1037</td>
</tr>
<tr>
<td>Mutual Atomic Energy Liability Underwriters, Robert Rahn</td>
<td>940</td>
</tr>
<tr>
<td>National Assisted Management Association, John A. Hood</td>
<td>110</td>
</tr>
<tr>
<td>National Association of Computer Consultant Businesses, Harvey J. Shulman</td>
<td>538</td>
</tr>
<tr>
<td>National Association of Convenience Stores, William C. &quot;Chris&quot; Girard</td>
<td>389</td>
</tr>
<tr>
<td>National Association of Home Builders: J. Leon Peace, Jr. (on behalf of Roger C. Glunt)</td>
<td>893</td>
</tr>
<tr>
<td>Mark Kalish (on behalf of Thomas N. Thompson)</td>
<td>1436</td>
</tr>
<tr>
<td>National Association of Housing Cooperatives, Terry Lewis</td>
<td>947</td>
</tr>
<tr>
<td>National Association of Independent Insurers, Robert Jarratt</td>
<td>1548</td>
</tr>
<tr>
<td>National Association of Manufacturers, William G. Dakin</td>
<td>1431</td>
</tr>
<tr>
<td>National Association of Mutual Insurance Cos., Robert Jarratt</td>
<td>1488</td>
</tr>
<tr>
<td>National Association of Railroad Passengers, Ross Capon</td>
<td>518</td>
</tr>
<tr>
<td>National Association of Water Cos., Donald L. Houch</td>
<td>132</td>
</tr>
<tr>
<td>National Congress of American Indians, Rachel A. Joseph</td>
<td>557</td>
</tr>
<tr>
<td>National Constructors Association, Michael E. Martello</td>
<td>1043</td>
</tr>
<tr>
<td>National Council of Health Facilities Finance Authorities, Roy A. Pentilla</td>
<td>966</td>
</tr>
<tr>
<td>National Council of State Housing Agencies, Angelo J. Aponte</td>
<td>976</td>
</tr>
<tr>
<td>National Foreign Trade Council, Inc., Robert H. Green</td>
<td>1507</td>
</tr>
<tr>
<td>National Grocers Association, Larry Contos</td>
<td>523</td>
</tr>
<tr>
<td>National Insurance Association, Larkin Teasley</td>
<td>187</td>
</tr>
<tr>
<td>National League of Cities, et al, Aurel M. Arndt</td>
<td>979</td>
</tr>
<tr>
<td>National Policy Committee:</td>
<td>1668</td>
</tr>
<tr>
<td>Stefan F. Tucker</td>
<td>247</td>
</tr>
<tr>
<td>William C. Rudin</td>
<td></td>
</tr>
</tbody>
</table>
National Retail Federation:  
David L. Feeney ................................................................. 1203  
James P. Sheridan .............................................................. 258  
National Rural Utilities Cooperative Finance Corp., Charles B. Gill ................................................................. 1346  
National Staff Network, Marvin R. Selter ................................................................. 100  
National Stripper Well Association, Virginia Lazenby ................................................................. 1242  
National Structured Settlement Trade Association (Andrew Larsen on behalf of Randy Dyer) ................................................................. 174  
National Trust for Historic Preservation, Harry K. Schwartz ................................................................. 916  
National Volunteer Fire Council, Kenneth E. Newton ................................................................. 105  
National Wood Energy Association, Gary Elliott ................................................................. 761  
Native American Affairs, Subcommittee on, Committee on Natural Resources,  
Hon. Bill Richardson, Chairman, and a Representative in Congress from the State of New Mexico ................................................................. 292  
Navajo Nation, Faith R. Roessel ................................................................. 549  
New 42nd Street, Inc., Cora Cahen ................................................................. 361  
New England Education Loan Marketing Corp., Lawrence W. O'Toole ................................................................. 1136  
New York State Division of Housing and Community Renewal, Angelo J. Aponte ................................................................. 876  
New York State office of Federal Affairs, Philip C. Metzger ................................................................. 788  
Newspaper Association of America, Timothy White ................................................................. 1179  
Newton, Kenneth E., Firemen's Association of the State of New York, and  
National Volunteer Fire Council ................................................................. 105  
North American Reinsurance Corp., Peter A. Gentile and Kenneth J. Kies ................................................................. 1480  
Northeast Midwest Institute, Charles Bartsch ................................................................. 840  
NPES The Association for Suppliers of Printing & Publishing Technologies,  
Mark J. Nuzzaco ................................................................. 1215  
Nurse Brokers and Contractors of America, Sally Sumner ................................................................. 1566  
Nuzzaco, Mark J., NPES The Association for Suppliers of Printing & Publishing Technologies ................................................................. 1215  
O'Connor, Edward A., Jr., Spaceport Florida Authority ................................................................. 998  
O'Connor, James E., Savings and Community Bankers of America ................................................................. 1316  
O'Toole, Lawrence W., New England Education Loan Marketing Corp., and  
Education Finance Council ................................................................. 1136  
O'Toole, Richard L., Battle Fowler Law Offices ................................................................. 227  
OMI Corp., Morton P. Hyman ................................................................. 660  
Ono, Ruth M., Queen Emma Foundation ................................................................. 414  
Oracle Corp., Gen. James A. Abrahamson ................................................................. 638  
Oregon Department of Veterans' Affairs, Jon A. Mangis ................................................................. 990  
Overseas Shipholding Group, Inc., Morton P. Hyman ................................................................. 660  
Owen, Don Associated Builders & Contractors, Inc., and P&P Contractors ................................................................. 1547  
P&P Contractors, Don Owen ................................................................. 1547  
Padwe, Gerald W., American Institute of Certified Public Accountants ................................................................. 486  
PaineWebber Inc., Stephen H. Haimrick ................................................................. 496  
Palko, Michael, Great Western Financial Corp. (see listing for Savings & Community Bankers of America)  
Paramount Farming Co., Joseph C. Macllvaine ................................................................. 1655  
Park Tower Realty Corp., Matthew Mayer ................................................................. 362  
Pattishall, B. Wyckliffe, Chicago Title & Trust Co. ................................................................. 1673  
Pay Less Supermarkets, Inc., Larry Condon ................................................................. 523  
Peace, J. Leon, Jr., National Association of Home Builders (see listing for  
Roger C. Glunt) ................................................................. 1176  
Pecarich, Pamela J., American Institute of Certified Public Accountants ................................................................. 1454  
Pennell, Jeffrey N., Emerson University School of Law ................................................................. 1776  
Pentilla, Roy A., National Council of Health Facilities Finance Authorities,  
Michigan State Hospital Finance Authority, and Michigan Higher Education Facilities Authority ................................................................. 966  
Perinson, Robert, Associated Builders & Contractors, Inc ................................................................. 427  
Petrochemical Energy Group, R. David Damron ................................................................. 1254  
PHH Corp., Samuel H. Wright ................................................................. 1089  
Phillips, Hon. Thomas R., Chief Justice, Supreme Court of Texas; Joint Task  
Force on Judicial Pension Plans; Conference of Chief Justices; and Conference of State Court Administrators ................................................................. 71  
Plaid Pantries, William C. "Chris" Girard ................................................................. 538  
PPG Industries, Inc., Donna Lee Walker ................................................................. 154  
Preservation Action, nellie L. Longworth ................................................................. 929  
Prime Group, Inc., James G. Martell ................................................................. 838  
Printing Industries of America, Howard C. Webber, Jr ................................................................. 1209
Southwind Management Company, Pamela K. Burton ........................................ 902
Spaceport Florida Authority, Edward A. O'Connor, Jr ........................................ 996
Stodghill, LaBrenda Garrett, Merrill Lynch & Co., Inc ........................................ 580
Strickland, Hon. Ted, a Representative in Congress from the State of Ohio ........ 871
Studds, Hon. Gerry E., a Representative in Congress from the State of Massachusetts ........................................ 49
Student Loan Interest Deduction Restoration Coalition, Paul Jung .......................... 1016
Sullivan & Worcester, Frederic G. Corneel ............................................................ 479
Sumner, Sally, Nurse Brokers and Contractors of America .................................... 1566
Sumney, Larry W., Alliance for Collaborative Research, and Semiconductor Research Corp ........................................ 371
Sun Co., Inc, Robert H. Campbell ................................................................. 1129
Sun-Diamond Growers of California, Richard Douglas ........................................ 1745
Susswein, Donald B., Coalition for Asset Backed Securities .................................. 214
Swift Energy Co., Bruce H. Vincent ...................................................................... 496
Texas & Larkin, National Insurance Association, and Golden State Mutual Life Insurance Co ........................................ 187
Technitrol, Inc, Roy E. Hock ............................................................................. 1604
Teco Energy, Inc, Tom Remar ............................................................................. 677
Texas, State Bar of, Section of Taxation, Cecil A. Ray, Jr ..................................... 814
Texas, Supreme Court of, Hon. Thomas R. Phillips, Chief Justice ......................... 71
Thompson, Edward, Jr., American Farmland Trust ............................................. 801
Thompson, Thomas N. (see listing for National Association of Home Builders) ......
Thompson, Warren, Frank Russell Co., and Frank Russell Investment Management Co ........................................ 593
Times Square Center Associates, Matthew Mayer and Dale W. Wickham ............ 362
Times Union, Timothy White .............................................................................. 1179
Torricelli, Hon. Robert G., a Representative in Congress from the State of New Jersey .......................................................................................................................... 52
Trade Taxes Group, Timothy Lovain .................................................................... 507
Travelers Corp, Robert W. Crispin ......................................................................... 180
Tucker, Hon. Walter R. III, a Representative in Congress from the State of California .......................................................................................................................... 1057
Tucker, Stefan F., National Realty Committee ..................................................... 1668
Twenty-First (21st) Century Science & Technology, Marjorie Mazel Hecht .......... 1730
U.S. Chamber of Commerce, Julie Leigh Gackenbach ......................................... 1444
U.S. Multinational Corporation Tax Policy Coalition, Peter Merrill ...................... 1516
Uvena, Frank, R.R. Donnelley & Sons Co ............................................................ 1148
Vaughn, Eric, Renewable Fuels Association ....................................................... 741
Veterans of Foreign Wars of the United States, James N. Magill ................. 123
Veterans' Affairs, Committee, Hon. G.V. (Sonny) Montgomery, and a Representa-
vit in Congress from the State of Mississippi ......................................................... 46
Vincent, Bruce H., Investment Program Association, and Swift Energy Co ........ 496
Volunteers of America, John A. Hood ................................................................ 940
Walker, Donna Lee, PPG Industries, Inc .............................................................. 154
Washington Public Utility Districts' Association, Stephen F. Johnson ............... 770
Waters, Hon. Maxine, a Representative in Congress from the State of Californi-
a .............................................................................................................................. 1075
Webber, Howard C., Jr., Printing Industries of America, Graphic Arts Legisla-
tive Council, and Cohber Press, Inc ................................................................. 1209
Weinstein, Mark J., Screen Actors Guild, American Federation of Television and Radio Artists, Actors' Equity Association ......................................................... 1121
Western Commercial Space Center, Donald David Smith .................................. 1005
Western Growers Association, Joseph C. Macllvaine ....................................... 1655
Western Pistachio Association, Joseph C. Macllvaine ....................................... 1655
Wheat, Hon. Alan, a Representative in Congress from the State of Missouri .... 1384
White, Timothy, Times Union, Advertising Tax Coalition, and Newspaper Associa-
tion of America .................................................................................................. 1179
Wiseck, Raymond J., Emergency Committee for American Trade ....................... 1528
Wickham, Dale W., Times Square Center Associates ........................................... 362
Wm. Bolthouse Farms, Inc, John Guerard .......................................................... 1662
Wm. T. Coskren & Sons Co, Tom Remar ......................................................... 677
Wright, Samuel H., PHH Corp ............................................................................. 1089
Xerox Corp., Michael J. Farren ............................................................................ 631
Zimmerman, Mary Beth, Alliance to Save Energy ............................................... 699
## SUBMISSIONS FOR THE RECORD

### LISTING BY SUBJECT—REVENUE LOSERS

### TAX ACCOUNTING

National Association of Regulatory Utility Commissioners, Linda Bisson Stevens, letter and attachments .......................................................... 1787

### FINANCIAL INSTITUTIONS

<table>
<thead>
<tr>
<th>Institution</th>
<th>Contact Details</th>
<th>Submission Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Associated Bank, N.A, Neenah, Wis.</td>
<td>Michael B. Mahlik</td>
<td>Letter</td>
</tr>
<tr>
<td>Bank South, N.A., Atlanta, Ga.,</td>
<td>J. Blake Young, Jr.</td>
<td>Letter and attachments</td>
</tr>
<tr>
<td>Commerce Bancshares, Inc., Kansas City, Mo., John S. Archer,</td>
<td>Letter</td>
<td>1798</td>
</tr>
<tr>
<td>First Fidelity Bank, N.A., Newark, New Jersey</td>
<td>John J. Phillips, letter</td>
<td>1799</td>
</tr>
<tr>
<td>First National Bank of Chicago, Michael P. Traba,</td>
<td>Statement</td>
<td>1801</td>
</tr>
<tr>
<td>First Source Bank, South Bend, Ind., James P. Coleman, letter</td>
<td>1804</td>
<td></td>
</tr>
<tr>
<td>First Trust National Association, St. Paul, Minn., John M. Murphy, Jr., letter</td>
<td>1806</td>
<td></td>
</tr>
</tbody>
</table>

Hawaiian Trust Co., Ltd., Honolulu, Hawaii, Douglas Philpotts, letter ........................................ 1807

Independent Bankers Association of America, James R. Lauffer, statement ............................................................................. 1809

Investment Co. Institute, statement (see listing under Multiple Issues heading)......................................................... 1826

KPMG Peat Marwick, New York, N.Y., Kathy L. Anderson, letter ........................................ 1811

Magna Trust Co., Belleville, Ill., Peter C. Merzian, letter ........................................................................ 1812

Meridian Asset Management, Inc., Valley Forge, Pa., Robert C. Williams, letter ................................................................ 1813

Midlantic National Bank, Edison, N.J., A.J. Dimatties, letter ........................................................................ 1814

Northern Trust Co., Chicago, Ill., Barry G. Hastings, letter ........................................................................ 1815

Old Kent Bank and Trust Co., Grand Rapids, Mich., E. Philip Farley, letter ........................................................................ 1816


Securities Industry Association, Marc E. Lackritz, statement ........................................................................ 1823


William O. Leszinske, letter ........................................................................ 1819

### INSURANCE

Association of Financial Guaranty Insurers, William A. Geoghegan, statement and attachments ........................................................................ 1837

Canadian Life and Health Insurance Association, Raymond L. Britt, Jr., and Mary V. Harcar, statement ........................................................................ 1826


Mutual of America, Daniel W. Coyne, letter ........................................................................ 1836

### PASS-THROUGH ENTITIES

Alcoma Association, Inc., Lake Wales, Fla., Lawrence C. Updike, statement ........................................................................ 1858

Arkansas Electric Cooperative Corp., Carl S. Whillock, letter ........................................................................ 1870

Florida Bar, Tax Section, Jerald David August, statement ........................................................................ 1849

Griffin Industries, Inc., Cold Spring, Ky., Dennis B. Griffin, statement ........................................................................ 1864

(XII)
Investment Co. Institute, statement (see listing under Multiple Issues heading) ........................................ 1871
National Rural Electric Cooperative Association, Bob Bergland, statement ........................................... 1871
Schnitzer Investment Corp., Portland, Ore., Kenneth M. Novack, statement ............................................. 1866
Solo Cup Co., statement ................................................................................................................................. 1859
Wells Manufacturing Co., statement .............................................................................................................. 1862

COST RECOVERY

American Automobile Manufacturers Association, statement ........................................................................... 1883
D’Agostino Supermarkets, Inc., Larchmont, N.Y., Nicholas D’Agostino, Jr., letter ........................................ 1885
Delta Queen Steamboat Co., New Orleans, La., statement .......................................................................... 1876
Kennelly, Hon. Barbara B., a Representative in Congress from the State of Connecticut, statement (see listing under Multiple Issues heading) ......................................................... 1876
National Association for the Self-Employed, Bennie L. Thayer, letter (see listing under Multiple Issues heading) ......................................................... 1876
New York Cruise Lines, Inc., August J. Ceradini, Jr., letter ........................................................................ 1879
Passenger Vessel Association, Eric G. Scharf, letter .................................................................................... 1880
Sayville Ferry, Sayville, N.Y., Ken Stein, Jr., letter ...................................................................................... 1882

EMPLOYEE BENEFITS

AlliedSignal Inc., Ronald A. Sinaikin, statement ......................................................................................... 1908
American Legion, Steve A. Robertson, statement ....................................................................................... 1887
Bedford County (Va.) Circuit Court, Hon. William W. Sweeney, letter (forwarded by the Hon. L.F. Payne, a Representative in Congress from the State of Virginia) ................. 1896
Chrysler Corp., Robert G. Liberatore, statement and attachment ............................................................... 1902
Committee of Annuity Insurers, statement and attachment ....................................................................... 1898
Crisalli, Donna M., Washington, D.C., statement ......................................................................................... 1889
ESOP Association:
  Statement ..................................................................................................................................................... 1901
  J. Michael Keeling, statement .................................................................................................................... 1906
Illinois Supreme Court, Hon. Benjamin K. Miller, Chief Justice, letter and attachment ....................... 1893
Investment Co. Institute, statement (see listing under Multiple Issues heading) ................................... 1890
Kansas City Royals Baseball, Michael E. Herman, statement ..................................................................... 1385
Kennelly, Hon. Barbara B., a Representative in Congress from the State of Connecticut, statement (see listing under Multiple Issues heading) ......................................................... 1890
Non Commissioned Officers Association of the United States of America, Larry D. Rhea and Michael Ouellette, statement ................................................................................... 1912
PPG Industries, Inc., Raymond W. LeBouef, statement ............................................................................. 1911
Rahall, Hon. Nick J., II, a Representative in Congress from the State of West Virginia, statement .......... 1890
Stump, Hon. Bob, a Representative in Congress from the State of Arizona, letter and attachment ........ 1892

INDIVIDUAL

American Dental Association, statement and attachment ......................................................................... 1926
American Society for Payroll Management, Robert D. Williamson, statement ........................................ 1917
Associated Builders and Contractors, Inc., Charles E. Hawkins III, letter .................................................. 1919
Building and Construction Trades Department, AFL-CIO, Robert A. Georgine, statement ................... 1921
Construction Financial Management Association, Joseph J. Lozano, statement .................................. 1924
Johnson, Hon. Nancy L., a Representative in Congress from the State of Connecticut, statement ....... 851
Military Coalition, Paul W. Arcari and Michael Ouellette, letter ............................................................... 1929

ESTATE AND GIFT

American Farm Bureau Federation, statement ............................................................................................... 1957
Appalachian Mountain Club, Boston, Mass., Jennifer Melville, statement ............................................... 1942
Appalachian Trail Conference, Harpers Ferry, W.Va., John Stokes and David N. Startzell, statement ........ 1943
Baptist Foundation of Oklahoma, James H. Lockhart, statement ............................................................... 1931
XIV

<table>
<thead>
<tr>
<th>Name, Corporation, or Office, Location, Statement</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brandywine Conservancy, Chadds Ford, Pa., George A. Weymouth</td>
<td>1545</td>
</tr>
<tr>
<td>Brennan, Edward V., Gray, Cary, Ames &amp; Frye, La Jolla, Calif., statement and attachments</td>
<td>1934</td>
</tr>
<tr>
<td>Brewster, Hon. Bill, a Representative in Congress from the State of Oklahoma</td>
<td>1932</td>
</tr>
<tr>
<td>Chesapeake Bay Foundation, Annapolis, Md., William C. Baker</td>
<td>1946</td>
</tr>
<tr>
<td>Dutchess Land Conservancy, Stanfordville, N.Y., Ira Stern</td>
<td>1947</td>
</tr>
<tr>
<td>Johnson, Hon. Nancy L., a Representative in Congress from the State of Connecticut, statement</td>
<td>609</td>
</tr>
<tr>
<td>Land Trust Alliance, Jean W. Hocker</td>
<td>1948</td>
</tr>
<tr>
<td>Oregon Trout, Inc., Portland, Ore., Geoff Pampush</td>
<td>1950</td>
</tr>
<tr>
<td>Save the Bay, Providence, R.I., Curt Spalding</td>
<td>1951</td>
</tr>
<tr>
<td>South Carolina Coastal Conservation League, Charleston, S.C., Dana Beach</td>
<td>1952</td>
</tr>
<tr>
<td>Ward L. Quaal Co., Ward L. Quaal</td>
<td>1954</td>
</tr>
<tr>
<td>Worthy, K. Martin, Hopkins &amp; Sutter, Washington, D.C., statement</td>
<td>611</td>
</tr>
</tbody>
</table>

**FOREIGN TAX PROVISIONS**

<table>
<thead>
<tr>
<th>Name, Corporation, or Office, Location, Statement</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>American Petroleum Institute</td>
<td>1961</td>
</tr>
<tr>
<td>Bell Atlantic Corp., statement and attachment</td>
<td>1965</td>
</tr>
<tr>
<td>Beneficial Corp., Gary J. Perkinson</td>
<td>2012</td>
</tr>
<tr>
<td>Cargill, Inc., Minneapolis, Minn., Bruce H. Barnett</td>
<td>2028</td>
</tr>
<tr>
<td>Caribbean Latin American Action, Peter Johnson</td>
<td>2009</td>
</tr>
<tr>
<td>Chevron Corp.: Statement</td>
<td>1985</td>
</tr>
<tr>
<td>Committee on State Taxation, Mark Cahoon</td>
<td>1970</td>
</tr>
<tr>
<td>Emergency Committee for American Trade, Robert L. McNeill</td>
<td>1975</td>
</tr>
<tr>
<td>Federation of American Controlled Shipping, Philip J. Loree</td>
<td>1987</td>
</tr>
<tr>
<td>General Motors Corp., statement</td>
<td>2014</td>
</tr>
<tr>
<td>Information Technology Association of America, Luanne James</td>
<td>1984</td>
</tr>
<tr>
<td>Matsui, Hon. Robert T., a Representative in Congress from the State of California</td>
<td>674</td>
</tr>
<tr>
<td>McClure, Trotter &amp; Mentz, Chtd., Washington, D.C., William P. McClure</td>
<td>2023</td>
</tr>
<tr>
<td>National Foreign Trade Council, Inc., statement</td>
<td>1976</td>
</tr>
<tr>
<td>Shaw, Hon. E. Clay, Jr., a Representative in Congress from the State of Florida</td>
<td>1996</td>
</tr>
<tr>
<td>Tax Executives Institute, Inc., Robert H. Perlman</td>
<td>1981</td>
</tr>
</tbody>
</table>

**NATURAL RESOURCES**

<table>
<thead>
<tr>
<th>Name, Corporation, or Office, Location, Statement</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>American Gas Association</td>
<td>2062</td>
</tr>
<tr>
<td>American Methanol Institute, Raymond A. Lewis</td>
<td>2069</td>
</tr>
<tr>
<td>American Public Power Association, Larry Hobart; National Rural Electric Cooperative Association, Bob Bergland; and National Association of Regulatory Utility Commissioners, Thomas Choman, joint letter</td>
<td>2095</td>
</tr>
<tr>
<td>City Utilities of Springfield, Mo., Robert E. Roundtree</td>
<td>2074</td>
</tr>
<tr>
<td>Columbia Gas Development Corp., Houston, Tex., Robert C. Williams, Jr., statement</td>
<td>2050</td>
</tr>
<tr>
<td>Destec Energy, Inc, Houston, Tex., Charles F. Golf</td>
<td>2040</td>
</tr>
<tr>
<td>Electric Transportation Coalition, Kateri A. Callahan, letter</td>
<td>2075</td>
</tr>
<tr>
<td>Independent Oil and Gas Association of West Virginia, Rich Heffelfinger</td>
<td>2044</td>
</tr>
<tr>
<td>Page</td>
<td></td>
</tr>
<tr>
<td>------</td>
<td></td>
</tr>
<tr>
<td>Independent Petroleum Association of America, Roy W. Willis, letter .......... 2080</td>
<td></td>
</tr>
<tr>
<td>Kenetech/U.S. Windpower, Robert T. Boyd, statement .................. 2088</td>
<td></td>
</tr>
<tr>
<td>Large Public Power Council, and Salt River Project of Phoenix, Ariz., Mark Bonsall, statement .......... 2085</td>
<td></td>
</tr>
<tr>
<td>Los Angeles, Calif., City of, statement ................................ 2083</td>
<td></td>
</tr>
<tr>
<td>Louisiana Land &amp; Exploration Co., New Orleans, La., Leighton Steward, statement .......... 2054</td>
<td></td>
</tr>
<tr>
<td>Matsui, Hon. Robert T., a Representative in Congress from the State of California, statement .......... 730</td>
<td></td>
</tr>
<tr>
<td>MDU Resources Group, Inc., Bismarck, N.Dak., Robert E. Wood, statement ..... 2057</td>
<td></td>
</tr>
<tr>
<td>Mitchell Energy &amp; Development Corp., The Woodlands, Tex., Craig G. Good- man, letter and attachment .......... 2059</td>
<td></td>
</tr>
<tr>
<td>National Rural Electric Cooperative Association, Bob Bergland, statement ...... 718</td>
<td></td>
</tr>
<tr>
<td>Natural Resources Defense Council, Marika Tatsutani, statement ............. 2084</td>
<td></td>
</tr>
<tr>
<td>Northeast Public Power Association, Westbrook, Mass., statement (see listing under Multiple Issues heading) .......... 2054</td>
<td></td>
</tr>
<tr>
<td>Northwest Independent Forest Manufacturers, Tacoma, Wash., M.J. &quot;Gus&quot; Kuehne, statement and attachment .......... 2036</td>
<td></td>
</tr>
<tr>
<td>Sacramento, Calif., Municipal Utility District, statement .......... 2086</td>
<td></td>
</tr>
<tr>
<td>Southern California Public Power Authority, Pasadena, Calif., statement ..... 2086</td>
<td></td>
</tr>
<tr>
<td>Tampa (Fla.) Electric Co., statement .......... 2042</td>
<td></td>
</tr>
<tr>
<td>USX Corp., statement .......... 2091</td>
<td></td>
</tr>
<tr>
<td>Washington Citizens for World Trade, Olympia, Wash., Nicholas J. Kirkmire, statement .......... 2093</td>
<td></td>
</tr>
<tr>
<td>Wise, Hon. Bob, a Representative in Congress from the State of West Virginia, letter and attachments .......... 2045</td>
<td></td>
</tr>
</tbody>
</table>

**HOUSING**

<table>
<thead>
<tr>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ford, Hon. Harold E., a Representative in Congress from the State of Tennessee, statement and attachment .......... 849</td>
</tr>
<tr>
<td>Lowey, Hon. Nita M., a Representative in Congress from the State of New York, statement .......... 2109</td>
</tr>
<tr>
<td>National Cooperative Business Center, Russell C. Notar, statement .......... 2102</td>
</tr>
<tr>
<td>New York, City of, Hon. David N. Dinkins, Mayor, statement (see listing under Multiple Issues heading) .......... 2098</td>
</tr>
<tr>
<td>PacifiCorp Financial Services, Portland, Ore., William E. Peressini, statement .......... 2104</td>
</tr>
<tr>
<td>Salem, Irving, and Carol A. Quinn, Latham &amp; Watkins, New York, N.Y., statement .......... 2098</td>
</tr>
</tbody>
</table>

**TAX-EXEMPT BONDS**

<table>
<thead>
<tr>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alaska Aerospace Development Corp., Anchorage, Alaska, H.P. &quot;Pat&quot; Ladner, statement .......... 2114</td>
</tr>
<tr>
<td>Alaska Housing Finance Corp., statement .......... 2117</td>
</tr>
<tr>
<td>American Association of Port Authorities, Jean C. Godwin, letter .......... 2146</td>
</tr>
<tr>
<td>American Public Power Association, Larry Hobart, statement .......... 2133</td>
</tr>
<tr>
<td>Barcia, Hon. Peter W., a Representative in Congress from the State of Wisconsin, statement .......... 2129</td>
</tr>
<tr>
<td>Belz Investment Co., Inc., Memphis, Tenn., Jack A. Belz, statement (see listing under Multiple Issues heading) .......... 2129</td>
</tr>
<tr>
<td>Council of Development Finance Agencies, statement .......... 2120</td>
</tr>
<tr>
<td>Edison Electric Institute, statement .......... 2136</td>
</tr>
<tr>
<td>Kennelly, a Representative in Congress from the State of Connecticut, Hon. Barbara B. statement (see listing under Multiple Issues heading) .......... 2131</td>
</tr>
<tr>
<td>Kleczka, Hon. Gerald D., a Representative in Congress from the State of Wisconsin, statement .......... 2140</td>
</tr>
<tr>
<td>Matsui, Hon. Robert T., a Representative in Congress from the State of California: Statement .......... 853</td>
</tr>
<tr>
<td>Statement .......... 855</td>
</tr>
<tr>
<td>National Association of Bond Lawyers, statement .......... 2141</td>
</tr>
</tbody>
</table>
XVI

National Association of Independent Colleges and Universities; American Council on Education; Association of American Universities, and National Association of State Universities and Land Grant Colleges, Richard F. Rosser, joint letter ........................................ 2124
New Mexico, State of, Hon. Casey Luna, Lt. Governor, statement ........................................ 2115
New York, City of, Hon. David N. Dinkins, Mayor, statement (see listing under Multiple Issues heading) ........................................ 2115
Northeast Public Power Association, Westborough, Mass., statement (see listing under Multiple Issues heading) ........................................ 2116
Stanford University, Stanford, Calif., Peter Van Etten, statement ........................................ 2122
Texas Veterans Land Board, Austin, Tex., Garry Mauro, statement ........................................ 2118
Wisconsin Department of Veterans Affairs, Daniel D. Stier, letter ........................................ 2119

COMPLIANCE

Brewster, Hon. Bill K., a Representative in Congress from the State of Oklahoma, statement ........................................ 1037

MISCELLANEOUS ISSUES

Allegheny Electric Cooperative, Inc., Harrisburg, Pa., Ed Ursivi, letter ........................................ 2178
American Bakers Association, Paul C. Abenante, letter ........................................ 2191
American College of Trust and Estate Counsel, James M. Trapp, letter ........................................ 2198
American Vintners Association, statement ........................................ 2167
Arctic Slope Regional Corp., Goldbelt Corp., and Sealaska Corp., joint statement ........................................ 2151
Art Institute of Southern California, Laguna Beach, Calif., John W. Lottes, letter ........................................ 2159
Association of American Medical Colleges, Robert G. Petersdorf, M.D., letter ........................................ 2193
Basin Electric Power Cooperative, Bismark, N.Dak., Robert L. McPhall, statement ........................................ 2180
Belz Investment Co., Inc., Memphis, Tenn., Jack A. Belz, statement (see listing under Multiple Issues heading) ........................................ 2180
D'Amato, Hon. Alfonse M., a United States Senator from the State of New York, statement ........................................ 2174
Dairymen, Inc., Boyd M. Cook, statement ........................................ 2153
Harrington, Carol A., Kathryn G. Henkel, Carlyln S. McCaffrey, Lloyd Leva Plaine, and Pam H. Schneider, American Bar Association, Real Property, Probate & Trust Section, joint letter ........................................ 2201
Harsch Investment Corp., Portland Ore., Harold and Arlene Schnitzer, statement ........................................ 2160
Kanjorski, Hon. Paul E., a Representative in Congress from the State of Pennsylvania, statement ........................................ 2169
Koncor Forest Products Co., Anchorage, Alaska, John Sturjeon, statement ........................................ 2155
Maryville University, St. Louis, Mo., Keith Lovin, letter ........................................ 2206
Moakley, Hon. John Joseph, a Representative in Congress from the State of Massachusetts, statement ........................................ 2196
Myers, Robert J., Silver Spring, Md., statement ........................................ 2195
National Association for the Self-Employed, Bennie L. Thayer, letter (see listing under Multiple Issues heading) ........................................ 2186
National Presto Industries, Inc., Eau Claire, Wis., Joseph H. Berney, statement ........................................ 2183
National Staff Leasing Association, Rob Lederer, letter ........................................ 2186
Neal, Hon. Richard E., a Representative in Congress from the State of Massachusetts, statement ........................................ 2197
New York, State of, Vincent Tese, statement ........................................ 2176
Shoshone and Arapaho Tribes' Joint Business Council, Fort Washakie, Wyo., Richard L. Ortiz, letter and attachment ........................................ 2148
Sierra Semiconductor Corp., O'Fallon, Ill., letter and attachment ........................................ 2176
Southfork Corp., Dallas, Tex., Ronald L. Platt, statement ........................................ 2171
University of Arkansas, Fayetteville, Ark., A.H. Edwards, letter ........................................ 2208
Western Farmers Electric Cooperative, Anadarko, Okla., James D. Pendergrass, statement ........................................ 2165

MULTIPLE Issues

Belz Investment Co., Inc., Memphis, Tenn., Jack A. Belz, statement ........................................ 2209
Investment Co. Institute, statement ........................................ 2211
Kennelly, Hon. Barbara B., a Representative in Congress from the State of Connecticut, statement ........................................... 2219
National Association for the Self-Employed, Bennie L. Thayer, letter 2221
New York, City of, Hon. David N. Dinkins, Mayor, statement 2223
Northeast Public Power Association, Westborough, Mass., statement 2230

COMBINED LISTING BY NAME AND ORGANIZATION (LOSERS)

Abenante, Paul C., American Bakers Association, letter ........................................... 2191
Alaska Aerospace Development Corp., Anchorage, Alaska, H.P. "Pat" Ladner, statement 2114
Alaska Housing Finance Corp., statement .................................................................. 2117
Alcoa Association, Inc., Lake Wales, Fla., Lawrence C. Updike, statement 1858
Allegheny Electric Cooperative, Inc., Harrisburg, Pa., Ed Urvacic, letter 2178
AlliedSignal Inc., Ronald A. Sinaikin, statement ..................................................... 1908
American Association of Port Authorities, Jean C. Godwin, letter 2146
American Automobile Manufacturers Association, statement .................................. 1883
American Bakers Association, Paul C. Abenante, letter ........................................... 2191
American College of Trust and Estate Counsel, James M. Trapp, letter 2198
American Council on Education, Richard F. Rosser, joint letter (see listing
for National Association of Independent Colleges and Universities
American Dental Association, statement and attachment ........................................... 1926
American Farm Bureau Federation, statement .......................................................... 1957
American Gas Association, statement ..................................................................... 2062
American Legion, statement ..................................................................................... 1887
American Methanol Institute, Raymond A. Lewis, statement 2069
American Petroleum Institute, statement .................................................................. 1961
American Public Power Association, Larry Hobart, statement ................................. 2133
American Public Power Association, Larry Hobart; National Rural Electric
Cooperative Association, Bob Bergland; and National Association of Regu-
lar Utility Commissioners, Thomas Choman, joint letter ........................................... 2095
American Society for Payroll Management, Robert D. Williamson, statement ........ 1917
American Vintners Association, statement ................................................................ 2167
Anderson, Kathy L., KPMG Peat Marwick, New York, N.Y., letter ........................ 1811
Appalachian Mountain Club, Boston, Mass., Jennifer Melville, statement .......................... 1942
Appalachian Trail Conference, Harpers Ferry, W.Va., John Stokes and David
N. Startzell, statement .............................................................................................. 1943
Arcari, Paul W., Military Coalition, letter ................................................................. 1929
Arch, John S., Commerce Bancshares, Inc., Kansas City, Mo., letter ......................... 1798
Arctic Slope Regional Corp., Goldbelt Corp., and Sealaska Corp., joint state-
ment ......................................................................................................................... 2151
Arkansas Electric Cooperative Corp., Carl S. Whillock, letter ..................................... 1870
Art Institute of Southern California, Laguna Beach, Calif., John W. Lottes,
letter ......................................................................................................................... 2159
Associated Bank, N.A, Neenah, Wis., Michael B. Mahlik, letter ................................. 1792
Association of American Medical Colleges, Robert C. Petersdorf, M.D., letter ............. 2193
Association of American Universities (see listing for National Association
of Independent Colleges and Universities)
Association of Financial Guaranty Insurers, William A. Geoghegan, statement
and attachments ........................................................................................................ 1837
August, Jerald David, Florida Bar, Tax Section, statement ........................................ 1849
Baker, William C., Chesapeake Bay Foundation, Annapolis, Md., letter ..................... 1946
Bank Securities Association, statement ..................................................................... 1793
Bank South, N.A., Atlanta, Ga., J. Blake Young, Jr., letter .......................................... 1796
Baptist Foundation of Oklahoma, James H. Lockhart, statement ................................. 1931
Barca, Hon. Peter W., a Representative in Congress from the State of Wiscon-
sin, statement ........................................................................................................... 2129
Barnett, Bruce H., Cargill, Inc., Minneapolis, Minn., statement and attach-
ments ......................................................................................................................... 2028
Basin Electric Power Cooperative, Bismark, N.Dak., Robert L. McPhail, state-
ment ......................................................................................................................... 2180
Beach, Dana, South Carolina Coastal Conservation League, Charleston, S.C.,
statement ................................................................................................................... 1952
<table>
<thead>
<tr>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1896</td>
</tr>
<tr>
<td>1965</td>
</tr>
<tr>
<td>2209</td>
</tr>
<tr>
<td>2012</td>
</tr>
<tr>
<td>718</td>
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<td>1871</td>
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<td>2183</td>
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<td>1997</td>
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<td>2085</td>
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<td>2088</td>
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<td>1945</td>
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<td>1934</td>
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<td>1932</td>
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<td>1037</td>
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<td>1826</td>
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<td>1921</td>
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<td>2028</td>
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<td>2009</td>
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<td>1879</td>
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<td>1946</td>
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<td>1985</td>
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<td>2016</td>
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<td>1902</td>
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<td>1970</td>
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<td>2074</td>
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<td>1804</td>
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<td>1844</td>
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<td>2050</td>
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<td>1798</td>
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<td>1898</td>
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<td>2026</td>
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<td>2127</td>
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<td>1924</td>
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<td>2163</td>
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<td>2120</td>
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<td>1836</td>
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<td>1889</td>
</tr>
<tr>
<td>1885</td>
</tr>
<tr>
<td>2174</td>
</tr>
</tbody>
</table>
Dairymen, Inc., Boyd M. Cook, statement .................................................. 2163
Delsan Lumber Co., Hardeid Mutual Plywood Corp., Manke Lumber Co., and
Conifcr Pacific, joint statement .............................................................. 2034
Delta Queen Steamboat Co., New Orleans, La., statement .................. 1876
Diller, James V., Sierra Semiconductor Corp., statement and attachments 2187
DiMatties, A.D., Midlantic National Bank, Edison, N.J., letter .......... 1814
Dinkins, Hon. David N., Mayor, City of New York, statement .......... 2223
Dutcher, Kermit D., Farm Service Agency, Stanfordville, N.Y., Ira Stern, statement 1947
Edison Electric Institute, statement ......................................................... 2136
Edwarda, A.H., University of Arkansas, Fayetteville, Ark., letter .... 2208
Electric Transportation Coalition, Kateri A. Callahan, letter .......... 2075
Emergency Committee for American Trade, Robert L. McNeill, letter .. 1975
ESOP Association:
Statement ............................................................................................................ 1901
J. Michael Keeling, statement ................................................................. 1906
Farley, E. Philip, Old Kent Bank and Trust Co., Grand Rapids, Mich., letter 1816
Federation of American Controlled Shipping, Philip J. Loree, statement 1987
First Fidelity Bank, N.A., New Jersey, John J. Phillips, letter .......... 1799
First National Bank of Chicago, Michael P. Traba, statement .......... 1801
First Source Bank, South Bend, Ind., James P. Coleman, letter .... 1804
First Trust National Association, St. Paul, Minn., John M. Murphy, Jr., letter ........ ................................................... 1805
Florida Bar, Tax Section, Gerald David August, statement .......... 1849
Ford, Hon. Harold E., a Representative in Congress from the State of
Tennessee, statement and attachment .......................................................... 849
General Motors Corp., statement ............................................................ 2014
Geoghegan, William A., Association of Financial Guaranty Insurers, state-
ment and attachments .................................................................................. 1837
Georgine, Robert A., Building and Construction Trades Department, APL-
CIO, statement ........................................................................................... 1921
Godwin, Jean C., American Association of Port Authorities, letter .... 2146
Goff, Charles F., Destec Energy, Inc., Houston, Tex., statement .... 2040
Goldbelt Corp., joint statement (see listing for Arctic Slope Regional Corp.)
Goodman, Craig G., Mitchell Energy & Development Corp., The Woodlands,
Tex., letter and attachment ............................................................................ 2059
Griffin Industries, Inc., Cold Spring, Ky., Dennis B. Griffin, statement .. 1864
Harcar, Mary V., Canadian Life and Health Insurance Association, state-
ment ................................................................................................................ 1826
Hardeid Mutual Plywood Corp., joint statement (see listing for Delsan Lumber
Co.) ............................................................................................................... 2136
Harrington, Carol A., Kathryn G. Henkel, Carlyn S. McCaffrey, Lloyd Leva
Plaine, and Pam H. Schneider, American Bar Association, Real Property,
Probate & Trust Section, joint letter .......................................................... 2201
Harsch Investment Corp., Portland Ore., Harold and Arlene Schnitzer, state-
ment .............................................................................................................. 2160
Hastings, Barry G., Northern Trust Co., Chicago, Ill., letter .......... 1815
Hawaiian Trust Co., Ltd., Honolulu, Hawaii, Douglas Philpotts, letter .. 1807
Hawkins, Charles E., III, Associated Builders and Contractors, Inc., letter .... 1919
Heffelfinger, Rich, Independent Oil and Gas Association of West Virginia,
statement .................................................................................................. 2044
Henkel, Kathryn G., American Bar Association, Real Property, Probate &
Trust Section, joint letter (see listing for Carol A. Harrington) .......... 1385
Herman, Michael E., Kansas City Royals Baseball, statement .......... 1804
Hobart, Larry, American Public Power Association; National Rural Electric
Cooperative Association, Bob Bergland; and National Association of Regu-
latory Utility Commissioners, Thomas Choman, joint letter .......... 2095
Hobart, Larry, American Public Power Association, statement .......... 2133
Hocker, Jean W., Land Trust Alliance, statement .................................. 1948
Hynes, Timothy J., III, Security Trust Co., N.A., Baltimore, Md., letter ... 1817
Illinois Supreme Court, Hon. Benjamin K. Miller, Chief Justice, letter and
attachment .................................................................................................. 1893
Independent Bankers Association of America, James R. Laflffer, statement ... 1809
Independent Oil and Gas Association of West Virginia, Rich Heffelfinger,
statement .................................................................................................. 2044
Independent Petroleum Association of America, Roy W. Willis, letter ........................................ 2080
Information Technology Association of America, Luanne James, statement .................................. 1984
Investment Co. Institute, statement .................................................................................................. 2211
J&B Management Co., Fort Lee, N.J., Bernard Rodin, statement .................................................. 2110
James, Luanne, Information Technology Association of America, statement .................................. 1984
Johnson, Hon. Nancy L., a Representative in Congress from the State of Connecticut:
Statement ............................................................................................................................................ 609
Statement ........................................................................................................................................... 851
Johnson, Peter, Caribbean Latin American Action, letter ................................................................. 2009
Kanjiorski, Hon. Paul E., a Representative in Congress from the State of Pennsylvania, statement .................................................................................................................................................. 2162
Kansas City Royals Baseball, Michael E. Herman, statement ......................................................... 1385
Keeling, J. Michael, ESOP Association, statement ............................................................................. 1906
Kennedy, Hon. Gerald R., a Representative in Congress from the State of Connecticut, statement .................................................................................................................................................. 2219
Kennedy, Hon. Barbara B., a Representative in Congress from the State of Connecticut, statement .................................................................................................................................................. 2219
Kennedy, Hon. Robert T., a Representative in Congress from the State of Connecticut, statement .................................................................................................................................................. 2219
Kirkmire, Nicholas J., Washington Citizens for World Trade, Olympia, Wash., statement ................. 2093
Klecka, Gerald D., a Representative in Congress from the State of Wisconsin, statement ................. 2131
Koncor Forest Products Co., Anchorage, Alaska, John Sturgeon, statement .................................. 2155
KPMG Peat Marwick, New York, N.Y., Kathy L. Anderson, letter .................................................... 1801
Krehm, M.J. "Gus", Northwest Independent Forest Manufacturers, Tacoma, Wash., statement and attachment .................................................................................................................................................. 2036
Lackritz, Marc E., Securities Industry Association, statement .......................................................... 1823
Ladner, H.P. "Pat", Alaska Aerospace Development Corp., Anchorage, Alaska, statement ................. 2114
Land Trust Alliance, Jean W. Hocker, statement .............................................................................. 1948
Large Public Power Council, Phoenix, Ariz., Mark Bonsall, statement ............................................ 2085
Lauffer, James R., Independent Bankers Association of America, statement .................................... 1809
LeBoeuf, Raymond W., PPG Industries, Inc., statement ................................................................... 1911
Lederer, Rob, National Staff Leasing Association, letter .................................................................... 2186
Leszinski, William O., Texas Commerce Investment Co., Houston, Tex., letter ................................. 1819
Lewis, Raymond A., American Methanol Institute, statement .......................................................... 2069
Liberatore, Robert G., Chrysler Corp., statement and attachment ..................................................... 1902
Lockhart, James H., Baptist Foundation of Oklahoma, statement ..................................................... 1931
Loree, Philip J., Federation of American Controlled Shipping, statement ........................................ 1987
Los Angeles, Calif., City of, statement ............................................................................................... 2083
Lottes, John W., Art Institute of Southern California, Laguna Beach, Calif., letter .............................. 2159
Louisiana Land & Exploration Co., New Orleans, La., Leighton Steward, statement ......................... 2054
Lovin, Keith, Maryville University, St. Louis, Mo., letter .................................................................... 2206
Lowey, Hon. Nita M., a Representative in Congress from the State of New York, statement ............. 2109
Luzano, Joseph J., Construction Financial Management Association, statement .............................. 1924
Luna, Hon. Casey, Lt. Governor, State of New Mexico, statement .................................................. 2115
Magna Trust Co., Belleville, Ill., Peter C. Merzian, letter ................................................................. 1812
Mahlik, Michael B., Associated Bank, N.A, Neenah, Wis., letter ..................................................... 1792
Manke Lumber Co., joint statement (see listing for Delson Lumber Co.) ............................................ 2034
Maryville University, St. Louis, Mo., Keith Lovin, letter .................................................................... 2206
Massachusetts Municipal Wholesale Electric Co., statement ............................................................. 2140
Matsui, Hon. Robert T., a Representative in Congress from the State of California:
Statement .............................................................................................................................................. 674
Statement ............................................................................................................................................ 780
Statement ............................................................................................................................................ 853
Statement ............................................................................................................................................ 855
Mauro, Garry, Texas Veterans Land Board, Austin, Tex., statement ............................................... 2118
McCaffrey, Caryn S., American Bar Association, Real Property, Probate & Trust Section, joint letter (see listing for Carol A. Harrington)
McNeill, Robert L., Emergency Committee for American Trade, letter .................................. 1975
McPhail, Robert L., Basin Electric Power Cooperative, Bismark, N.Dak., statement .................. 2180
MDU Resources Group, Inc., Bismarck, N.Dak., Robert E. Wood, statement .................. 2057
Melville, Jennifer, Appalachian Mountain Club, Boston, Mass., statement .................. 1942
Meridian Asset Management, Inc., Valley Forge, Pa., Robert C. Williams, letter .................. 1813
Merzian, Peter C., Magna Trust Co., Belleville, Ill., letter .............................. 1812
Midlantic National Bank, Edison, N.J., A.J. DiMatties, letter .................................. 1814
Military Coalition, Michael Ouelette and Paul W. Amori, letter .................................. 1929
Miller, Hon. Benjamin K., Chief Justice, Illinois Supreme Court, letter and attachment .......... 1883
Mitchell Energy & Development Corp., The Woodlands, Tex., Craig G. Goodman, letter and attachment ................................................................. 2059
Moakley, Hon. John Joseph, a Representative in Congress from the State of Massachusetts, statement .......................................................... 2196
Murphy, John M., Jr., First Trust National Association, St. Paul, Minn., letter .................. 1805
Mutual of America, Daniel W. Coyne, letter .............................................................. 1836
Myers, Robert J., Silver Spring, Md., statement .................................................... 2195
National Association for the Self-Employed, Bennie L. Thayer, letter .................. 2221
National Association of Bond Lawyers, statement .................................................. 2141
National Association of Independent Colleges and Universities; American Council on Education; and National Association of State Universities and Land Grant Colleges, Richard F. Rosser, joint letter ........................................ 2124
National Association of Regulatory Utility Commissioners; Thomas Choman, joint letter (see listing for American Public Power Association) 1787
Linda Bisson Stevens, letter and attachments ......................................................... 1787
National Association of State Universities and Land Grant Colleges, Richard F. Rosser, joint letter (see listing for National Association of Independent Colleges and Universities) 2102
National Cooperative Business Center, Russell C. Notar, statement .................. 2084
National Foreign Trade Council, Inc., statement .................................................. 1976
National Presto Industries, Inc., Eau Claire, Wis., Joseph H. Berney, statement .................. 2183
National Rural Electric Cooperative Association, Bob Bergland; Joint letter (see listing for American Public Power Association) Statement .................................. 718
National Staff Leasing Association, Rob Lederer, letter ........................................ 2166
Natural Resources Defense Council, Marika Tatsutani, statement .................. 2084
Neal, Hon. Richard E., a Representative in Congress from the State of Massachusetts, statement .......................................................... 2197
New Mexico, State of, Hon. Casey Luna, Lt. Governor, statement .................. 2115
New York, City of, Hon. David N. Dinkins, Mayor, statement .................. 2123
New York Cruise Lines, Inc., August J. Cerdanini, Jr., letter .......................... 1879
New York, State of, Vincent Tese, statement .................................................. 2176
Non Commissioned Officers Association of the United States of America, Larry D. Rhea and Michael F. Ouelette, statement ........................................ 1913
Northeast Public Power Association, Westborough, Mass., statement .................. 2230
Northern Trust Co., Chicago, Ill., Barry G. Hastings, letter ............................... 1815
Northwest Independent Forest Manufacturers, Tacoma, Wash., M.J. "Gus" Kuehne, statement and attachment .................................................. 2036
Notar, Russell C., National Cooperative Business Center, statement .................. 2102
Novack, Kenneth M., Schnitzer Investment Corp., Portland, Ore., statement .................. 1866
O'Hare, Dean R., Chubb Corp., Warren, N.J., statement .................................. 1970
Old Kent Bank and Trust Co., Grand Rapids, Mich., E. Philip Farley, letter .................. 1816
Oregon Trout, Inc., Portland, Ore., Geoff Pampush, letter .................................. 1950
Ortiz, Richard L., Shoshone and Arapaho Tribes' Joint Business Council, Fort Washakie, Wyo., letter and attachment ........................................ 2148
Ouelette, Michael: Military Coalition, letter .................................................. 1929
Non Commissioned Officers Association of the United States of America, statement .................. 1913
PacificCorp Financial Services, Portland, Ore., William E. Peressini, statement .................. 2098
Pampush, Geoff, Oregon Trout, Inc., Portland, Ore., letter .................................. 1850
XXII

Passenger Vessel Association, Eric G. Scharf, letter .................................. 1880
Pendergrass, James D., Western Farmers Electric Cooperative, Anadarko, Okla., statement ............................................................ 2165
Peressini, William E., PacificCorp Financial Services, Portland, Ore., statement ............................................................... 2098
Perkinson, Gary J., Beneficial Corp., statement ........................................... 2012
Perlman, Robert H., Tax Executives Institute, Inc., letter ......................... 1981
Petersdorf, M.D., Robert G., Association of American Medical Colleges, letter . 2193
Phillips, John J., First Fidelity Bank, N.A., New Jersey, letter ............... 1799
Philpotts, Douglas, Hawaiian Trust Co., Ltd., Honolulu, Hawaii, letter .... 1807
Plaine, Lloyd Leva, American Bar Association, Real Property, Probate & Trust Section, joint letter (see listing for Carol A. Harrington)
Platt, Ronald L., and Gregory F. Jenner, McDermott, Will & Emery, Washing-
ton, D.C., statement .............................................................................. 1958
Platt, Ronald L., Southland Corp., Dallas, Tex., statement ...................... 2171
PPG Industries, Inc., Raymond W. LeBoeuf, statement ............................. 1911
Quinn, Carol A., and Irving Salem, Latham & Watkins, New York, N.Y., statement ........................................................................... 2104
Rahall, Hon. Nick J., II, a Representative in Congress from the State of West Virginia, statement ................................................ .................. 1890
Rhode Island Commissioned Officers Association of the United States of America, statement ................................................................. 1913
Robertson, Steve A., American Legion, statement .................................... 1887
Rodin, Bernard, J&B Management Co., Fort Lee, N.J., statement ............ 2110
Rosser, Richard F., National Association of Independent Colleges and Universities; American Council on Education; and National Association of State Universities and Land Grant Colleges, joint letter .................................. 2124
Roundtree, Robert E., City Utilities of Springfield, Mo., letter (forwarded by the Hon. Mel Hancock, a Representative in Congress from the State of Missouri) ................................................................. 2074
Sacramento, Calif., Municipal Utility District, statement ......................... 2096
Salem, Irving, and Carol A. Quinn, Latham & Watkins, New York, N.Y., statement ........................................................................... 2104
Salt River Project of Phoenix, Ariz., Mark Bonsall, statement .................. 2085
Save the Bay, Providence, R.I., Curt Spalding, letter ............................... 1951
Savings Bank Life Insurance Co., Woburn, Mass., Robert K. Sheridan, state-
ment ........................................................................................................ 1820
Sayville Ferry, Sayville, N.Y., Ken Stein, Jr., letter .................................... 1882
Scharf, Eric G., Passenger Vessel Association, letter ............................... 1880
Schneider, D. ham H., American Bar Association, Real Property, Probate & Trust Section, joint letter (see listing for Carol A. Harrington)
Schnitzer, Harold and Arlene, Harsch Investment Corp., Portland Ore., state-
ment ........................................................................................................ 2160
Schnitzer Investment Corp., Portland, Ore., Kenneth M. Novack, statement ................................................................. 1866
Sealaska Corp., joint statement (see listing for Arctic Slope Regional Corp.) Security Industry Association, Marc E. Lackritz, statement ...................... 1823
Shaw, Hon. E. Clay, Jr., a Representative in Congress from the State of Florida, statement ................................................................. 1996
Sheridan, Robert K., Savings Bank Life Insurance Co., Woburn, Mass., state-
ment ........................................................................................................ 1820
Shoshone and Arapaho Tribes' Joint Business Council, Fort Washakie, Wyo., Richard L. Ortiz, letter and attachment ........................................ 2148
Sierra Semiconductor Corp., James V. Diller, statement and attachments .... 2187
Sinaikin, Ronald A., AlliedSignal Inc., statement ....................................... 1906
Solo Cup Co., statement .......................................................................... 1859
South Carolina Coastal Conservation League, Charleston, S.C., Dana Beach, statement ........................................................................... 1952
Southern California Public Power Authority, Pasadena, Calif., statement ................................................................. 2086
Southland Corp., Dallas, Tex., Ronald L. Platt, statement ......................... 2171
Spalding, Curt, Save the Bay, Providence, R.I., letter .............................. 1951
Stanford University, Stanford, Calif., Peter Van Etten, statement ............. 2122
Startzell, David N., Appalachian Trail Conference, Harpers Ferry, W.Va., statement ........................................................................... 1943
Stein, Ken, Jr., Sayville Ferry, Sayville, N.Y., letter ................................ 1882
Stern, Ira, Dutchess Land Conservancy, Stanfordville, N.Y., statement ...... 1947
<table>
<thead>
<tr>
<th>Name and Organization</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stevens, Linda Bisson, National Association of Regulatory Utility Commissioners</td>
<td>1787</td>
</tr>
<tr>
<td>Steward, Leighton, Louisiana Land &amp; Exploration Co., New Orleans, La.</td>
<td>2054</td>
</tr>
<tr>
<td>Stier, Daniel D., Wisconsin Department of Veterans Affairs, letter</td>
<td>2119</td>
</tr>
<tr>
<td>Stokes, John, Appalachian Trail Conference, Harpers Ferry, W.Va., statement</td>
<td>1943</td>
</tr>
<tr>
<td>Stump, Hon. Bob, a Representative in Congress from the State of Arizona, letter and attachment</td>
<td>1892</td>
</tr>
<tr>
<td>Sturgeon, John, Koncor Forest Products Co., Anchorage, Alaska, statement</td>
<td>2155</td>
</tr>
<tr>
<td>Suggs, Hon. Joseph M., Jr., Connecticut, State of, statement</td>
<td>2127</td>
</tr>
<tr>
<td>Sweeney, Hon. William W., Bedford County (Va.) Circuit Court, letter (forwarded by the Hon. L.F. Payne, a Representative in Congress from the State of Virginia)</td>
<td>1896</td>
</tr>
<tr>
<td>Tampa (Fla.) Electric Co., statement</td>
<td>2042</td>
</tr>
<tr>
<td>Tatsutani, Marika, Natural Resources Defense Council, statement</td>
<td>2084</td>
</tr>
<tr>
<td>Tax Executives Institute, Inc., Robert H. Perlman, letter</td>
<td>1981</td>
</tr>
<tr>
<td>Teese, Vincent, State of New York, statement</td>
<td>2176</td>
</tr>
<tr>
<td>Texas Commerce Investment Co., Houston, Tex.:</td>
<td></td>
</tr>
<tr>
<td>Traba, Michael L., National Association for the Self-Employed, letter</td>
<td>2221</td>
</tr>
<tr>
<td>Traba, Michael P., First National Bank of Chicago, statement</td>
<td>1801</td>
</tr>
<tr>
<td>Trapp, James M., American College of Trust and Estate Counsel, letter</td>
<td>2198</td>
</tr>
<tr>
<td>University of Arkansas, Fayetteville, Ark., A.H. Edwards, letter</td>
<td>2208</td>
</tr>
<tr>
<td>Updike, Lawrence C., Alcoma Association, Inc., Lake Wales, Fla., statement</td>
<td>1858</td>
</tr>
<tr>
<td>Urvic, Ed, Allegheny Electric Cooperative, Inc., Harrisburg, Pa., letter</td>
<td>2178</td>
</tr>
<tr>
<td>USX Corp., statement</td>
<td>2091</td>
</tr>
<tr>
<td>Van Etten, Peter, Stanford University, Stanford, Calif., statement</td>
<td>2122</td>
</tr>
<tr>
<td>Ward L. Quaal Co., Ward L. Quaal, statement</td>
<td>1954</td>
</tr>
<tr>
<td>Washington Citizens for World Trade, Olympia, Wash., Nicholas J. Kirkmire, statement</td>
<td>2093</td>
</tr>
<tr>
<td>Wells Manufacturing Co., statement</td>
<td>1662</td>
</tr>
<tr>
<td>Western Farmers Electric Cooperative, Anadarko, Okla., James D. Pendergrass, statement</td>
<td>2165</td>
</tr>
<tr>
<td>Weymouth, George A., Brandywine Conservancy, Chadds Ford, Pa., statement</td>
<td>1945</td>
</tr>
<tr>
<td>Whillock, Carl S., Arkansas Electric Cooperative Corp., letter</td>
<td>1870</td>
</tr>
<tr>
<td>Williams, Robert C., Jr., Columbia Gas Development Corp., Houston, Tex., statement</td>
<td>2050</td>
</tr>
<tr>
<td>Williams, Robert C., Meridian Asset Management, Inc., Valley Forge, Pa., letter</td>
<td>1813</td>
</tr>
<tr>
<td>Williamson, Robert D., American Society for Payroll Management, statement</td>
<td>1917</td>
</tr>
<tr>
<td>Willis, Roy W., Independent Petroleum Association of America, letter</td>
<td>2080</td>
</tr>
<tr>
<td>Wisconsin Department of Veterans Affairs, Daniel D. Stier, letter</td>
<td>2119</td>
</tr>
<tr>
<td>Wise, Hon. Bob, a Representative in Congress from the State of West Virginia, letter and attachments</td>
<td>2045</td>
</tr>
<tr>
<td>Wood, Robert E., MDU Resources Group, Inc., Bismark, N.Dak., statement</td>
<td>2057</td>
</tr>
<tr>
<td>Worthy, K. Martin, Hopkins &amp; Sutter, Washington, D.C., statement</td>
<td>611</td>
</tr>
<tr>
<td>Young, J. Blake, Jr., Bank South, N.A., Atlanta, Ga., letter</td>
<td>1796</td>
</tr>
</tbody>
</table>

**LISTING BY SUBJECT—REVENUE RAISERS**

**GENERAL**

<table>
<thead>
<tr>
<th>Name and Organization</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business Roundtable, statement</td>
<td>2233</td>
</tr>
<tr>
<td>National Society of Public Accountants, Leroy A. Strubberg, and Jeffrey A. Lear, statement</td>
<td>2235</td>
</tr>
</tbody>
</table>

**ALTERNATIVE MINIMUM TAX**

<table>
<thead>
<tr>
<th>Name and Organization</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>American Forest and Paper Association, statement (see listing under Multiple Issues heading)</td>
<td></td>
</tr>
<tr>
<td>Coal Tax Committee, statement</td>
<td>2240</td>
</tr>
<tr>
<td>National Coal Association, Richard L. Lawson, statement</td>
<td>2237</td>
</tr>
</tbody>
</table>
ACCOUNTING

American Bankers Association, statement (see listing under Multiple Issues heading)
American Electronics Association, statement (see listing under Multiple Issues heading)
American Forest and Paper Association, statement (see listing under Multiple Issues heading)
American Trucking Associations, Inc., statement (see listing under Multiple Issues heading)
Barth, James P., North Bend, Ohio, letter ............................................. 2243
Black Entertainment Television, Robert L. Johnson, letter ........................ 2244
Burt, R.L., Southampton, Mass., letter (see listing under Multiple Issues heading)
Center for the Study of Commercialism, Michael F. Jacobson, letter ......... 2245
Centex Corp., Dallas, Tex., Richard C. Harvey, letter (see listing under Multiple Issues heading)
Danaher Corp., Washington, D.C., James H. Ditkoff, letter and attachment ... 2249
Edwin L. Cox Co., Dallas, Tex., J. Oliver McGonigle, letter ...................... 2251
Fisher, John J., Barrington, Ill., letter ................................................... 2252
Food Marketing Institute, and International Mass Retail Association, joint statement ................................................................. 2253
Larsen, Bryant & Porter, CPAs, P.C., Lincoln, Neb., Brent L. Stehlik, letter (see listing under Multiple Issues heading)
Mattel, Inc., statement ........................................................................... 2255
Miles Inc., Pittsburgh, Pa., Helge H. Wehmeier, letter .............................. 2257
National Association of Enrolled Agents, James E. Forrester, statement (see listing under Multiple Issues heading)
Sundquist, Hon. Don, a Representative in Congress from the State of Tennessie, statement ................................................................. 2263
Techtron Imaging Centre, Chicago, Ill., Walter C. Pabst, letter ................ 2280

FINANCIAL INSTITUTIONS

American Bankers Association, statement (see listing under Multiple Issues heading)
Centex Corp., Dallas, Tex., Richard C. Harvey, letter (see listing under Multiple Issues heading)
Fidelity Federal Bank, Glendale, Calif., Kathleen A. Christianson, letter ...... 2258
National Association of Water Companies, James L. Good, statement ........ 2274
Sundquist, Hon. Don, a Representative in Congress from the State of Tennessee, statement ................................................................. 2280

COST RECOVERY

Kieffer-Nolde, Chicago, Ill., Neil J. Schecter, letter ....................................... 2278
National Association of Water Companies, James L. Good, statement ........ 2274
Techtron Imaging Centre, Chicago, Ill., Walter C. Pabst, letter .................. 2281
INDIVIDUAL INCOME TAX

American Greyhound Track Operators Association, Henry C. Cashen and John C. Dill, statement (see listing under Multiple Issues heading)
American Horse Council, Inc., statement (see listing under Multiple Issues heading)
American Trucking Associations, Inc., statement (see listing under Multiple Issues heading)
Billray, Hon. James H., a Representative in Congress from the State of Nevada, statement (see listing under Multiple Issues heading)
Bryan, Hon. Richard, a United States Senator from the State of Nevada, statement (see listing under Multiple Issues heading)
Burt, R.I., Southampton, Mass., letter (see listing under Multiple Issues heading)
Coopers & Lybrand, Washington, D.C., statement ............................................... 2284
Customs Science Services, Inc., Kensington, Md., Roger J. Crain, letter ........... 2283
Larsen, Bryant & Porter, CPA's, P.C., Lincoln, Neb., Brent L. Stehlik, letter (see listing under Multiple Issues heading)
National Association for the Self-Employed, Bennie L. Thayer, letter (see listing under Multiple Issues heading)
National Association of Enrolled Agents, James E. Forrester, statement (see listing under Multiple Issues heading)
National Association of Realtors, statement (see listing under Multiple Issues heading)
National Conference of State Social Security Administrators, Daryl Dunagan, letter (see listing under Multiple Issues heading)
Nevada Resort Association, David Beldin, statement .................. 2287
Reid, Hon. Harry, a United States Senator from the State of Nevada, statement (see listing under Multiple Issues heading)
SeaWest, San Diego, Calif., Thomas G. Farnham, letter ..................................... 2290
Swavelle/Mill Creek Fabrics, New York, N.Y., Jeffrey B. Kraut, letter .............. 2282
True Companies, Casper, Wyo., statement (see listing under Multiple Issues heading)
United States Telephone Association, John Sodolski, statement (see listing under Multiple Issues heading)
Vucanovich, Hon. Barbara F., a Representative in Congress from the State of Nevada, statement (see listing under Multiple Issues heading)

NATURAL RESOURCES

American Trucking Associations, Inc., statement (see listing under Multiple Issues heading)
Center for International Environmental Law, Robert F. Housman, statement .................. 2294
National Petroleum Refiners Association, Urvan R. Sternfels, letter ....................... 2295
Reid, Hon. Harry, a United States Senator from the State of Nevada, statement .................. 2291
True Companies, Casper, Wyo., statement (see listing under Multiple Issues heading)

FOREIGN TAX PROVISIONS

American Bankers Association, statement (see listing under Multiple Issues heading)
American Electronics Association, statement (see listing under Multiple Issues heading)
American Federation of Labor and Congress of Industrial Organizations, Robert E. Lucore, statement .............................. 2325
American Forest and Paper Association, statement (see listing under Multiple Issues heading)
American Petroleum Institute, statement (see listing under Multiple Issues heading)
American Trucking Associations, Inc., statement (see listing under Multiple Issues heading)
Arthur Andersen & Co., Andre P. Fogarasi and Richard A. Gordon, statement .................. 2329
Association of British Insurers, statement .......................................................... 2339
Attorneys' Liability Assurance Society, Inc., John E. Chapoton and Thomas A. Stout, Jr., letter .................................................................................. 2345
XXVI

Danaher Corp., Washington, D.C., James H. Ditkoff, letter ........................................... 2337
Export Source Coalition, Paul W. Oosterhuis and Roseann M. Cutrone, statement and attachments ................................................................. 2299
International Tax Policy Forum, Joel Slemrod, statement and attachment ...................... 2309
Kennelly, Hon. Barbara B., a Representative in Congress from the State of Connecticut, letter and attachments ......................................................... 2350
National Association of Insurance Brokers, Michael J. Hass, letter ............................... 2364
Organization for International Investment Inc., Alexander Spitzer, statement and attachments (see listing under Multiple Issues heading) .............. 2407
Public Securities Association, statement ........................................................................... 2318
Reinsurance Association of America, statement ................................................................ 2366
Risk and Insurance Management Society, Inc., Paul S. Brown, letter ......................... 2374
Securities Industry Association, Marc E. Lackritz, statement ........................................ 2320
Tax Executives Institute, Inc., Ralph J. Weiland, statement (see listing under Multiple Issues heading) ................................................................. 2409
United States Council for International Business:
Statement .................................................................................................................................................................................. 2312
Statement .................................................................................................................................................................................. 2324
United States Telephone Association, John Sodolski, statement (see listing under Multiple Issues heading) ................................................................. 2381
United Technologies, William F. Paul, letter ...................................................................... 2396

EXCISE TAXES

American Forest and Paper Association, statement and attachment ............................ 2399
American Horse Council, Inc., statement (see listing under Multiple Issues heading) .... 2407
American Trucking Associations, Inc., statement (see listing under Multiple Issues heading) ........................................................................................................................................... 2402
Asociacion de Exportadores De Chile (Chilean Exporter's Association), Ronald S. Bown F., letter and attachment ................................................................. 2408
Association of Home Appliance Manufacturers, statement ............................................... 2407
Bilbray, Hon. James H., a Representative in Congress from the State of Nevada, statement (see listing under Multiple Issues heading) ......................................................... 2396
Bryan, Hon. Richard, a United States Senator from the State of Nevada, statement (see listing under Multiple Issues heading) ................................................................. 2410
Carrier Corp., Syracuse, N.Y., Edward A. Baily, letter ..................................................... 2409
Cetylite Industries, Inc., Pennsauken, N.J., Stanley L. Wachman, statement ............... 2410
Mack Trucks, Inc., Mark Cherry, statement and attachments ........................................... 2388
National Cable Television Association, Decker Anstrom, statement .................................. 2381
National Truck Equipment Association, Michael E. Kastner, letter and attachment ...... 2396
Nevada Resort Association, David Belding, statement ..................................................... 2378
Newspaper Association of America, statement ................................................................. 2382
Organization for International Investment Inc., Alexander Spitzer, statement and attachments (see listing under Multiple Issues heading) ................. 2412
Polyisocyanurate Insulation Manufacturers Association, Jared O. Blum, statement .......... 2382
Reid, Hon. Harry, a United States Senator from the State of Nevada, statement (see listing under Multiple Issues heading) ......................................................... 2383
Renewable Fuels Association, Eric Vaughn, statement ..................................................... 2383
Tax Executives Institute, Inc., Ralph J. Weiland, statement (see listing under Multiple Issues heading) ................................................................. 2416
Truck Trailer Manufacturers Association, Richard P. Bowling, letter ......................... 2398
True Companies, Casper, Wyo., statement (see listing under Multiple Issues heading) ........................................................................................................................................... 2416
United States Telephone Association, John Sodolski, statement (see listing under Multiple Issues heading) ................................................................. 2407
Vucanovich, Hon. Barbara F., a Representative in Congress from the State of Nevada, statement (see listing under Multiple Issues heading) ................. 2412
Whirlpool Corp., Michael C. Thompson, statement .................................................................. 2421

TAX-EXEMPT ENTITIES

Alliance for Justice, Nan Aron and Carol Siefert, letter and attachment ....................... 2431
American Association of Museums, Edward H. Able, Jr., letter ..................................... 2436
American Gas Association, statement (see listing under Multiple Issues heading)
American Petroleum Institute, statement (see listing under Multiple Issues heading)
American Trucking Associations, Inc., statement (see listing under Multiple Issues heading)
Center for Non-Profit Corporations, Princeton, N.J., Linda M. Czipo, letter .... 2438
Independent Bankers Association of America, statement (see listing under Multiple Issues heading)
National Association of Convenience Stores, statement (see listing under Multiple Issues heading)
National Association of Realtors, statement (see listing under Multiple Issues heading)
National Club Association, statement .................................................. 2423
National Panhellenic Conference, Harriett B. Macht; National Pan-Hellenic Council, Inc., Daisy Wood; and National Interfraternity Conference, Robert D. Lynd, joint statement and attachment .............................................. 2426
National Venture Capital Association, Dean C. Gordonier, Jr., letter .............. 2440
Tax Executives Institute, Inc., Ralph J. Weiland, statement (see listing under Multiple Issues heading)
True Companies, Casper, Wyo., statement (see listing under Multiple Issues heading)
United States Telephone Association, John Sodolski, statement (see listing under Multiple Issues heading)

COMPLIANCE

American Bankers Association, statement (see listing under Multiple Issues heading)
American Electronics Association, statement (see listing under Multiple Issues heading)
American Forest and Paper Association, statement (see listing under Multiple Issues heading)
American Gas Association, statement (see listing under Multiple Issues heading)
American Greyhound Track Operators Association, Henry C. Cashen and John C. Dill, statement (see listing under Multiple Issues heading)
American Horse Council, Inc., statement (see listing under Multiple Issues heading)
American Land Title Association, Ann vom Eigen, statement........................ 2447
American Trucking Associations, Inc., statement (see listing under Multiple Issues heading)
Bilbray, Hon. James H., a Representative in Congress from the State of Nevada, statement (see listing under Multiple Issues heading)
Bryan, Hon. Richard, a United States Senator from the State of Nevada, statement (see listing under Multiple Issues heading)
Burt, R.L., Southampton, Mass., letter (see listing under Multiple Issues heading)
Coalition on Interest Disallowance, statement ................................................ 2455
Federation of Tax Administrators, Harley T. Duncan, statement and attachment .......................................................... 2449
Gomola, Gary R., Coughlin & Gomola, Middletown, Conn., letter .................. 2453
Independent Bankers Association of America, statement (see listing under Multiple Issues heading)
Larsen, Bryan & Porter, CPA's, P.C., Lincoln, Neb., Brent L. Stehlik, letter (see listing under Multiple Issues heading)
Levenson, Daniel D., Lourie & Cutler, P.C., Boston, Mass., statement ............. 2461
National Association for the Self-Employed, Bennie L. Thayer, letter (see listing under Multiple Issues heading)
National Association of Convenience Stores, statement (see listing under Multiple Issues heading)
National Association of Enrolled Agents, James E. Forrester, statement (see listing under Multiple Issues heading)
National Conference of State Social Security Administrators, Daryl Dunagan, letter (see listing under Multiple Issues heading)
Nevada Resort Association, David Belding, statement ........................................ 2458
Reid, Hon. Harry, a United States Senator from the State of Nevada, statement (see listing under Multiple Issues heading)
Tax Executives Institute, Inc., Ralph J. Weiland, statement (see listing under Multiple Issues heading)
True Companies, Casper, Wyo., statement (see listing under Multiple Issues heading)
United States Telephone Association, John Sodolski, statement (see listing under Multiple Issues heading)
Vucanovich, Hon. Barbara F., a Representative in Congress from the State of Nevada, statement (see listing under Multiple Issues heading)

MISCELLANEOUS ISSUES

Alliance Exchange Group, Inc., Santa Ana, Calif., Deanna F. Burton, letter ........................................ 2498
American Electronics Association, statement (see listing under Multiple Issues heading) ......................................... 2499
American Equity Exchange, Inc., Dillon, Mont., Max A. Hansen, letter ...................................................... 2500
American Forest and Paper Association, statement (see listing under Multiple Issues heading) ......................... 2501
American Gas Association, statement (see listing under Multiple Issues heading) ............................................. 2502
American Land Title Association, Ann vom Eigen, statement ................................................................. 2503
American Petroleum Institute, statement (see listing under Multiple Issues heading) ........................................ 2504
American Trucking Associations, Inc., statement (see listing under Multiple Issues heading) ......................... 2505
Bishop, Barbara, Pasedena, Calif., letter .................................................................................................................. 2506
Building and Construction Trades Department, AFL-CIO, Robert A. Georgine, statement ............................. 2507
Coalition for Independent Contractors, Edward N. Delaney and Russell A. Hollrah, statement ................................ 2508
Environcol, James C. Godbout, Diane Herndon, and Mary Frances Pearson, statement ........................................... 2509
Equity Advantage, Inc., Salem, Ore., Lonnie C. Nielson, Thomas N. Moore, and David S. Moore, letter ............... 2510
Equity Reserve, Inc., Newport Beach, Calif., Frank C. Huntsman, letter .......................................................... 2511
Federation of Exchange Accommodators, Newport Beach, Calif., Andrew G. Potter, letter .................................. 2512
Hulen, Myron, Colorado State University; William Kinny, Portland State University; Jack Robison, California Polytechnic State University; and Michael Vaughan, Colorado State University, joint statement ................................................................. 2513
Independent Fuel Terminal Operators Association, statement and attachment .......................................................... 2514
International Council of Shopping Centers, Steven J. Guttman, statement .......................................................... 2515
Lantos, Hon. Tom, a Representative in Congress from the State of California, statement ........................................... 2516
National Association for the Self-Employed, Bennie L. Thayer, letter (see listing under Multiple Issues heading) .......... 2517
National Association of Convenience Stores, statement (see listing under Multiple Issues heading) .................. 2518
National Association of Realtors, statement (see listing under Multiple Issues heading) ........................................ 2519
National Federation of Independent Business, statement ....................................................................................... 2520
New York Gas Group, Donald F. Straetz, statement ................................................................................................. 2521
Real Estate Exchange, Inc., Portland, Ore., James C. Casterline, letter ................................................................. 2522
Security Trust Co., San Diego, Calif., J. Paul Spring, letter ...................................................................................... 2523
Shays, Hon. Christopher, a Representative in Congress from the State of Connecticut, statement .......................... 2524
Studds, Hon. Gerry E., a Representatives in Congress from the State of Massachusetts, statement .......................... 2526
Tax Executives Institute, Inc., Ralph J. Weiland, statement (see listing under Multiple Issues heading) .................. 2527
True Companies, Casper, Wyo., statement (see listing under Multiple Issues heading) ........................................... 2528
United Brotherhood of Carpenters and Joiners of America, AFL-CIO, statement .................................................. 2529
XXIX

United States Telephone Association, John Sodolski, statement (see listing under Multiple Issues heading)

MULTIPLE ISSUES

American Bankers Association, statement .......................................................... 2525
American Electronics Association, statement .................................................. 2529
American Forest and Paper Association, statement ......................................... 2533
American Gas Association, statement .............................................................. 2535
American Greyhound Track Operators Association, Henry C. Cashen and John C. Dill, statement ................................................................. 2544
American Horse Council, Inc., statement ........................................................ 2546
American Petroleum Institute, statement ......................................................... 2551
American Trucking Associations, Inc., statement ......................................... 2560
Bilkey, Hon. James H., a Representative in Congress from the State of Nevada, statement ................................................................. 2563
Bryan, Hon. Richard, a United States Senator from the State of Nevada, statement ........................................................................................................... 2564
Burt, R.L., Southampton, Mass., letter .............................................................. 2566
Centex Corp., Dallas, Tex., Richard C. Harvey, letter ................................... 2567
Independent Bankers Association of America, statement .............................. 2568
Larsen, Bryant & Porter, CPA's, P.C., Lincoln, Neb., Brent L. Stehlik, letter ... 2570
National Association for the Self-Employed, Bennie L. Thayer, letter ........... 2573
National Association of Convenience Stores, statement ................................ 2576
National Association of Enrolled Agents, James E. Forrester, statement ........... 2580
National Association of Realtors, statement .................................................... 2583
National Conference of State Social Security Administrators, Daryl Dunagan, letter ........................................................................................................ 2587
Organization for International Investment Inc., Alexander Spitzer, statement and attachments ................................................................. 2589
Reid, Hon. Harry, a United States Senator from the State of Nevada, statement ........................................................................................................... 2597
Tax Executives, Inc., Ralph J. Weiland, statement ......................................... 2599
Tax Executives, Casper, Wyo., statement ....................................................... 2600
United States Telephone Association, John Sodolski, statement ..................... 2618
Vucanovich, Hon. Barbara F., a Representative in Congress from the State of Nevada, statement ............................................................................... 2623

COMBINED LISTING BY NAME AND ORGANIZATIONS (RAISERS)

Able, Edward H., Jr., American Association of Museums, letter ................. 2436
Alliance Exchange Group, Inc., Santa Ana, Calif., Deanna F. Burton, letter ... 2498
Alliance for Justice, Nan Aron and Carol Siefert, letter and attachment ....... 2431
American Association of Museums, Edward H. Able, Jr., letter ................. 2436
American Bankers Association, statement ....................................................... 2525
American Electronics Association, statement .................................................. 2529
American Equity Exchange, Inc., Dillon, Mont., Max A. Hansen, letter ....... 2499
American Federation of Labor and Congress of Industrial Organizations, Robert E. Lucore, statement ................................................................. 2325
American Forest and Paper Association: Statement and attachment ......... 2399
Statement ........................................................................................................... 2533
American Gas Association, statement .............................................................. 2535
American Greyhound Track Operators Association, Henry C. Cashen and John C. Dill, statement ................................................................. 2544
American Horse Council, Inc., statement ........................................................ 2546
American Land Title Association, Ann vom Eigen: Statement ....................... 2447
Statement ........................................................................................................... 2500
American Petroleum Institute, statement ........................................................ 2551
American Trucking Associations, Inc., statement ......................................... 2560
Anstrom, Decker, National Cable Television Association, statement ............. 2381
Aron, Nan, Alliance for Justice, letter and attachment ................................... 2431
Arthur Andersen & Co., Andre P. Fogarasi and Richard A. Gordon, statement ........................................................................................................... 2329
Asociacion de Exportadores De Chile (Chilean Exporter's Association), Ronald S. Bown F., letter and attachment ............................................................... 2402
Association of British Insurers, statement ....................................................... 2339
Association of Home Appliance Manufacturers, statement .............................................. 2407
Attorneys’ Liability Assurance Society, Inc., John E. Chapoton and Thomas A. Stout, Jr., letter .......................................................... 2345
Bailly, Edward A., Currier Corp., Syracuse, N.Y., letter .................................................. 2409
Barth, James P., North Bend, Ohio, letter ..................................................................... 2243
Belding, David, Nevada Resort Association: .................................................................... 2287
Statement .......................................................................................................................... 2378
Statement .......................................................................................................................... 2458
Bilbray, Hon. James H., a Representative in Congress from the State of Nevada, statement ........................................................................................................................................ 2563
Bishop, Barbara, Pasedena, Calif., letter ............................................................................. 2502
Black Entertainment Television, Robert L. Johnson, letter ............................................. 2244
Blum, Jared O., Polyisocyanurate Insulation Manufacturers Association, statement .................................................................................................................. 2412
Bowling, Richard P., Truck Trailer Manufacturers Association, letter .......................... 2398
Bown F., Ronald S., Asociacion de Exportadores De Chile (Chilean Exporter’s Association), letter and attachment ........................................................................... 2402
Brown, Paul S., Risk and Insurance Management Society, Inc., letter ......................... 2374
Bryan, Hon. Richard, a United States Senator from the State of Nevada, statement .................................................................................................................. 2564
Building and Construction Trades Department, AFL-CIO, Robert A. Georgine, statement ........................................................................................................................................ 2463
Bush, P. & Southampton, Mass., letter ................................................................................ 2566
Burton, Deanna F., Alliance Exchange Group, Inc., Santa Ana, Calif., letter .................. 2498
Business Roundtable, statement ..................................................................................... 2233
Carrier Corp., Syracuse, N.Y., Edward A. Bailly, letter .................................................. 2409
Cashen, Henry C., American Greyhound Track Operators Association, statement .... 2544
Casterline, James C., Real Estate Exchange, Inc., Portland, Ore., letter ......................... 2510
Cent for International Environmental Law, Robert F. Houman, statement .................. 2294
Center for Non-Profit Corporations, Princeton, N.J., Linda M. Czipo, letter ............... 2438
Center for the Study of Commercialism, Michael F. Jacobson, letter .......................... 2245
Centex Corp., Dallas, Tex., Richard C. Harvey, letter .................................................... 2567
Cetylite Industries, Inc., Pennsauken, N.J., Stanley L. Wachman, statement .............. 2410
Chapoton, John E., Attorneys’ Liability Assurance Society, Inc., letter ......................... 2345
Cherry, Mark, Mack Trucks, Inc., statement and attachments .................................... 2388
Christianson, Kathleen A., Fidely Federal Bank, Glendale, Calif., letter ....................... 2287
Coal Tax Committee, statement .................................................................................. 2240
Coalition for Independent Contractors, Edward N. Delaney and Russell A. Hollrah, statement .............................................................................................................. 2469
Coalition on Interest Disallowance, statement ................................................................ 2455
Coopers & Lybrand, Washington, D.C., statement .......................................................... 2284
Customs Science Services, Inc., Kensington, Md., Robert J. Crenn, letter ...................... 2283
Cutrone, Roseann M., Export Source Coalition, statement and attachments ................ 2299
Czipo, Linda M., Center for Non-Profit Corporations, Princeton, N.J., letter ............... 2438
Danaher Corp., Washington, D.C., James H. Ditkoff: .................................................... 2249
Letter .................................................................................................................................. 2337
Letter .................................................................................................................................. 2249
Delaney, Edward N., Coalition for Independent Contractors, statement ....................... 2469
Dill, John C., American Greyhound Track Operators Association, statement ............ 2544
Ditkoff, James H., Danaher Corp., Washington, D.C.: .................................................... 2249
Letter .................................................................................................................................. 2237
Dunagan, Daryl, National Conference of State Social Security Administrators, letter .......................................................... 2587
Duncan, Harley T., Federation of Tax Administrators, statement and attachment ....... 2449
Edwin L. Cox Co., Dallas, Tex., J. Oliver McGonigle, letter .......................................... 2251
Environcol, James C. Godbout, Diane Herndon, and Mary Frances Pearson, statement ........................................................................................................................................ 2513
Equity Advantage, Inc., Salem, Ore., Lonnie C. Nielson, Thomas N. Moore, and David S. Moore, letter ........................................................................................................................................ 2503
Equity Reserve, Inc., Newport Beach, Calif., Frank C. Huntsman, letter ......................... 2504
Export Source Coalition, Paul W. Oosterhuis and Roseann M. Cutrone, statement and attachments .............................................................................................................. 2299
Farnham, Thomas G., SeaWest, San Diego, Calif., letter ............................................... 2290
XXXI

Federation of Exchange Accommodators, Newport Beach, Calif., Andrew G. Potter, letter .................................................. 2505
Federation of Tax Administrators, Harley T. Duncan, statement and attachment .......................................................... 2449
Fidelity Federal Bank, Glendale, Calif., Kathleen A. Christianson, letter .......................................................... 2267
Fisher, John J., Barrington, Ill., letter .................................................................................................................. 2262
Fogarasi, Andrew P., Arthur Andersen & Co., statement .................................................................................. 2329
Food Marketing Institute, and International Mass Retail Association, joint statement ................................................. 2253
Forrester, James E., National Association of Enrolled Agents, statement .................................................. 2580
Georgine, Robert A., Building and Construction Trades Department, AFL-CIO, statement .................................. 2463
Giusti, Steve, Laser Graphics, Inc., Hillside, Ill., letter .................................................................................. 2279
Godbout, James C., Environcol, statement ........................................................................................................ 2513
Gomola, Gary R., Coughlin & Gomola, Middletown, Conn., letter ...................................................................... 2453
Good, James L., National Association of Water Companies, statement .................................................................. 2274
Gordanier, Dean C., Jr., National Venture Capital Association, letter .................................................................. 2440
Gordon, Richard A., Arthur Andersen & Co., statement .................................................................................. 2329
Gutman, Steven J., International Council of Shopping Centers, statement .................................................. 2507
Hansen, Max A., American Equity Exchange, Inc., Dillon, Mont., letter .......................................................... 2499
Harvey, Richard C., Centex Corp., Dallas, Tex., letter ..................................................................................... 2567
Haas, Michael J., National Association of Insurance Brokers, letter .......................................................... 2364
Healey, Maureen A., Society of the Plastics Industry, Inc., letters and attachments .............................................. 2416
Heinrodt, Diane, Environcol, statement ........................................................................................................ 2513
Hollrab, Russell A., Coalition for Independent Contractors, statement .................................................................. 2469
Housman, Robert F., Center for International Environmental Law, statement .......................................................... 2294
Hulen, Myron, Colorado State University; William Kinny, Portland State University; Jack Robison, California Polytechnic State University; and Michael Vaughan, Colorado State University, joint statement .................................................................................. 2474
Huntman, Frank C., Equity Reserve, Inc., Newport Beach, Calif., letter .................................................................. 2504
Independent Bankers Association of America, statement .................................................................................. 2568
Independent Fuel Terminal Operators Association, statement and attachment .................................................. 2518
International Council of Shopping Centers, Steven J. Gutman, statement .................................................. 2507
International Mass Retail Association, and Food Marketing Institute, joint statement .............................................. 2253
International Tax Policy Forum, Joel Slemrod, statement and attachment .................................................. 2309
Jacobson, Michael F., Center for the Study of Commercialism, letter .................................................................. 2245
Johnson, Robert L., Black Entertainment Television, letter .................................................................................. 2244
Kastner, Michael E., National Truck Equipment Association, letter and attachment .................................................. 2396
Kennelly, Hon. Barbara B., a Representative in Congress from the State of Connecticut, letter and attachments ............................................................................................................................................................................ 2350
Kieffer-Nolde, Chicago, Ill., Neil J. Schecter, letter ...................................................................................... 2278
Kinny, William, Portland State University, joint statement (see listing for Myron Hulen) .................................................................................................................................................................................. 2570
KPMG Peat Marwick, statement .......................................................................................................................... 2268
Kraut, Jeffrey B., Swavelle/Mill Creek Fabrics, New York, N.Y., letter .......................................................... 2282
Lackritz, Marc E., Securities Industry Association, statement .................................................................................. 2320
Lantos, Hon. Tom, a Representative in Congress from the State of California, statement .................................................................................................................................................................................. 1379
Larsen, Bryant & Porter, CPA's, P.C., Lincoln, Neb., Brent L. Stehlik, letter .......................................................... 2570
Lawson, Richard L., National Coal Association, statement .................................................................................. 2237
Lear, Jeffrey A., National Society of Public Accountants, statement .................................................................. 2235
Levenson, Daniel D., Lourie & Cutler, P.C., Boston, Mass., statement .......................................................... 2461
Lucore, Robert E., American Federation of Labor and Congress of Industrial Organizations, statement .................................................................................................................................................................................. 2325
Lynd, Robert D., National Interfraternity Conference, joint statement and attachment (see listing for National Panhellenic Conference) .................................................................................................................................................................................. 1250
Macht, Harriett B., National Panhellenic Conference, joint statement and attachment .................................................. 2426
Mack Trucks, Inc., Mark Cherry, statement and attachments .................................................................................. 2388
Mattel, Inc., statement .................................................................................................................................................. 2255
McGonigle, J. Oliver, Edwin L. Cox Co., Dallas, Tex., letter .................................................................................. 2251
Miles Inc., Pittsburgh, Pa., Helge H. Wehmeier, letter .................................................................................. 2257
Moore, David S., Equity Advantage, Inc., Salem, Ore., letter .................................................................................. 2503
Moore, Thomas N., Equity Advantage, Inc., Salem, Ore., letter ........................................ 2503
National Association for the Self-Employed, Bennie L. Thayer, letter ................................ 2573
National Association of Convenience Stores, statement .................................................. 2576
National Association of Enrolled Agents, James E. Forrester, statement .......................... 2580
National Association of Insurance Brokers, Michael J. Haa, letter ................................ 2364
National Association of Realtors, statement ..................................................................... 2583
National Association of Water Companies, James L. Good, statement ........................... 2274
National Cable Television Association, Decker Anstrom, statement ............................... 2381
National Club Association, statement ............................................................................. 2423
National Coal Association, Richard L. Lawson, statement .............................................. 2237
National Conference of State Social Security Administrators, Daryl Dunagan, letter ....... 2587
National Federation of Independent Business, statement ............................................... 2482
National Panhellenic Conference, Harriett B. Macht; National Pan-Hellenic Council, Inc., Daisy Wood; and National Interfraternity Conference, Robert D. Lynd, joint statement and attachment ................................................................. 2426
National Petroleum Refiners Association, Urvan R. Sternfels, letter ................................. 2298
National Society of Public Accountants, Leroy A. Strubberg, and Jeffrey A. Lear, statement ................................................................. 2235
National Truck Equipment Association, Michael E. Kastner, letter and attachment ...... 2396
National Venture Capital Association, Dean C. Gordonier, Jr., letter ............................... 2440
Nevada Resort Association, David Belding:
   Statement .................................................................................................................. 2287
   Statement .................................................................................................................. 2378
   Statement .................................................................................................................. 2458
New York Gas Group, Donald F. Straetz, statement .......................................................... 2523
Newspaper Association of America, statement .................................................................. 2382
Nielson, Lonnie C., Equity Advantage, Inc., Salem, Ore., letter ......................................... 2503
Oosterhuis, Paul W., Export Source Coalition, statement and attachments ...................... 2299
Organization for International Investment Inc., Alexander Spitzer, statement and attachments .................................................................................................................. 2386
Pabst, Walter C., Techtron Imaging Centre, Chicago, Ill., letter ...................................... 2281
Paul, William F., United Technologies, letter ..................................................................... 2316
Pearson, Mary Frances, Envirocon, statement ................................................................... 2513
Polyisocyanurate Insulation Manufacturers Association, Jared O. Blum, statement ....... 2412
Porter, Andrew G., Federation of Exchange Accommodators, Newport Beach, Calif., letter .................................................................................................................. 2505
Public Securities Association, statement ......................................................................... 2318
Ralston Purina Co., Ronald B. Weinel, statement and attachments ................................. 2258
Real Estate Exchange, Inc., Portland, Ore., James C. Casterline, letter ............................ 2510
Reid, Hon. Harry, a United States Senator from the State of Nevada:
   Statement .................................................................................................................. 2291
   Statement .................................................................................................................. 2597
Reinsurance Association of America, statement ............................................................... 2366
Renewable Fuels Association, Eric Vaughn, statement .................................................... 2383
Retail Tax Committee of Common Interest, statement ............................................... 2263
Risk and Insurance Management Society, Inc., Paul S. Brown, letter ............................ 2374
Robison, Jack, California Polytechnic State University, joint statement (see listing for Myron Hulen) ............................................................................................................ 2278
Schecter, Neil J., Kieffer-Nolde, Chicago, Ill., letter ......................................................... 2278
SeaWest, San Diego, Calif., Thomas G. Farnham, letter .................................................... 2290
Securities Industry Association, Marc E. Lackritz, statement .......................................... 2320
Security Trust Co., San Diego, Calif., J. Paul Spring, letter ............................................. 2512
Shays, Hon. Christopher, a Representative in Congress from the State of Connecticut, statement .................................................................................................................. 1382
Siebert, Carol, Alliance for Justice, letter and attachment ................................................. 2431
Slemrod, Joel, International Tax Policy Forum, statement and attachment ..................... 2309
Sodolski, John, United States Telephone Association, statement .................................... 2618
Spitzer, Alexander, Organization for International Investment Inc., statement and attachments .................................................................................................................. 2589
Spring, J. Paul, Security Trust Co., San Diego, Calif., letter ............................................ 2512
Stehlik, Brent L., Larsen, Bryant & Porter, CPA's, P.C., Lincoln, Neb., letter ................. 2570
Sternfels, Urvan R., National Petroleum Refiners Association, letter .............................. 2298
<table>
<thead>
<tr>
<th>Name</th>
<th>Organization</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stout, Thomas A., Jr.</td>
<td>Attorneys' Liability Assurance Society, Inc.</td>
<td>2345</td>
</tr>
<tr>
<td>Strachtz, Donald F.</td>
<td>New York Gas Group</td>
<td>2323</td>
</tr>
<tr>
<td>Stratford Technologies, Inc.</td>
<td>Somerset, N.J., William R. Patterson</td>
<td>2490</td>
</tr>
<tr>
<td>Strubberg, Leroy A.</td>
<td>National Society of Public Accountants</td>
<td>2236</td>
</tr>
<tr>
<td>Studds, Hon. Gerry E.</td>
<td>a Representative in Congress from the State of Massachusetts</td>
<td>2497</td>
</tr>
<tr>
<td>Stout, Thomas A., Jr.</td>
<td>Attorneys' Liability Assurance Society, Inc.</td>
<td>2266</td>
</tr>
<tr>
<td>Swavelle/Mill Creek Fabrics, New York, N.Y.</td>
<td>Jeffrey B. Kraut, letter</td>
<td>2280</td>
</tr>
<tr>
<td>Techtron Imaging Centre, Chicago, Ill.</td>
<td>Walter C. Pabst, letter</td>
<td>2599</td>
</tr>
<tr>
<td>Thayer, Bennie L.</td>
<td>National Association for the Self-Employed</td>
<td>2573</td>
</tr>
<tr>
<td>Thompson, Michael C.</td>
<td>Whirlpool Corp.</td>
<td>2421</td>
</tr>
<tr>
<td>United States Telephone Association, John Sodolski, statement</td>
<td>2618</td>
<td></td>
</tr>
<tr>
<td>Vaughan, Michael</td>
<td>Colorado State University, joint statement (see listing for Myron Hulen)</td>
<td>2816</td>
</tr>
<tr>
<td>Vaughn, Eric</td>
<td>Renewable Fuels Association</td>
<td>2383</td>
</tr>
<tr>
<td>Vucanovich, Hon. Barbara F.</td>
<td>a Representative in Congress from the State of Nevada</td>
<td>2500</td>
</tr>
<tr>
<td>Wachman, Stanley L.</td>
<td>Cetylite Industries, Inc.</td>
<td>2410</td>
</tr>
<tr>
<td>Weinert, Helge H.</td>
<td>Miles Inc., Pittsburgh, Pa.</td>
<td>2257</td>
</tr>
<tr>
<td>Weinel, Ronald B.</td>
<td>Ralston Purina Co.</td>
<td>2258</td>
</tr>
<tr>
<td>Whirlpool Corp., Michael C.</td>
<td>Thompson, statement</td>
<td>2421</td>
</tr>
<tr>
<td>Wood, Daisy</td>
<td>National Pan-Hellenic Council, Inc.</td>
<td>2263</td>
</tr>
</tbody>
</table>
MISCELLANEOUS REVENUE ISSUES

WEDNESDAY, SEPTEMBER 8, 1993

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:05 a.m., in room 1100, Longworth House Office Building, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

Chairman RANGEL. Good morning.

The Subcommittee on Select Revenue Measures will resume its series of hearings on miscellaneous revenue issues. Earlier this year, we conducted four hearings focused on these matters. All of those were the revenue-losing issues. We will consider additional testimony today on other miscellaneous items. This time we will concentrate on those issues that raise revenue.

As those of you who are familiar with the committee are aware, Chairman Rostenkowski and our committee have a strong commitment to deficit reduction and responsible fiscal policy. In keeping with long tradition, any miscellaneous issue that the committee brings up, the member must offset it by an appropriate revenue-raising item. So we have to do both, raise the issue and find out how we are going to pay for it. Those suggested revenue raisers will be the subject of today's hearing and again on September 21 we will review or return to this issue.

We will hear from public witnesses in the following areas: the alternative minimum tax, accounting, financial institution costs, recovery pass-through entities, individual taxes, natural resources issue, and tax-exempt entities. On the second day of the hearings, Treasury is expected to testify on these issues, which will be September 21.

At this point, I would like to recognize the ranking member of the subcommittee, Mel Hancock for whatever opening remarks he has to make.

Mr. HANCOCK. Thank you, Mr. Chairman.

Today we will hear testimony from a wide variety of witnesses on a number of revenue-raising proposals before this subcommittee. As you remember, the committee spent several weeks this summer considering the revenue-losing provisions which constituted the easy part of the miscellaneous tax bill's journey through the Ways and Means Committee.

Many items discussed in the previous hearings made good sense and many should be enacted into law, but when you look at the list of revenue raisers we have before us today, and the additional
items we will discuss later this month, one has to ask: Do the ben­
efits derived from this process outweigh the burdens placed on indi­
viduals and businesses through the so-called revenue-raising off­
sets?

One merely has to look at this list of offsets to see that the bur­
den on individuals and business will be great, in my opinion much
greater than any benefits provided through this process. What is
worse, these new tax proposals come 1 month after the President
signed into law a new massive tax plan, which will affect nearly
every individual and business in this country.

The effects of this process appear to be just as grave. Not only
will these numerous provisions increase direct costs to individuals
and businesses, the cost of complying with these complicated pro­
posals could be astoundingly high. Limiting deductions, lengthen­
ing recovery periods, and stretching out amortization schedules are
the methods of choice in raising this revenue.

Few of these proposals contain the characteristics of sound tax
policy, and several make no sense at all. Many were conceived with
no concern for their effect on those who will be impacted, but merely
as a means to finance other provisions of the bill. In these times
of slow economic growth and on the heels of the largest tax in­
crease in history, we should not seriously be considering the items
before us today.

While at first glance the items we will explore today may seem
minor, let me assure you, Mr. Chairman, they are very important
to those who will be affected and could hold disastrous economic
consequences. I think it is some sort of dichotomy that yesterday
the Vice President released an administration proposal to reinvent
Government through consolidation and simplification. Now here we
are today.

I encourage my colleagues on this panel to listen carefully to the
witnesses who will testify before us, many of whom have already
sacrificed under the President's tax bill. At the end of this long day,
it should be clear to all that the burdens mandated through this
process outweigh any benefits which may exist.

Mr. Chairman, this is the first day back from a vacation and I
wish we had held this up for a few more days because this is not
something I want to address this quickly after a pleasant 30 days
away from here. I know it has to be done, but let's seriously con­
sider what we are doing and consider the impact that this is going
to have on the people who are going to end up paying these addi­
tional taxes.

Chairman RANGEL. If your district had the problems that my dis­
trict had, you would recognize the vacation starts today for me. I
am glad to be back here.

Does anyone seek recognition?

We have a panel before us led by Hon. Walter Tucker concerning
a project that the committee is anxious to hear about in the sov­
ereign State of California. We welcome all members of the delega­
tion.

Ms. Allard is here. Mr. Horn is here. Ms. Waters is expected, and
Congresswoman Harman is here. As others arrive, they will be
recognized.
STATEMENT OF STEFAN F. TUCKER, COUNSEL, TUCKER, FLYER & LEWIS, ON BEHALF OF THE NATIONAL REALTY COMMITTEE

Mr. TUCKER. Good morning. Thank you very much, Mr. Chairman and staff.

I am Stefan Tucker. I am a member of the law firm of Tucker Flyer & Lewis, in Washington, D.C. I am tax counsel to the National Realty Committee.

By way of analogy from real estate to the agricultural products you have just seen, I would point out until the Tax Reform Act of 1986, real estate was considered a 24-karat investment. Unfortunately, that has changed over the past few years.

The National Realty Committee is the real estate roundtable in Washington on national issues affecting real estate. Its members are America's principal commercial and multifamily real estate owners, advisers, builders, investors, lenders, and managers.

The proposal that we are focusing on today is to impose upon the present rules of like-kind exchanges, the similar or related in-service, in-use rule of 1033-A of the Internal Revenue Code applying generally to involuntary conversions.

I would recall the fact that in 1958, the Senate Small Business Committee on behalf of the Nation's small business, introduced an act, that ultimately became a 1958 Tax Act, that brought into the Internal Revenue Code Section, 1033-G of the Internal Revenue Code with regard to involuntary conversions or condemnations of real estate, that said that you would have the same like-kind provisions as to involuntary conversions or condemnations that we now have in other like-kind exchanges under section 1031.

It is interesting to see there is now a proposal to move from the straightforward simplicity of section 1031 for like-kind exchanges, into the difficult and extraordinary situations that result into a lot of litigation under section 1033-A, as to what is or may be similar or related in service or use.

The Treasury Department, we are pleased to note, opposed this particular provision on the basis that the administration is not persuaded that there is presently any need to revise the standard based on the use of property received in exchange of like-kind property for determining whether property exchanges qualify for tax deferral. We agree with the Treasury Department in this context.

The concept of similar or related in service or use is a far narrower provision that focuses on, with respect to an investor, the kind of services that go into the property, and with respect to an owner-user, the kind of use that goes into a property, and has resulted, under section 1033-A, in a number of what we see as extremely strange rulings of the Internal Revenue Service that have, at times, had to have been reversed by the courts in terms of this.

For example, in 1976, in Revenue Ruling 76-319, there was a billiards center that had been reinvested in by a taxpayer, which had a lounge. And they had invested the proceeds from a fire on a bowling center, which likewise had a lounge. And the Internal Revenue Service said that a billiards center and a bowling center simply are not similar or related in service or use.

In 1970, the Internal Revenue Service focused on a hotel that had been destroyed by fire. Revenue Ruling 70-399. The hotel had
been subject to a net lease. When it was rebuilt with the proceeds from insurance, they then did the hotel as an owner-operator hotel.

The holding of the Internal Revenue Service was this was not similar or related in service or use because, on the one hand, it had been net leased and, on the other hand, it had been owner-operated.

Now, we all can get around these kinds of things if we want to go through the intricacies of getting around them and result in a lot of audit issues and a lot of litigation and a lot of misuse of the courts for what ought not to be used. But we think that the present standard, which encourages like-kind exchanges, which results in some one or more parties in the chain resulting in recognition of income from the trading or selling of property ought to be retained.

And with that, I thank you for your time.

Chairman RANGEL. Thank you.

[The prepared statement follows:]
My name is Stefan F. Tucker and I am a stockholder in the law firm of Tucker, Flyer & Lewis in Washington, D.C. I am pleased to have the opportunity to present testimony today on behalf of National Realty Committee (NRC) regarding a proposed revision to the rules relating to tax-deferred real property exchanges. NRC serves as Real Estate's Roundtable in Washington on national issues affecting real estate. Its members are America's principal commercial and multifamily real estate owners, advisors, builders, investors, lenders and managers.

Summary

When Congress authorized non-recognition of gain or loss on property exchanges in 1924, it did so because of a desire not to impose a tax on a theoretical gain where a taxpayer continued his investment in a "like-kind" property. In addition, Congress recognized that severe administrative burdens would result if all property exchanges had to be evaluated to ensure that each property precisely matched the other. We believe that these concepts remain sound policy considerations today and we support retention of the current law.

The proposal before the Committee would replace the current law "like-kind" standard with a much narrower "similar or related in service or use" standard. The proposed standard is the one now used in determining whether a tax is imposed on the reinvested proceeds received from an involuntary conversion (e.g., property destruction or theft). This standard is appropriate in cases of involuntary conversion because in such cases cash proceeds have been provided to the taxpayer and the taxpayer has direct control over their reinvestment. However, to apply this standard to all property exchanges, as is proposed, where the taxpayers do not receive cash proceeds, would eliminate many economically beneficial exchanges of commercial and residential real estate, farms, ranches, small business real estate, parks, timberlands, mineral interests and other types of real property.

The proposed "similar or related in service or use" standard represents a significant narrowing of the types of exchanges which would qualify for tax deferral. For owners who use their property, it would require that both the physical characteristics and the end uses of the two properties be closely similar to qualify. For owners who lease their property, the "similar use" rules require a close examination of the nature of the taxpayer's relation to the properties. This would present severe administrative difficulties and taxpayer uncertainty. It is interesting to note that the proposed "similar use" standard is one which existed previously for cases involving condemnations of real property. Because of the administrative difficulties it posed for the Internal Revenue Service and because it resulted in significant taxpayer unfairness, Congress modified and liberalized the "similar use" standard for condemnations in 1958 to reflect the like-kind concept.

Taxing exchanges which meet a "like-kind" but not a "similar use" standard would result in taxing phantom income because no cash is received in the exchange to pay the tax — such a result would be grossly unfair to taxpayers. Most exchanges simply would not go forward if they were taxed as such; therefore, the proposal will not increase Federal revenue by the amount projected. Additionally, taxable transactions now affiliated with multi-party exchanges would in many cases be discouraged because the affiliated exchange would not be undertaken.

The balance of my statement presents a synopsis of current law regarding like-kind property exchanges, explains the proposal to narrow current law and presents several reasons and examples why current law should be maintained.
Current Like-Kind Exchange Rules

Since 1924 Congress has recognized that gain or loss should not be taxed currently when property held for productive use in a trade or business, or for investment, is exchanged solely for property of a like-kind (Internal Revenue Code section 1031). The reason for this rule is that Congress appropriately determined that taxpayers exchanging like-kind property have not altered the level or type of their investment and therefore the economic position of the taxpayer has not changed. Additionally, because an exchange of like-kind property is exactly that, no cash is generated to pay a current tax.

The key concept underlying these rules is the requirement that the property exchanged and that received be of a "like-kind." The like-kind standard refers to the nature or character of the property, not to its grade or quality. For example, improvements on real estate relate to its grade or quality, not to its character as real estate. Therefore, unimproved real property may qualify as like-kind to improved property. In addition to looking to the nature or character of the exchanged properties, the IRS also seeks to ensure that the rights created in, and to, the properties are not substantially different. Under this standard, an assignment of oil payments and an interest in real estate are not like-kind. That's as it should be.

Finally, to ensure that abuse does not occur, current law specifically excludes certain types of property (e.g., partnership interests), requires that the property to be received in an exchange be identified within 45 days, and mandates that the exchange be completed within 180 days following the original transfer.

Although the general current law rule is that no gain is taxed when like-kind property is exchanged, in many transactions there are, in fact, taxes paid. This occurs because cash or other non-like-kind property (boot) received in the exchange is subject to current taxation if such boot exceeds the adjusted basis of the property transferred. Importantly, boot may also include mortgage debt liability which is assumed by the party receiving the property in an exchange. Therefore, to the extent that a taxpayer has received non-like-kind property in an exchange, the existing rules require current taxation.

Moreover, often there are taxable sales which occur before, and in anticipation of, a qualifying like-kind exchange. In such multi-party transactions, a party on one end of the transaction is purchasing property to be exchanged for property that is like-kind. This happens when the owner of like-kind property will not sell but will exchange only because of the high tax cost of selling.

The Proposal and Why It Should Be Rejected

The proposal which is the subject of today's hearing would significantly narrow the range of transactions qualifying for tax-free treatment by replacing the section 1031 "like-kind" standard with the "similar or related in service or use" standard now used under section 1033 in determining the taxation of proceeds that are received from an involuntary conversion and reinvested.

We believe that the current like-kind exchange rules are fundamentally sound and, for the following reasons, we support retention of current law.

Current law is non-abusive and should be maintained. The current rules permitting deferral of tax in a like-kind exchange exist because a taxpayer who exchanges like-kind property has not altered the level or type of its investment, and, therefore, the economic position of the taxpayer has not changed. These rules have worked well for over 60 years. Their flexibility has helped enable all manner and kind of productive exchanges, from single family rental homes to large multi-user rental properties, from farm or ranch property to large unimproved tracts of real property. For example, the rules have helped park management programs obtain unimproved property adjacent to parks by offering developed property in exchange. Farmers and ranchers otherwise faced with once-in-a-lifetime capital gains taxes have retired and exchanged their farm or ranch property for property that could provide retirement income. Many of these beneficial transactions would be curtailed under the proposal to restrict exchange transactions.
The proposed "similar or related in service or use standard" should be rejected because it is too narrow. A "similar or related in service or use" standard represents a significant narrowing of the types of exchanges which will qualify and produces results which are simply unfair to taxpayers. It is the one which must be met under current IRS section 1033 to assure deferral of gain when the cash proceeds from an involuntary conversion are reinvested. It would clearly disallow exchanges of raw land for developed real estate. Thus, owners of unimproved real estate facing extremely high selling costs would not be encouraged to put the land to productive use through an exchange for existing income-producing property, and park managers would not be able to entice trades for unimproved park land by offering developed property.

The proposed standard would be difficult to administer and would create taxpayer uncertainty. The similar use standard also would produce a rule which is administratively much different, depending on whether the taxpayer is an owner who uses the property or an owner who leases the property.

It requires that, in the case of owners who use the property, both the physical characteristics and the end uses of the two properties must be closely similar to qualify for deferral. Under this test, an owner-occupied billiard center has been ruled to not qualify as replacement for an owner-occupied bowling center. The standard also has disallowed replacing a owner-managed motel with an owner-managed mobile home park.

For owners who lease their property, the "similar use" rules require a close examination of the nature of the taxpayer's relation to the properties. That is, are the management activities the same, are the amount of the kind of services rendered to tenants the same, and are the business risks the same? Under this standard, a leased restaurant is not similar to an operated motel, nor is a building used for bank purposes similar to a building leased as office space. There are countless other examples of why the "similar use" standard would be unfair, unworkable and would thwart many exchanges currently qualifying as like-kind.

The bulk of the revenue projected to be derived from taxing these transactions will not materialize. If these proposed changes take effect, most transactions now qualifying as "like-kind" but not qualifying as "similar use" will not be consummated either as exchanges or sales. In fact, revenue from taxable sales in the chain of the multi-party transaction might be lost if the ultimate exchange no longer qualifies for deferral. Overall, this would result in a chilling of real estate markets across-the-country and lessened economic activity in the marketplace.

The proposed standard would impose a tax on phantom income. Taxing like-kind exchanges as sales would result in taxing phantom income. Since any cash received in a like-kind exchange is already subject to tax under current law, and no other cash is received for the property exchanged, insufficient funds are generated with which to pay any additional tax required under this proposal. Moreover, if the taxpayer borrows against the property to satisfy the tax liability, the interest on the borrowed amount is non-deductible.

Conclusion

The proposal to restrict the types of transactions qualifying for tax-free status by replacing the current law "like-kind" standard with a "similar or related in service or use" standard should be rejected. It is unnecessary as there are no examples of abuse under current law. The proposal would be administratively very difficult for the IRS to implement. It would undermine taxpayer confidence and compliance with the tax system and it would halt many economically beneficial property exchanges that otherwise would occur.

Enactment of this proposal would be inconsistent with the steps taken this past summer by this Committee and Congress in the Tax Act of 1993 to rationalize the tax treatment of real estate — an important sector of the economy, the stability and efficiency of which is key to our national economic recovery and growth.

Thank you for the opportunity to present testimony to the Committee on this important issue. National Realty Committee is prepared to respond to any questions regarding this issue.
STATEMENT OF B. WYCKLIFFE PATTISHALL, JR., VICE PRESIDENT, CHICAGO TITLE & TRUST CO.

Chairman Rangel. Mr. Pattishall.

Mr. PATTISHALL. Mr. Chairman, members of the committee and staff, I am Wyck Pattishall, a businessman, vice president of Chicago Title & Trust Co., parent of the Nation's largest family of title insurance companies.

The benefits to society which result from a public policy promoting the reinvestment rather than the consumption of the proceeds of sale of capital assets have been acknowledged for centuries. Under feudal property systems, the proceeds from the sale of appreciated property—usually land—were corpus, or capital that had to be reinvested for the benefit of remaindermen, or those who follow.

The gains were not part of the income interest, usually the harvest from the land, and could not be consumed. Well, such restrictions rarely exist under modern property law and so the question remains, if it is good public policy to foster the reinvestment of capital, how can this policy be promoted and enforced? The like-kind exchange provisions of section 1031 promote exactly that type of activity and the proposal to restrict like-kind exchanges to similar use property is, therefore, not good tax policy.

The proposal inappropriately discriminates against investment in real estate at a time when the industry is struggling to recover from the worst recession in four decades. While it may be argued that reducing the number of nonrecognition opportunities is a good idea, it is inappropriate to do so with real estate.

The Tax Reform Act of 1986 exacted an enormous toll on real estate investment and this contributed strongly to the national recession and the weakness of the current recovery.

The recovery period for depreciation on new nonresidential real estate was lengthened from 15 years in 1980, to 18 years in 1984, to 31 1/2 years in 1986, and to 39 years by the Omnibus Budget Reconciliation Act of 1993. The change made by the 1993 Tax Act alone will reduce construction spending by more than $3 billion per year according to economists at DRI McGraw-Hill.

Section 1031 is merely one of several nonrecognition provisions which allow property to be exchanged for other property on a tax-deferred basis. For example, the stock of a privately-held corporation can be exchanged on a tax-deferred basis for the stock of a large publicly held corporation.

There is no reason to allow the owner of a corporation to trade his stock for General Motors' stock without incurring tax, but to require the owner of real estate to pay tax if he trades for other real estate. Most people would view the stock of a publicly traded Fortune 500 company as closer to the equivalent of cash than any real estate could possibly be.

There is no guarantee that the proposal will result in increased revenues. Many taxpayers with appreciated property will not trade or sell, instead preferring to obtain their profits through refinancing. And, furthermore, most like-kind exchanges actually increase revenues.

This is because in the typical exchange the replacement property is acquired in a taxable sale that may have not occurred in the ab-
sence of the like-kind exchange. I suspect that the proposed change will result in what economists call a deadweight loss, reflecting a cost imposed on some individuals without any offsetting benefit to others. A pure economic inefficiency.

An example of a deadweight loss was the luxury tax imposed on airplane sales which the joint committee estimated would raise $6 million in revenue in 1991. The actual revenues were $53,000.

Applying the similar related in service or use test to like-kind exchanges, and the like-kind test to condemnations of real property, simply makes no sense at all.

When Congress first enacted legislation on like-kind exchanges in 1921, it provided for nonrecognition of gain only when both properties were of the same like-kind or use. Congress amended the test in 1924, dropping the “or use” provisions and leaving the like-kind provisions, which have remained in effect for the last 69 years. The reason the use requirement was dropped was because it quickly became apparent that in order to prove the use requirement an inquiry must be made to discover the taxpayer’s intention at the time of the exchange.

A taxpayer’s intent at a particular point in time can only be established by a close examination of the facts in each case. Such an overwhelmingly fact-based test is not the kind of legal standard that lends itself to interpretation by regulatory agencies or appellate courts. If enacted, the proposal will result in substantial confusion, increased litigation, reduced velocity and liquidity in the real estate markets and probably no revenue gain.

Thank you very much.

Chairman RANGEL. Thank you.

[The prepared statement follows:]
September 23, 1983

Proposal: To amend the like-kind exchange rules under IRC Section 1031 to require that the replacement property be "similar or related in service or use" to the property exchanged, except in the case of condemnation.

Witness: B. Wyckoff Pettishall, Jr.
Vice President
Chicago Title and Trust Company
171 North Clark Street
Chicago, Illinois 60601-3294
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Recommendation: That the proposal not become part of any bill.

Testimony: I am B. Wyckoff Pettishall, Jr., Vice President of Chicago Title and Trust Company, parent of the nation's largest family of title insurance companies.

I am concerned that the proposal is not good tax policy and will only serve to unnecessarily complicate an area that so many, both within the government and outside the government, have tried with some success to simplify in the last few years. Most importantly, I suspect that the proposed change will result in what economists call a "dead weight loss", reflecting a cost imposed on some individuals without any offsetting benefit to others - a pure economic inefficiency. An example of a "dead weight loss" was the luxury tax imposed on airplane sales which the Joint Committee on Taxation estimated would raise revenues of $6 million in 1991. The actual revenues were $63,000.

The benefits to society which result from a public policy promoting the reinvestment, rather than consumption, of proceeds from the sale of capital assets have been acknowledged for centuries. Under feudal property systems, the proceeds of sale of appreciated property, (usually land), were "corpus" or capital that had to be reinvested for the benefit of remaindermen. The gains were not part of the income interest, (usually the harvest from the land), and could not be consumed. Such restrictions rarely exist under modern property law, and so the question remains: if it is good public policy to foster the reinvestment of capital, how can this policy be promoted and enforced? The like kind exchange provisions of Section 1031 of the Code achieve exactly that goal, and the proposal to restrict those provisions is not good tax policy.

Section 1031 is merely one of several non-recognition provisions which allow property to be exchanged for other property on a tax-deferred basis. For example, the stock of a privately held corporation may be exchanged on a tax-deferred basis for the stock of a large, publicly traded corporation. There is no reason to allow the owner of a corporation to trade his stock for General Motors stock without incurring tax, but to require the owner of real estate to pay tax if he trades for other real estate. Most people would view the stock of a publicly traded Fortune 500 company as closer to the equivalent of cash than any real estate could possibly be.

While it may be argued that reducing the number of nonrecognition opportunities is a good idea, it is inappropriate to start with real estate at a time when the industry is struggling to recover from the worst recession in four decades. The Tax Reform Act of 1986 exacted an enormous toll on real estate investment which contributed strongly to the national recession and the weakness of the current economy. The recovery
period for depreciation on new, non-residential real estate investment was lengthened from 15 years in 1980, to 18 years in 1984, to 31.5 years in 1986, and to 39 years by the Omnibus Budget Reconciliation Act of 1993. The change made by the 1989 Tax Act alone will reduce construction spending by more than $3 billion per year according to economists at DRU/McGraw Hill. The passive loss rules, the extension of the at-risk rules, the installment sales rules, and the uniform capitalization rules also had a severe adverse effect on the real estate industry.

There is no guarantee that the proposal will result in increased revenues. Many taxpayers with appreciated real estate will not trade or sell, preferring instead to obtain their profits by refinancing. Furthermore, most like kind exchanges actually increase revenues. This is because in the typical exchange, the replacement property is acquired in a taxable sale that might not have occurred in the absence of the like kind exchange.

Applying the "similar or related in service or use" test to like kind exchanges, and the "like kind" test to condemnations simply makes no sense whatsoever.

There are two pragmatic reasons why the "similar or related in service or use" test should not be applied to like kind exchanges. First, the cases interpreting the similar-use test in the involuntary conversion area demonstrate no clear doctrine or set of guidelines; the various Circuits have proposed four different tests, with much debate between the courts over the content of two of those tests. The relevance of the physical characteristics of property held for rental incomes has never been clearly addressed by the courts, ensuring extensive litigation if Congress adopts the proposed amendment. Beyond the unsettled nature of the case law, the proposed change would lead to increased litigation because application of the similar-use test is unusually fact-based and therefore lees subject to precedential authority developed by the courts. Secondly, Section 1031 once contained a "like kind or use" test. Congress dropped the "or use" language because it found the intention of the party using the property is difficult to determine and unfair as a basis of tax liability. The passing years have made the determination no easier.

I. The Case Law Under IRC Section 1033 Demonstrates Substantial Uncertainty in the Application of the "Similar or Related In Service or Use" Test.

A. Six Circuits and the Internal Revenue Service have developed four different standards for application of the similar-use test to an owner-lessee.

1. The Second, Sixth, and Seventh Circuits, as well as the IRS (Rev Rul 84-237) apply the Lien test: "a court must compare, inter alia, the extent and type of the lessor's management activity, the amount and kind of services rendered by him to the tenants, and the nature of his business risks connected with the properties." Lien 9 AFTR 2d 1557, 1560 (2d Cir. 1962). The Service and the courts have diverged in their application of this standard.

2. Eighth Circuit (Loco Realty 10 AFTR 2d 5359, 5366 (8th Cir. 1962)): "[I]t is sufficient if, coupled with the leasehold characteristics of the taxpayer's properties, there is also a reasonable similarity in the leased premises themselves." This standard does not seem to have been applied in any subsequent cases.

3. Ninth Circuit (Filipippi. 11 AFTR 2d 1720, 1722 (9th Cir. 1983)): "The test is a practical one. The taker of fact must determine from all the circumstances whether the taxpayer has achieved a sufficient continuity of investment to justify non-recognition of the gain, or whether the differences in the relationship of the taxpayer to the two investments are such as to compel the conclusion that he has taken advantage of the condemnation to alter the nature of his investment for his own purposes."
The Filippini court specified a list of factors that should be considered in making the determination:

The broad range of the appropriate inquiry is suggested by Liant's enumeration of relevant factors: including "the extent and type of the lessor's management activity, the amount and kinds of services rendered by him to the tenants, and the nature of his business risks connected with the property."

Since the essential inquiry is whether the taxpayer has committed the condemnation award to a substantially equivalent investment, the relevant facts include all those which would influence an investor in determining the attractiveness of the respective uses for his capital; the character and location of the particular properties, their potential and actual employment, the state of the market of which each is a part. As Liant suggests and Clifton Investment emphasizes, the relevant facts also include the demands which the respective investments may make upon the taxpayer for supervision and service.

11 AFTR 2d at 1722 (citations omitted).

Fourth Circuit (Stuart Bros., 3AFTR 2d 318 (3rd Cir. 1958)): This is the first case making the owner-use/owner-lessee distinction. Stuart does not clearly articulate limitations on the similarity of real property held for rental income. Some later cases understand Stuart to hold that all rental properties are similar; other cases interpret Stuart as employing a "same general class test." See Part B(1) infra.

B. The Loco Realty and Stuart tests are themselves unclear.


Stuart was the first case drawing an owner-user/owner-user lessor distinction, and its statement of the law is ambiguous as to whether all rental properties are of similar use or whether the properties must be in the "same general class." In Loco Realty, 10 AFTR 2d 5359, 5365 (8th Cir. 1962), the court noted the ambiguity in Stuart equally broadly. On the other hand, McCaffrey, 5AFTR 2d 774 (3rd Cir. 1950), which is the only circuit to apply the functional use test to an owner-lessee (a position the Service rejected in 1964), understood Stuart as creating the "same general class" test. The district court in Filippini, 9 AFTR 2d 313 (N.D.Ca. 1971), after 11 AFTR 2d 1720 (9th Cir. 1963), reached the same conclusion. (The Ninth Circuit rejected the "same general class" test.)

The Pohn court, 10 AFTR 2d 5780,5782 (7th Cir. 1962), reviewed the overall situation in 1962, before Filippini added yet another test, as follows: "There is a basic difference of opinion between the Third and Second, Fourth and Eighth Circuits, and among the latter three there are shades of difference in the test applied."

2. Loco Realty

Loco Realty's requirement of "reasonable similarity of the leased premises" has been subject to different interpretations by two courts that have cited it. In Pohn, the court interpreted the Loco Realty test as more restrictive than the Second Circuit's Liant test, asserting that "the (Loco Realty) court avoided the extreme statement of the Stuart and Liant doctrine that both properties need only qualify as investments." However, the concurring opinion in Clifton Investment Co., 11 AFTR 2d 649, 651 (6th Cir. 1963), construed Loco Realty as more liberal than Liant. In his concurrence, Judge Miller wrote:

"I think that the investment character of the properties involved should be given more consideration than what seems to me is given by the ruling in the Liant case, although I do not think that investment basis alone is sufficient to comply with the statute, as Stuart Brothers, Inc. v. Commissioner..."
might be construed as holding. As pointed out in Loco Realty Co. v. Commissioner, the statute was not intended to penalize but to protect persons whose property may be taken on condemnation and, accordingly, should be construed liberally. I agree with the standard adopted in the opinion in that case, although for our present purposes I do not think that it results in a reversal of the decision of the Tax Court.

id. at 651 (citations omitted).

Judge Miller cites Loco Realty here as more liberal than the Liant test, in direct contradiction with the Poyn court.

C. A crucial issue regarding the similar use test remains undecided.

Unlike the functional use test applied to an owner-user, which looks to the property's physical characteristics and end uses, the Service, following Liant, applies a management activity test to an owner-lessee. As long as both properties are used by the taxpayer for rental income, the properties are of similar use if they demand from the taxpayer the same amount and kind of management activity, services and relations to tenants, and give rise to the same business risks. This test seems to completely disregard the physical characteristics of the properties. Indeed, Johnson, 43 TC 736 (1965), permitted the replacement of improved farmland leased to a riding club with urban land leased to a gas station.

In conflict with this line of reasoning, a number of courts seem to have understood that Reg. Section 1.1033(a)-2(c)(9)(i) applies to prevent even an owner-lessee from replacing unimproved with improved realty. These cases imply that similar use requires similar physical characteristics even for an owner-lessee. The unresolved question is the extent to which the character of the property is relevant in the case of a replacement by an owner-lessee.

D. The Filippini test provides for case-by-case decision making by lower courts, ensuring a substantial increase in litigation if this proposal is enacted.

The Filippini test examines "all the circumstances" to reach an overall sense of whether the taxpayer has maintained continuity of investment. The Filippini court expressly rejected any more definite standard. Any test consisting of a broad survey of the circumstances is likely to be an overwhelmingly fact-based exercise. However, the Filippini court went even further, when in n. 4, it cited Dubkin, 363 U.S. 278, 279 (1960):

Decision of the issue presented in these cases must be based ultimately on the application of the fact-finding tribunal's experience with the mainsprings of human conduct to the totality of the facts of each case. The non-technical nature of the statutory standard, the close relationship of it to the data of practical human experience, and the multiplicity of relevant factual elements, with their various combinations, creating the necessity of sacrificing the proper force to each, confirm us in our conclusion that primary weight in this area must be given to the conclusions of the trier of fact.

The court thus expressed its conclusion that the similar use test is not the kind of legal standard that allows appellate courts to clearly guide the lower courts. Instead, each case is different, with the lower courts applying their experience "with the mainsprings of human conduct to the totality of the case." This delegation to the lower courts will substantially increase litigation if applied in the context of like kind exchanges.
II. IRC Section 1031 Was Amended To Remove the Use Test

In 1921, when Congress first enacted the section 1031 equivalent, section 202(c) provided for nonrecognition when both properties were of the same like kind or use. In 1924, Congress amended the test to "like kind" and its reasoning is particularly instructive.

According to a document entitled the "Gregg Statement" released for publication by Chairman Green of the House Ways and Means Committee, and the Senate Finance Committee Report, (Sen. Rep. No. 398, April 1924), the change was intended to respond to the contention that the "like kind or use" test created two classes of property; property held for investment, and property held for productive use in a trade or business. Consequently, it was argued, the "use" language prevented the exchange of properties in different classes. The Gregg Statement and the Senate Report rejected this reliance on use because "the intention of the party at the time of the exchange is difficult to determine, is subject to change by him, and does not represent a fair basis of determining tax liability." Gregg Statement at 11-12; Sen. Rep.at 14.

The "use" requirement was dropped because it quickly became apparent that in order to prove a taxpayer's "use", an inquiry must be made to discover the taxpayer's intention at the time of the exchange. A taxpayer's intent, at a particular point in time, can only be established by a close examination of the facts in each case. Such an overwhelmingly fact based test is not the kind of legal standard that lends itself to interpretation by regulatory agencies or appellate courts.

If enacted, the proposal will result in substantial confusion, increased litigation, reduced velocity and liquidity in the real-estate markets, and probably no revenue gain.
Chairman Rangel. Mr. Levine.

Mr. LEVINE. Good morning, Mr. Chairman, I am Howard Levine, partner with the Washington, D.C. and New York law firm of Roberts and Holland, which specializes only in tax matters. I have been practicing tax law for over 21 years, the first four with the chief counsel's office of the Internal Revenue Service. I am also an adjunct professor of tax law at Georgetown University Law School.

My interest in like-kind exchanges spans my entire career as a lawyer. Although I have several clients who would be affected by this proposal, I have deep academic and nonclient professional interest as well, having written extensively on the area over the years, including authoring the BNA Tax Management Portfolio publication on like-kind exchanges.

In addition, I have previously chaired the American Bar Association Tax Section Subcommittee on Like-Kind Exchanges. I now chair the ABA Tax Section's Sales, Exchanges and Basis Committee, which has primary jurisdiction over like-kind exchanges, although I am testifying today in my individual capacity and not as an officer of the American Bar Association.

I am concerned that the proposal is not good tax policy and will only serve to unnecessarily complicate an area that so many, both within the Government and outside the Government, have tried with some success to finally simplify in the last few years. There are basically two reasons for opposing application of the similar use test to like-kind exchanges:

First, the cases interpreting the similar-use test and the involuntary conversion area demonstrate no clear doctrine or guidelines. The various circuits have proposed four different tests, with much debate between the courts over the content of two of those tests. The relevance of the physical characteristics of property held for rental income has never been clearly addressed by the courts, ensuring extensive litigation if Congress adopts the proposed amendment.

Beyond the unsettled nature of the case law, the proposed changes would lead to increased litigation because application of the similar-use test is unusually fact-based and, therefore, less subject to precedential authority developed by appellate courts.

Second, section 1031 once contained a like-kind or use test. Congress dropped the "or use" language because it found the intention of the parties using the property is difficult to determine and unfair as a basis of tax liability. The passing years have made the determination no easier.

The gist of much of my written statement, which I will not go over, basically outlines and explores the various tests that have been adopted in the different circuits and the conflicting and inconsistent positions that have been adopted among those circuits and how difficult it has been to apply those tests.

A crucial issue regarding the similar-use test also remains. Unlike the functional-use test that has been applied to an owner user, which looks to the property's physical characteristics and end uses, the IRS applies a management activity test to an owner-lessee. As long as both properties are used by the taxpayer for rental income,
the properties are of similar use if they demand from the taxpayer the same amount and management activity, services and relations to tenants and give rise to the same business risks.

However, in conflict with this line of reasoning, other courts have understood that the existing regulations in the involuntary conversion area prevent even an owner-lessee from replacing unimproved with improved realty. The question left open, then, is the extent to which the character of the property is relevant in the case of a replacement by an owner-lessee.

The question is a crucial one. It is particularly inappropriate for Congress to apply to transactions as common as exchanges a test with such an important issue unresolved.

There was also, as I said, a prior amendment to section 1031 to remove the use test. In 1921, when Congress first enacted the equivalent to 1031, it provided nonrecognition if properties were of the same like-kind or use. Congress specifically amended 1031 to take out the “or use” provision because it simply was unworkable and not administrable.

The passage of time has made intent no easier to determine. In fact, the frequency of exchanges today compound the difficulties of applying the use test with the likelihood that such a test would have to be applied on a regular basis.

Congress should follow its 1924 decision to provide for a test based solely on the nature and character of the property. There is no overriding necessity to make the proposed change.

In fact, if the change is made, Congress will have to rethink legislation it has recently passed, and is likely to pass in the future, that allows exchanges of ancient forest and mineral rights held by private corporations and individuals for less ecologically sensitive government-owned lands. Unless there is a special provision in the legislation exempting those transactions from income tax, the transferrers of the land could not be assured that the transactions are not taxable, even though such transactions were historically tax deferred.

For all of the reasons stated, as well as the reasons stated in my written testimony, I believe the proposed amendment should not become part of any bill. The IRS, Treasury and taxpayers have worked hard over the past few years to simplify the area of like-kind exchanges so that not every transaction needs the assistance of expensive tax lawyers. The bill would only serve to reverse this trend and to create substantial uncertainty.

Thank you for your consideration.

[The prepared statement follows:]
Proposition: To amend the like-kind exchange rules under IRC §1031 to require that the replacement property be "similar or related in service or use" to the property exchanged, except in the case of condemnation.

Witness: Howard J. Levine, Esq.
Roberts & Holland
1001 22nd Street, N.W.
Washington, D.C. 20037
(202) 293-3400

Recommendation: That the proposal not become part of any bill.

Testimony:

I am Howard J. Levine, a partner with the Washington, D.C. and New York law firm of Roberts & Holland, which I believe is the largest law firm in the country specializing only in tax matters.

I have been practicing tax law for over 21 years, the first four with the Chief Counsel's office of the Internal Revenue Service. I am also an adjunct professor of tax law at Georgetown University Law School.

My interest in like kind exchanges spans my entire career as a lawyer. Although I have several clients who would be affected by this proposal, I have deep academic and non-client professional interests as well, having written extensively on the area over the years, including authoring the BNA Tax Management Portfolio publication on like kind exchanges. In addition, I have previously chaired the American Bar Association Tax Section Subcommittee on Like Kind exchanges. I now chair the ABA Tax Section's Sales, Exchanges and Basis Committee, which has primary jurisdiction over like kind exchanges, although I am testifying today in my individual capacity, and not as an officer of the American Bar Association.

I am concerned that the proposal is not good tax policy and will only serve to unnecessarily complicate an area that so many, both within the government and outside the government, have tried, with some success, to simplify in the last few years.

There are basically two reasons for opposing application of the similar use test to like kind exchanges. First, the cases interpreting the similar use test in the involuntary conversion area demonstrate no clear doctrine or guidelines; the various Circuits have proposed four different tests, with much debate between the courts over the content of two of those tests. The relevance of the physical characteristics of property held for rental income has never been clearly addressed by the courts, ensuring extensive litigation if Congress adopts the proposed amendment. Beyond the unsettled nature of the case law, the proposed change would lead to increased litigation because application of the similar use test is unusually fact-based and therefore less subject to precedential authority developed by appellate courts. Secondly, section 1031 once contained a "like kind or use" test. Congress dropped the "or use" language because it found the intention of the party using the property is
difficult to determine and unfair as a basis of tax liability. The passing years have made the determination no easier.

I. The Case Law Under 11033 Demonstrates Substantial Uncertainty in the Application of the Similar Use Test.

A. Six Circuits and the IRS Have Developed Four Different Standards for Application of the Similar Use Test to an Owner-Lessor.

1. The Second, Sixth and Seventh Circuits, as well as the IRS (Rev. Rul. 64-237) apply the Liant test: "a court must compare, inter alia, the extent and type of the Lessor's management activity, the amount and kind of services rendered by him to the tenants, and the nature of his business risks connected with the properties." Liant 9 AFTER 2d 1557, 1560 (2d Cir. 1962).

The Service and courts have diverged in their application of the standard.

2. According to the Eighth Circuit (Loco Realty 10 AFTR 2d 5159, 5366 (8th Cir. 1962)): "It is sufficient if, coupled with the leasehold characteristic of the taxpayer's properties, there is also a reasonable similarity in the leased premises themselves." This standard does not seem to have been applied in any subsequent cases.

3. According to the Ninth Circuit (Filippini, 11 AFTR 2d 1720, 1722 (9th Cir. 1963)): "The test is a practical one. The trier of fact must determine from all the circumstances whether the taxpayer has achieved a sufficient continuity of investment to justify non-recognition of the gain, or whether the differences in the relationship of the taxpayer to the two investments are such as to compel the conclusion that he has taken advantage of the condemnation to alter the nature of his investment for his own purposes."

The Filippini court specified a list of factors that should be considered in making the determination:

The broad range of the appropriate inquiry is suggested by Liant's enumeration of relevant factors as including "the extent and type of the lessor's management activity, the amount and kind of services rendered by him to the tenants, and the nature of his business risks connected with the properties." Since the essential inquiry is whether the taxpayer has committed the condemnation award to a substantially equivalent investment, the relevant factors include all of those which would influence an investor in determining the attractiveness of the respective uses for his capital: the character and location of the particular properties, their potential and actual employment, the state of the market of which each is a part. As Liant suggests and Clifton Investment emphasizes, the relevant facts also include the demands which the respective investments may make upon the taxpayer for supervision and service.

11 AFTR 2d at 1722 (citations omitted).

4. According to the Fourth Circuit (Stewart Bros., 3 AFTR 2d 318 (3d Cir. 1958)): This is the first case making the owner-use/owner-lessee distinction. Aft ADV does not clearly articulate limitations on the similarity of real property held for rental income. Some later cases understand Stewart to hold
that all rental properties are similar; other cases interpret Stewart as employing a "same general class test." See Part B(1) infra.

B. The Loco Realty and Stewart Tests are Themselves Unclear.

1. Stewart Bros., 3 AFTR 2d 318 (3d Cir. 1958). Stewart was the first case drawing on owner-user/owner-lessee distinction, and its statement of the law is ambiguous as to whether all rental properties are of similar use or whether the properties must be in the "same general class." In Loco Realty, 10 AFTR 2d 5359, 536405 (8th Cir. 1962), the court noted the ambiguity in Stewart, leaning toward an interpretation that all rental property is similar under § 1033. Pohn, 10 AFTR 2d 5780, 5782 (7th Cir. 1980), cited below, reads Stewart equally broadly. On the other hand, McCaffrey, 5 AFTR 2d 774 (3d Cir. 1960), which is the only circuit to apply the functional test to an owner-lessee (a position the Service rejected in 1964), understood Stewart as creating the "same general class" test. The district court in Filipinni, 9 AFTR 2d 313 (N.D. Cal. 1971), aff'd 11 AFTR 2d 1720 (9th Cir. 1963), reached the same conclusion. (The Ninth Circuit rejected the "same general class" test.)

The Pohn court, a n.4, reviewed the overall situation in 1962, before Filipinni added yet another test, as follows: "There is a basic difference of opinion between the Third and Second, Fourth and Eighth Circuits, and among the latter three there are shades of difference in the test applied."

2. Loco Realty

Loco Realty's requirement of "reasonable similarity of the leased premises" has been subject to different interpretations by the court that have cited it. In Pohn, 10 AFTR 2d 5780, 5782 (7th Cir. 1962), the court interpreted the Loco Realty test as more restrictive than the Second Circuit's Liant test, asserting that "the [Loco Realty] court avoided the extreme statement of the Stewart and Liant doctrine that both properties need only qualify as investments." However, the concurring opinion in Clifton Investment Co., 11 AFTR 2d 649, 641 (6th Cir. 1963), construed Loco Realty as more liberal than Liant. In his concurrence, Judge Miller said:

I think that the investment character of the properties involved should be given more consideration than what seems to me is given by the ruling the Liant case, although I do not think that investment basis alone is sufficient to comply with the statute, as Stewart Brothers, Inc. v. Commissioner might be construed as holding. As pointed out in Loco Realty Co. v. Commissioner, the statute was not intended to penalize but to protest persons whose property may be taken on condemnation and, accordingly, should be construed liberally. I agree with the standard adopted in the opinion in that case, although for our present purposes I do not think that it results in a reversal of the decision of the Tax Court.

Id. at 651 (citations omitted).

Judge Miller cites Loco Realty here as more liberal than the Liant test, in direct contradiction with the Pohn court.
C. A Crucial Issue Regarding the Similar Use Test Remains Open.

Unlike the functional use test applied to an owner-user, which looks to the property's physical characteristics and end uses, the Service, following Fili

D. The Fili Test Provides for Case-by-Case Decision Making by Lower Courts, Imposing Substantially Increased Litigation.

The Fili test, cited above, examines "all the circumstances to reach an overall sense of whether the taxpayer has maintained continuity of investment. The Fili court expressly rejected any more definite standard or "rule of thumb."

Any test consisting of a broad survey of the circumstances is likely to be an extremely fact-based exercise. However, the Fili court went even further, when, in n. 4, it cited Duberstein, 363 U.S. 278, 279 (1960):

Decision of the issue presented in these cases must be based ultimately on the application of the fact-finding tribunal's experience with the mainsprings of human conduct to the totality of the facts of each case. The non-technical nature of the statutory standard, the close relationship of it to the data of practical human experience, and the multiplicity of relevant factual elements, with their various combinations, creating the necessity of ascribing the property force to each, confirm us in our conclusion that primary weight in this area must be given to the conclusions of the trier of fact.

With this quotation, the court expressed its feeling that the similar use test is not the kind of legal standard that allows appellate courts to clearly guide the lower courts. Instead, each case is different, with the lower courts applying their experience "with the mainsprings of human conduct to the totality of the case." This delegation to the lower courts will substantially increase litigation if applied to §1031.

In one subsequent case, the Tax Court cited Fili as "[t]he general test to be applied in a qualification under
It appears then that the Fillmmi test is likely to be applied by at least some courts even outside the Ninth Circuit. The concern about increased litigation is therefore relevant far beyond the reach of the Ninth Circuit. Congress would only exacerbate the problems of an already overloaded judiciary by adopting the similar use test for §1031 exchanges.

II. There was a Prior Amendment to §1031 to Remove the Use Test.

In 1921, when Congress first enacted the §1031 equivalent, §202(c) of the Code provided for nonrecognition when both properties were of the same like kind or use. In 1924, Congress shortened the test to "like kind," and its reasons are particularly instructive.

According to both a document called "the Gregg Statement," released for publication by Chairman Green of the House Ways and Means Committee, and the Senate Finance Committee Report, Sen. Rep. No. 398, April 1924, the change is intended to respond to a contention that the "like kind or use" test created two classes of property: property held for investment and property held for productive use in a trade or business. Consequently, it had been argued, the "use" language prevented the exchange of properties in different classes. The Gregg Statement and the Senate Report rejected this reliance on use because "[t]he intention of the party at the time of the exchange is difficult to determine, is subject to change by him, and does not represent a fair basis of determining tax liability." Gregg Statement at 11-12; Sen. Rep. at 14.

The passage of time has made intent no easier to determine. In fact, the frequency of exchanges today compound the difficulties of applying a use test with a likelihood that such a test would have to be applied on a regular basis. Congress should follow its 1924 decision to provide for a test based solely on the nature and character of the property. There is no overriding necessity to make the proposed change. In fact, if the change is made, Congress will have to rethink legislation it has recently passed, and is likely to pass in the future, that allows exchanges of ancient forest and mineral rights held by private corporations and individuals, for less ecologically sensitive government owned lands. Unless there is a special provision in the legislation exempting those transactions from income tax, the transferors of the land could not be assured that the transactions are not taxable even though such transactions were historically tax deferred.

For all of the above reasons, I believe the proposed amendment should not become part of any bill. The IRS, Treasury and taxpayers have worked hard over the last few years to somewhat simplify the area of like kind exchanges, so that not every transaction needs the assistance of expensive tax lawyers. The bill would only serve to reverse this trend and to create substantial uncertainty, not to mention numerous and expensive lawsuits. Thank you for your consideration.
STATEMENT OF JOHN W. LEE, PROFESSOR OF LAW, COLLEGE OF WILLIAM AND MARY, MARSHALL-WYTHE SCHOOL OF LAW, WILLIAMSBURG, VA.

Chairman RANGEL. Mr. Lee.
Mr. LEE. I am John Lee, a professor at William & Mary.
Chairman RANGEL. Move that mike a little closer to you.
Mr. LEE. And I actually requested to speak on two topics, the soil remediation and this, so I will do a brief one on soil remediation first.

And I think the major thrust I would like to make is that the law is not as clear as the previous panelists indicated; that they should be able to currently deduct the soil remediation costs. There are a few, I think, leading precedents, more recently, that would indicate distortion of income is really what is involved when you are talking about current deduction or capitalization. And if you have an extremely large amount, particularly if it accrued over years, then capitalization, but amortization over some period, is necessary.

Now, that, I think, would answer to some degree the retroactivity argument made by the previous panelists. More than that, I think this committee’s greatest concern should be in the fact there are tremendous—the IRS is auditing, there are tremendous amount of cases going to be building up there, and if we let this develop, if Congress lets this develop, as the intangibles developed, one day probably Congress will have to come back in, clean it up anyway, and then handle the retroactivity problems.

So it is much better now to avoid the litigation costs from both the private bar and, for the private taxpayers, and for the Government to address, to give an answer to soil remediation. And I would suggest, probably the answer is, in most cases, a 60-month amortization.

This is not really a repair, in most cases. It is just like the pollution control, the mine safety. It is something the Government is imposing. Probably for good reasons. Certainly for good reasons. And typically the pattern there is 60-month amortization. And there is a future benefit because they don’t get closed down.

And, as far as the subsidy to doing it, they have a big stick already. If they don’t do it, they don’t get closed down. So I don’t know that they need the tax incentive.

And very, very briefly, if you buy my argument that our real concern is avoiding litigation costs on both sides, then the whole area of capitalization, in which I have been writing for 20 years and have influenced the tax law, committee reports, various things, and, indeed, that technical advice memorandum, I think, was influenced by me, that area is probably one of the big investor specialization programs. By my count, a quarter of the issues are capitalization or amortization linked to it.

And the GAO study of the 12 most common code sections that generate half of the items in audit and 60 percent of the settlements, one of those is 263 capitalization. A subissue under 162 is capitalization. In short, already it is a big issue and it is going to get much bigger. And it would be so simple for this committee to simply pick out, with the remediation, simply say 60 months. And
there are some other narrow areas that probably should get current deduction.

And for the broader thing of capitalization, if you would simply say if it is big—or if it is small, it can be deducted. If it is current, it can be deducted. If it is big, you have to amortize. Give guidelines to the Service to let them start doing the rulings they are doing to build up to regs. That will cut down on litigation.

And the similar thought with 1031, the academic writers all agree as to real estate like-kind is too broad. The real underlying notion being that you should be able to exchange because you have not really economically changed.

We are going from raw land to an apartment building for a little old lady that has held the land for 30 years and then she becomes a passive investor—I am told anecdotally that often happens—that is not economically "like."

In every other area, personal property exchanges under 1031, involuntary conversions, the better cases do apply in economic analysis. But the panel is absolutely right that the wrong thing to do is simply incorporate 1033 and say, hey, go at it. They are absolutely right. The cases are in conflict there. There are better recent cases.

But, again, there, pick out what should be the factors. Probably risk, return and activities. And pick them out, set them in the committee report, and then let the service, by rulings and then regs build it up.

Don't do it the opposite way of detailed legislative regs, 263 Cap-A capitalization comes to mind. Instead, build up, and you can end up with something as beautiful as the 355 regs which allow the fact finder to make the right decision, looking at a number of different factors. We need evolution, but we need direction, and simply doing 1033 won't do it.

Thank you.

[The prepared statement follows:]
TAX POLICY ISSUES RELATED TO LIKE-KIND EXCHANGES AND TO SOIL REMEDIATION COSTS

I am John W. Lee, Professor of Law, College of William & Mary, appearing on my own behalf. I favor, with modifications, the proposals listed in Miscellaneous Issues §§ 3 (§§ 1031 and 1033) and 6 (soil remediation costs) in Press Release # 9, August 17, 1993.

SUBSTITUTION OF SECTION 1033'S "SIMILAR OR RELATED IN SERVICE OR USE" FOR "LIKE-KIND" IN SECTION 1031 VOLUNTARY EXCHANGES: SORCERER'S APPRENTICE OR ALCHEMIST'S STONE?

I. Introduction

In 1987 the Joint Staffs of the Joint Committee on Taxation and the House Ways & Means Committee suggested either (a) adding real estate to the tainted property exclusions to § 1031 (which the House effected in OBRA 1987 with a $100,000 cap on § 1031 real estate exchanges other than personal residences, or (b) applying the § 1033 "similar or related in service or use" ("SORISOU") standard in lieu of the current "like-kind" standard (which the House also effected in OBRA 1989, but both times these § 1031 restrictions were deleted from the Senate bill and died in Conference). The Joint Staff's reasoned that "1. Nonrecognition on like-kind exchanges is justified only when the taxpayer remains in a similar economic position after the exchange. The like-kind standard as applied to real estate is too broad and flexible to ensure that a taxpayer's economic position is not significantly altered by the exchange, giving investors a tax preference in comparison to investors in productive assets such as stocks and equipment. 2. The like-kind standard for comparing the property transferred with the property received should be no broader than the general standard applying for involuntary conversions. Involuntary conversions are not a tool for tax planning, and give rise to stronger equity reasons for not taxing gain than voluntary exchanges." Staff of Joint Committee on Taxation with Staff of the Committee on Ways & Means, Description of Possible Options to Increase Revenues Prepared for the Committee on Ways & Means, 240-41 (JCS-17-87, June 25, 1987); accord, H.R. Rep. No. 247, 101st Cong., 1st Sess. 1340 (1989) ("The committee believes that it is appropriate to accord nonrecognition only to exchanges and conversions where a taxpayer can be viewed as merely continuing his investment. The 'similar or related in service or use' standard contained in section 1033 (relating to involuntary conversions) better describes the types of transactions that the committee wishes to accord nonrecognition treatment."). The revenue is in the range of 1 billion over 3 to 4 years.1

Today this Subcommittee is again considering a "proposal to amend the like-kind exchange rules to require that Code section 1031 property received must be 'similar or related in service or use' to the property exchanged, except in the case of condemnation." I recommend that the Subcommittee adopt this proposal with the modification that its legislative history set forth the factors (principally risk and management activities) that the Service will apply in rulings which are to evolve from experience into "legislative" regulations administering structured "discretionary justice". Mere adoption of the current SORISOU standard probably would not exclude as many voluntary exchanges of different grades of real estate as the revenue estimates anticipate due to the quite liberal § 1033 precedent. Although not a Mickey Mouse solution, substitution of SORISOU for "like kind" in voluntary exchanges without further Congressional guidance will create many administrative problems as old issues are needlessly played out again. Just as Disney's Sorcerer's Apprentice did.

II. Origins of §§ 1031 and 1033 Standards for Non-Recognition

The policy basis for non-recognition in like-kind exchanges (as well as involuntary conversions to some extent) is preventing taxation of realizations of "paper" or theoretical "gains or losses, constituting a mere change in form, with continuity of investment without "cashing in".2 The earlier Treasury 1918

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1 Conference Comparison of H.R. 3299, Estimated Revenue Effects of Revenue Reconciliation Provisions 3 (JCS-70-89 Oct. 26, 1989)(31.341 billion for 1990-94); Levine, Tax-Free Swap Popular Among Investors, Part II, TAX L. 18 (Monday April 10, 1989); Cellis, Tax-Free Exchange to Again at Stake, WALL St. J. B-1, col. 1 (Wed., March 1, 1989)($350 million a year). The levied-audio $750,000 annual revenue on defaults of gains from real estate exchanges passed by the House in 1967 would have generated slightly more revenue on the average that the same policy based adoption of the § 1033 "similar or related in use" standard. Staff Joint Comm. on Taxation, Description of Additional Tax Proposals Submitted by Members for Ways and Means Committee Revenue Reconciliation Consideration (Oct. 13, 1987) (JCS-15-67); H.R. Rep. No. 391, 100th Cong., 1st Sess. 1638 (1967)($399 million for 1968-90). The argument has been made that no restricting like-kind exchanges will due to "loophole" decrease multi-party transactions and, hence, the growth in investment (and tax revenues) by at least one other party to the multi-party transaction. See Varian, infra. Also, Department'sProposed Search for Tax Evasion: Techniques and Questions Involving Section 1031 Like-Kind Exchanges in a World of Changing Tax Alternatives, 65 TAXS 973, 976-94 (1987). Stories of 1921.

Act Regulation's deferral of tax on gains from involuntary conversions if "the taxpayer immediately proceeded in good faith to replace the property" or established a "replacement fund" was bottomed on the notion that losses in an involuntary conversion and gains or losses on exchanges of substantially similar property were not "closed transactions." Treas. Reg. 45, Art. 49. The causes for the early involuntary conversion rule (without statutory authority) were WW I government condemnation for war production and "submaring" of vessels by "U-Boats." Treasury, Notes on the Revenue Act of 1918 (1919); (Confidential) Hearings on H.R. 824 (Revenue Act of 1921) before the Senate Finance Committee, 67th Cong., 1st Sess. 203 (1921)("Dr. Adams' Statement"). The 1918 Act regulations also contained a skeletal form of the continuity of investment concept and a "like-kind" requirement as to non-recognition exchanges of property in its definition of "realization" as arising upon a conversion of property into cash or other property to the extent of replacement property "(a) that is essentially different from the property disposed of and (b) that has a market value. In other words, both (a) a change in substance and not merely in form, and (b) a change into the equivalent of cash, are required to complete or close a transaction from which income may be realized." Treas. Reg. 45, Art. 1563. Treasury and the courts, however, interpreted the 1918 Act property exchange provision narrowly, e.g., taxing an exchange of farms (which then and now are more readily marketable than stock in close corporations).4

The Revenue Act of 1921, in which the predecessors to §§ 1031 and 1033 first appeared, was enacted by a Republican-controlled Congress and a new Republican Administration which had campaigned on cutting income taxes. Special Treasury Adviser Dr. Adams was more worried about taxpayers taking losses during the post-World War I depression than their deferring gains. 1921 Confidential Senate Hearings, supra at 28-9, 199, 200. He therefore persuaded the Senate to limit realization in exchanges of property to where the property received in the exchange had a readily realizable market value. But even if it had such a readily realizable market value, 4 no gain or loss shall be recognized—(1) when any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like-kind or use". 1921 Confidential Senate Hearings, supra at 200 (Dr. Adams reading statute)(Emphasis supplied). Dr. Adams was in such a quandary as to nonrecognition of investment losses and gains that he left to the Senate Finance Committee the decision whether to include investment property in the non-recognition set of "like-kind or use". id. at 201. It deleted "for investment" from this first like-kind exchange provision under the rationale that "whatever will make the bill least complicated and less calculated to drive people to insolvency in the thing to do." id. at 201. (Statement of Chair Penrose, R-Pa.). Secretary of the Treasury Mellon, however, persuaded the Conference Committee to restore non-recognition to exchanges of investments. These developments set the stage for populist Ways and Means Member John Nesse "Cactus Jack" Garner, D-Tex. (early 1930s Speaker of the House and then Vice President during the first two terms of President Franklin D. Roosevelt), to decry in the House 'debate on the Conference bill in 1921 about Congress following the maudates of a Treasury Department which desires "to relieve the heavy taxpayer from his taxes and continue the taxes upon the masses of the people ...", and a Treasury expert changing his mind at Mellon's direction.5 Incredibly, there's more to the story. High income taxpayers responding to brokerage firm advertisements "swamped" appreciated public stock or securities which were covered by the original predecessor to § 1031, perhaps even receiving cash "boot" then tax-free up to their basis, and sold their loss securities which, due to Senate intrascence, then resulted in an ordinary loss. Congress estimated the revenue loss to be $20,000,000 to $50,000,000 a year. 64 CONG. REC. (Part 3) 2851 (House February 1, 1923)(Remarks of House Ways & Means Chair Greene, R-Iowa)(about 5%)

4 ASHER, J. TAX POLICY 193, 203, 205 (1983); SCOTT, LIKE KIND REPLACEMENT PROPERTY: ANIMAL, VEGETABLE OR MINERAL, 23 SAN DIEGO L. REV. 1067, 1068-69, 1074-77 (1986) (traces history of "continuity of investment" back to Civil War rulings). Historically this policy was effected primarily through the "exchange" requirement and secondarily through the "like-kind" prerequisite. See Scott, supra at 1069; Bryan, Deferred Exchanges: Non-recognition Transactions after Sturgis, 36 TULANE L. REV. 42, 45-46 (1963). For development of the "continuity of investment" concept in the regulations see KERNSHAW, Section 1031: We Don't Need Another Hobo, 60 STAN. L. REV. 397, 407 n.19 (1967); Scott, supra 23 SAN DIEGO L. REV. 1068-72, 1091-94.

5 Carroll Fox so designated these Hearings. Dr. Adams, was the Tax Adviser to the Secretary of the Treasury—a Yale Professor of Economics who had been at Treasury since 1917 or so and was the binding income tax expert in part because he had directed the Minnesota experiment with the first state income tax commencing around 1909.

6 O.D. 429, 2 C.B. 38 (1920); 1921 Confidential Senate Hearings, supra at 27 (Dr. Adams); Pearson, et al., Trustees v. Comm'r, 15 B.T.A. 150, 151 (1930).

7 Publicly traded probably was meant, see 1921 Confidential Senate Hearings, supra at 199-200 (Statement of Dr. Adams); Treas. Reg. 45, Art. 1563.

8 "We find a Treasury expert there who came in in the morning and made a very interesting and, I thought, conclusive argument; that the Secretary of the Treasury would give him different instructions, and in the afternoon he would make the most conclusive argument on the other side of the same proposition that I ever heard in my life. 41 CONG. REC. (Part B) 8073 (November 21, 1921 House)(Remarks of Rep. Garner, D-Tex.).
of income tax revenue from individuals). In 1923 Congress held a special Fourth Session just to wrestle with the tax problems of like-kind exchanges. Both tax writing committees took the straightforward 1921 Senate Finance Committee path of deleting "for investment" from the required purpose for holding the exchanged properties. H.R. Rep. No. 1432, Exchange of Property, 67 Cong., 4th Sess. 1-2 (1923). This time the Congress itself added back "for investment" in a floor amendment at the suggestions of Ways and Means Member and former Chair Rep. Fordney, R-Mich., (1) to keep investments in general under the predecessor to § 1031 and instead (2) list tainted assets not qualifying for a tax-free like-kind exchange including securities. Cactus Jack explained that Fordney had been "out in the West" and absent from the Ways and Means Committee meeting adopting the bill, "perfect in form and substance", that deleted "for investment" and hurried back "post haste" to preserve non-recognition for "blocking up" swaps with the Department of the Interior of coal and timber lands out West. 64 CONG. REC. (Part 3) 2852 (House Feb. 1, 1923) (Remarks of Rep. Garner, D-Tex.). Fordney responded that Garner was a "big ear of corn in a little shuck". (By 1940 FDR may have shared that sentiment.)

The origin of the existing distinction in the Treasury regulations between (a) real estate with all grades or qualities being like and (b) personal property which implicitly is like only as to narrow categories is also interesting if less titillating. Dr. Adams provided in the Confidential 1921 Senate Hearings a widely quoted (as not too helpful) example of like-kind exchanges (including investments): "DR. ADAMS. An illustration would be where stocks were exchanged—stocks for stock or bonds for bonds—or where a factory was exchanged for another factory." Notice implicit narrow categories. The principle that all real estate is "like kind" appears extrapolated from Dr. Adams’s less well-known example of a qualifying trade of a farm for a depreciable (rental) house, 1921 Confidential Senate Hearings, supra at 205 (Statement of Dr. Adams explaining substituted basis). The 1921 Act regulations faithfully followed¹ the above hints dropped by Dr. Adams, adopting the following "standards" still contained in Treas. Reg. § 1.1031(a)-(b) or administrative rulings and current case law.

(1) "Like kind" refers to the "nature or character of the property and not its grade or quality." Treas. Reg. 62, Art. 1566(a); still contained in Treas. Reg. § 1.1031(a)-(b). Thus, "the fact that any real estate involved in an exchange is improved or unimproved makes two differences, for such facts relate only to grade or quality of the property and not to its kind or class." Id. The courts soon thereafter and to this day have applied the "like kind" standard liberally to interests in real estate of all grades and qualities.³

More recently both Congress and the courts have taken an "economic analysis" of "like kind" as to personal property. Cal. Fed’t Life Ins. Co. v. Comm’r, 76 T.C. 107 (1981), aff’d, 680 F.2d 85 (9th Cir. 1982) ("where a taxpayer’s economic situation after the exchange is fundamentally different from his economic situation prior to the transaction, the exchange does not encompass like-kind properties."); Cf. S. Rep. No. 552, 91st Cong., 1st Sess. 102 (1969) ("male calves ... are not held for breeding purposes and, in fact, are not of a 'like-kind' with females."). Cutting to the chase, a similar economic analysis now prevails under § 1033, sometimes quite liberally applied. Many but not all commentators believe that such an economic analysis goes a long way towards rationalizing the host of like-kind rulings and fewer cases as to personal property. While such economic analysis appears correct on a policy basis, i.e., sufficient shifting in risk makes property not "economically similar," cf., H.R. Rep. No. 391, 100th Cong., 1st Sess. 1039 (1987), its current inapplicability to real property exchanges creates economic inefficiencies. See Joint Staff’s Possible Revenue Options, supra at 241. The revised "like-class" safe harbor for exchanges of personal property take an overly restrictive definitional approach to "like class" safe harbors possibly due to the absence of case law or statutory support. Such strictness probably arises as well from the Service’s well-taken opposition to the notion that entire businesses could be exchanged under § 1031.¹⁰ Should Congress wish to follow such a

¹ This was such a good story that it grew with the telling to account for the capital gains preference itself. 65 CONG. REC. (Part 3) 2846 (House February 20, 1923) (Remarks of Rep. Oldfield, D-Ark.) Former House Ways & Means Chair Wilbur Mills, D-Ark., recounted that memories of sitting on the knees of Congressman [Oldfield] lead him to aim for business and Congress in life rather than his father’s goals for him.

² Carlisle, the original compiler of the 1909-1920 Legislative Histories (revised in 1979 by William S. Hein, Roan, Ed.), announced "Dr. Adams’ Statement" in the 1921 Confidential Senate Hearings concerning evaluating Act Sections, House debates, etc. See vol. 92 and 93A. REAMS, INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1920 HISTORIES, LAWS AND ADMINISTRATIVE DOCS (William S. Hein & Co. 1979). I suspect that the regulation drafters did the same.

³ Koch v. Comm’r, 71 T.C. 54, 63 (1978) ("§ 1031(a) requires a comparison of the exchanged properties to ascertain whether the nature and character of the transferred rights in and to the respective properties are substantially alike. In making this comparison, consideration must be given to the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties, the duration of the interests, and any other factor bearing on the nature or character of the properties as distinguished from their grade or quality. Equally important, as the standard for comparison, section 1031(a) refers to property of a kind—not an identical—kind. The comparison should be directed to ascertaining whether the taxpayer, in making the exchange, has used his property to acquire a new kind of asset or has merely exchanged it for an asset of like nature or character.").

narrow approach as to exchanges of personal and intangible property in revising § 1031, it should approve the concept of such "like class" personal property regulations. I recommend as Part IV a hopefully sounder approach of setting forth guidelines as to an economic analysis (risk and management activities) of SORISOU for IRS rulings which in an evolutionary fashion ultimately would be "codified" in structured "discretionary justice" regulations in the manner of the 1989 revised regulations under § 355.

How the § 1033 "similar or related in service or use" standard came to be more narrow as to real estate than § 1031 too makes a long story, also largely turning on historical accidents. The "classic" involuntary conversion was loss of an ocean freighter to "submarining" or "condemnation" of a factory by the government for war production during World War I when (a) immediate replacement was often impossible and (b) high wartime taxes (including corporate excess profits taxes)—10% x pre-War rates—on gain (inflated in part by war shortages), all taxed as ordinary income, would render replacement impossible after taxes. See American Nat'l Gas Co. v. United States, 279 F.2d 220, 225 (Ct. Cl. 1960). Albeit without statutory basis, the 1918 Act Regulations (Treas. Reg. 45, Art. 47) provided that the amount received by the taxpayer (a) for property lost or destroyed in whole or in part through fire, storm, shipwreck, or other casualty or (b) where title was lost through requisition or eminent domain (or voluntary conveyance induced by reason that a proceeding for such a purpose is imminent) was taxable only to extent gain exceeded the amount actually and reasonably expanded to "replace or restore the property substantially in kind, exclusive of any expenditures for additions or betterments. The new or restored property affects a replacement in kind only to the extent that it serves the same purpose as the property which it replaces without added capacity or other element of additional value." Id. (Emphasis added). The regulation was not explicitly elective, only transactionally so. Treasury Staff suggested a statutory amendment (even more bare bones than the regulation) providing for a "replacement fund for the replacement in kind of lost or damaged property" based on a hardship policy. Notes on the Revenue Act of 1918, Section 213(e), supra at 15.

The Revenue Act of 1921 which introduced the first "like-kind" tax-free exchange provision also birthed the first statutory involuntary conversion provision (actually 2, one for corporations and one for individual taxpayers) retroactively applicable to 1918. The 1921 Act involuntary conversion regulations added little to the statute, Treas. Reg. 62, Art. 261-63, probably because 1918 Act regulations already existed. Although the 1921 predecessor to § 1033 employed a deduction mechanism (changed to an exclusion of gain in 1924), the drafters of the Revenue Act of 1921 clearly saw involuntary conversions and like-kind exchanges as related as evidenced by their proposition in discussion in the 1921 Confidential Senate Hearings and even more by the similarity in descriptive terms of the continuity of investment standard in those Hearings and in the 1921 Floor Debate on the predecessor to § 1033. 1921 Confidential Senate Hearings, supra at 55, 203; 61 CONG. REC. (Part 5) 5201, 5296 (House Aug. 18-19, 1921)(Remarks of Rep. Hawley, R-Ore.); Scott, supra 23 SAN DIEGO REV. at 1075; see also Filipini v. United States, 200 F. Supp. 286, 293 (N.D. Calif. 1961), aff'd, 318 F.2d 841 (9th Cir. 1963). Furthermore, the 1921 version of both provisions employed parallel "kind" and "use" tests: "like kind or use" in the case of the predecessor to § 1031 and "character similar or related in service or use" in the case of the predecessor to § 1033. This parallelism disappeared in the Revenue Act of 1924. I suspect that Congress thought that at least the two original formulations of the qualifying standard under the predecessors to §§ 1031 and 1033 were essentially the same.

The involuntary conversion provision in the succeeding revenue acts and the income tax regulations under them continued largely unchanged until the regulations under the Revenue Act of 1934 were reworked apparently to reflect ruling and litigation experience over the preceding decade, particularly heavy on the eve of these regulatory revisions. Treas. Reg. 86, Art. 112(2)-(1). For example, the 1934 Act regulation's involuntary conversion provisions for the first time set forth rules in the following areas: (A) tracing requirement for proceeds of involuntary conversion expanded for replacements; (B) amounts retained by the government from a condemnation award to satisfy losses and liabilities are included in the amount of the net condemnation award, (C) expenditures for replacement property in excess of recovery for the loss are not currently deductible as a loss, (D) the involuntary conversion provisions apply to "residential" and "farm purposes", (E) use and occupancy insurance proceeds do not constitute involuntary conversion proceeds, and (F) "there is no investment in property similar in character and devoted to a similar use if: (1) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate. (2) The proceeds of conversion of real property are applied in reduction of indebtedness previously incurred in the purchase of a leasehold. (3) The owner of a requisitioned tag uses the proceeds to buy barge. (4) An award for
property taken for street widening is applied toward payment of special assessments for benefits accruing to the remaining property." Trans. Reg. 86, Art. 112(f)-1. Pre-1935 case law authority existed on all of the above rules except (D) and (F)(3) and (4) and cases were in the pipeline as to (F)(4). The then extant (and later) precedent did not always support, however, the positions taken in the regulations.

Courts initially relying upon the remedial policy of the predecessors to § 1033, particularly prior to the 1934 Act regulations, fashioned a host of liberal rules12 and in particular early on applied the SORISOU standard liberally as to involuntary conversions of real estate.13 But in the 1950s the Tax Court and some other tribunals adopted a "functional" test for determining whether replacement property for involuntarily converted real estate was "similar or related in service or use" which in revolution spawned "too many different tests and an acute case of hardening of categories." Johnson v. Comm'r, 43 T.C. 736, 736 (1965)(ct. reviewed)(abandoning functional test). The Tax Court dealing with fact patterns where the taxpayer itself was the actual user came to compare the actual physical use to which the exchanged properties were put, but extended this analysis to the lessor's end use where the taxpayer was the lessor. Loco Realty Co. v. Comm'r, 306 F.2d 207, 210-13 (8th Cir. 1962)(sketching evolution of test and rejecting it as to lessor exchanges).14 In 1958 Congress disapproved of application of the functional test as to involuntarily converted real estate but took the easy way out with new § 1033(g) deeming § 1033's SORISOU standard satisfied by meeting the § 1031 like-kind test in the case of real estate involuntarily converted. S. Rep. No. 1993, 85th Cong., 2d Sess. 72-73 (1958). I suspect that this view of the relative strictness of SORISOU as to real estate compared to "like kind", which many commentators share, underlay the Joint Select's reasoning in 1987 that the standard for voluntary exchanges of real estate should be no broader than the involuntary conversion standard. However, the 1958 amendments and legislative history rekindled the remedial flame—courts again sought creative solutions.

After 1958 courts proceeded to reconstruct the "similar or related in service or use" standard in a line of cases culminating during the early 1960's in Lient Record, Inc. v. Comm'r, 303 F.2d 326 (2d Cir. 1962), and its brethren, if not progeny. Lient Record stresses the service or use which the properties have to the taxpayer-lessee, not the lessor, measured by management activity, services rendered to the tenants, and business risk. Ultimately the Service and the Tax Court adopted this test as to SORISOU.15 Davis v. United States, 589 F.2d 446, 450 (9th Cir. 1979), tests the limits of analyzing the taxpayer's "relationship to the property" (management activities and investment risk) under the SORISOU standard, holding that the taxpayer's reinvestment of condemnation proceeds from disposition of a fishery plant and adjacent agricultural land into improvements to its existing industrial park land qualified under SORISOU. (The Ninth Circuit, famous for its liberalism as to § 1031, noted that "given the change in the Hawaiian economy, reinvestment in agricultural property was

12 "[P]orthwith ... acquisition" permitted a 2-year, diligent search for replacement property, Hubbard v. Comm'r, 25 B.T.A. 1370 (1932)(also zoning manufacturing for textile industry in "relatively," but not "similar," use to old textile plant does not "adopt the view that the "relating use"; Hubbard Overland Co. v. Comm'r, 4 B.T.A. 1088, 1092 (1926)(and with foundation put in, construction halted by external circumstances for replacement improved real estate used similarly to end goal of converted property). Remedial policy also gave birth later to liberal doctrines. E.g., economic unit rule, Johnson v. Comm'r, 30 T.C. 741 (1958); timely replacement by purchased corporation after its purchase (pursuant to tax free transactions doctrine), John Richard Corp. v. Comm'r, 46 T.C. 41 (1966); contingencies in purchase price, Conserv. v. Comm'r, 48 T.C. 156 (1967); "dissent" of condemnation, 52 B Realty Co. v. Comm'r, 54 T.C. 863 (1970); sales under "thrust" to third party, Z.H. Ewer & Co. v. Comm'r, 40 T.C. 142 (1963); and "reversion" and reimbursements, Graphic Press v. Comm'r, 523 F.2d 586 (9th Cir. 1975).

13 See, e.g., Hubbard Overland Co. v. Comm'r, 4 B.T.A. 1088, 1092 (1926)(not with taxpayer excavations and foundations for structure, where construction for auto sales office building not completed because WW II war shortages and then condemnation, for lot with building already improved for that purpose); Washington Market Co. v. Comm'r, 25 B.T.A. 576, 584 (1932)(not plant, cold storage refrigeration, and warehouses units replaced with property used for all three purposes except warehouses still); Hubbard v. Comm'r, 25 B.T.A. 1370 (1932)(zoning manufacturing plant building and production of atomic materials for own use replaced with plant for making atomic materials for sale to military service); Davis Regulator Co. v. Comm'r, 38 B.T.A. 457 (1939)(removal of an old policy building replaced with new building owned by defendant); Randall-Diamond Milling Co. v. Comm'r, 10 T.C. 7 (1948)(floor plant replaced by floor and food processing plant); Maudlin-Cleveland-Arbor Signs Co. v. Comm'r, 15 T.C. 79 (1950)(plant replaced by plant for similar manufacturing but with disproportionate mix of assets); Gagny Nevus Co. v. Comm'r, 22 T.C. 1172, 1179 (1954)(unapproved real estate acquired as plant site for real estate with entering improvements usable in part for new plant; it seems we insufficient to set up a functional classification in terms of improved or unimproved property).

14 Lient Record, Inc. v. Comm'r, 303 F.2d 326, 328-30 (2d Cir. 1962), in dictum accepted the "functional" test only where the taxpayer him or herself used the converted property. Davis v. Comm'r, 309 F.2d 427, 429 (7th Cir. 1962). But 1944, the former Lient Record, Inc. v. Comm'r, 254 U.S. 437 (1915)(here, "functional test" written by aide James Broun of the Fourth Circuit) by stating Stewart as adopting a Lient Record-esque test as a standard. However, this excellent student may be confusingly argues that a Lient Record--like Philippine market risk analysis should apply to both investment and productive business use property for purposes of § 1033. See Note, Involuntary Conversions and the Questions of Qualified Replacement Property, 38 Ohio St. L. J. 321, 320 (1977).

15 Rev. Rul. 64-357, 1964-2 C.B. 319; Johnson v. Comm'r, 43 T.C. 734, 739-41 (1965)(ct. reviewed). See also Loco Realty Co. v. Comm'r, 306 F.2d 207 (8th Cir. 1962); Filipino v. United States, 318 F.2d 841, 842 (9th Cir. 1963).
unreasonable, and purchase of another sea fishery was virtually impossible." Id. at 450 (Emphasis added). Under such analysis most business (or investment) real property could be swapped for most business real property (or investment real property, respectively). But raw land could not be swapped for a developed real estate investment due to the shift in risk (and current return in most cases). Nor could improved real estate used in a business be swapped for otherwise identical realty held for investment use due to the change in management activities.

In short the conventional wisdom that courts apply § 1033 more strictly than § 1031 appears more wrong than right early and late—less so in between. Nevertheless due to the controversies under §§ 1031's and 1033's standards, Congress this time should not simply adopt the § 1033 standard lock-stock-and-barrel in § 1031 (as the House did in 1989), while keeping the old § 1031 standard for involuntary conversions of real estate under § 1033. It should address at least the known conflicts or uncertainties, if only by approving or disapproving of specific precedent. For example since Davis was deliberately decided under § 1033(a), simple adoption of § 1033's "similar or related in service or use" test would support application of Davis to a like-kind exchange as well as an involuntary conversion. If Congress wants this result, then there is little need to retain a § 1033(g) like-kind test for involuntarily converted real estate. Please don't create more clutter in the Code.

III. Tax Policy and Politics

Continuity of investment was criticized just over a decade after enactment of the first predecessor to § 1031 as a rationale for nonrecognition. See Prevention of Tax Avoidance, Preliminary Report of a Subcommittee of the Committee on Ways and Means Relative to Methods of Preventing the Avoidance and Evasion of the Internal Revenue Laws Together with Suggestions for Simplification and Improvement Thereof, 73rd Cong., 2d Sess. 8-9, 38-9 (1933)(Subcommittee and Joint Committee Staff discounted "paper profits" rationale). More recently criticism of § 1031 has centered on (a) its overly restrictive—in inconsistent treatment of cash-outs with (contractually) required reinvestment and non-like-kind exchanges of illiquid property, Kornhauser, supra 60 SO. CAL. L. REV. at 409-11; Jensen, supra 4 AMER. J. OF TAX POLICY at 204; Comment, Exchange Requirement in Multiparty and Nonsimultaneous Exchanges: A Critical Analysis and Statutory Solution, 37 SW. L.J. 645, 646-47 (1983); (b) its overliberality in providing non-recognition for transactions which substantially change the form of investment as to the nature of risks and rewards, Bryce, supra 56 Tulane at 46; and (c) the overly narrow "like class" safe harbors for personal property and particularly the new like kind rules in these regulations as to intangibles, Bogdanski, On Beyond Real Estate: the New Like-Kind Exchange Regulations, 48 TAX NOTES 903, 904, 908 (Aug. 30, 1990).

The primary, usually (unstated policy) in allowing non-recognition for like-kind exchanges is the economic analogy to unrealized appreciation or depreciation, which in a continuing investment is not taxed or recognized until realized. See Jensen, supra 4 AMERICAN J. OF TAX POLICY at 199-201 (1985). However, there the principal (non-political) basis for non-recognition is (a) administrative convenience—annual valuations and self-reporting—and (b) lack of taxpayer liquidity. The focus in administrative difficulties is on (1) difficulty of "valuation" in "thousands of horse trades and similar barter transactions each year," H.R. Rep. No. 704, supra at 564; Hearings on Tax Shelters, Accounting Abuses, and Corporate and Securities Reforms, before the House Ways & Means Comm., 98th Cong., 2d Sess. 11, 24 (1984)Statement of Asst's Sec'ty Chapoton); and (2) hence, difficulty in compliance, Jensen, supra at 208-11. As to valuation, at least "boot" and multi-party transactions practically require valuations. See Jensen, supra 4 AMER. J. OF TAX POLICY at 209; Kornhauser, 60 SO. CAL. L. REV. at 409; Comment, 37 SW. L.J. at 648 (boot requires valuation); Briar, Like-Kind Exchanges of Partnership Interests: A Policy Oriented Approach, 38 TAX L. REV. 389, 401 n.47 (1983). As to compliance, this too probably is only a problem in true barter situations, hence, the appropriate remedy is a ceiling on the dollar amount of depreciable gain in non-recognition transactions. Cf. the $100,000 annual taxpayer ceiling on § 1031 exchanges of real estate under the House version of OBRA 1987.

The 1921 enactment of the like-kind exchanges was part of a package (including limiting "amount realized" to property with a readily realizable market value) designed to make more trades not currently taxable in order to defer recognition of stock losses during the then current post-war depression. See Hearings on H.R. 8245 (Revenue Act of 1921) before Sen. Fin. Comm., 67th Cong., 1st Sess. 199-202 (1921)(Statement of Dr. Adams); accord, Greene v. Comm'r, 15 B.T.A. 401, 407 (1929)(Board reviewed), aff'd, 42 F.2d 852 (2d Cir. 1930). Congress' continuation in 1934 of the non-recognition provisions in general, which the House would have repealed, also was based on the fear that recognized losses in the heart of the Depression would have exceeded recognized gains. Jensen, 4 AMER. J. TAX POLICY at 211-12 and n.86. However, with chronic and at times substantial inflation over the past 25 years, this policy has become anachronistic. Id. at 212.
Professor Kornhauser, utilizing historical research, has convincingly hypothesized several factors involved in the enactment of § 1031 in 1921 and the amendments in 1923 and 1924: (1) concern about whether capital gains were income; (2) confusion about when realization occurs; (3) sympathy for a consumption theory of income taxation; and (4) economic and political conditions encouraging an economic policy in the tax laws to foster investment. Kornhauser, 60 So. Cal. L. Rev. at 411; see also id. at 400, 438-39 (trick was for Congress to encourage investment while maintaining nominally progressive rates, which capital gains preference and tax-free like-kind exchanges accomplished), accord id. at 440-41. The legislative history in Part II confirms that the architects of § 1031 had at least intended for the predecessors to § 1031 and to the corporate reorganization provisions to act as a back-door consumption tax for high income individuals, i.e., reinvest and you won’t be taxed; don’t and you will at least not very high capital gains rates.

The economic efficiency argument too was present in the genesis of § 1031: mere changes in form should not impede business transactions, H.R. Rep. No. 350, 67th Cong., 1st Sess. 10 (1921); 64 Cong. Rec. (Part 3) 2855 (House Feb. 1, 1923) (Remarks of Rep. Green, R-Iowa); Kornhauser, 60 So. Cal. L. Rev. 408 n.25, and underlies the limitation to business or investment property and even more the exclusion ab initio of personal use property. Jensen, 4 AMER. J. TAX POLICY at 213 n.94. However, this rationale too is flawed in that the “like-kind” test actually channels otherwise “locked in” assets only to “like-kind” investments rather than to the best user and uses the betterment mechanism entailing high transactional costs. Jensen, 4 AMER. J. TAX POLICY at 214-15; Kornhauser, 60 So. Cal. L. Rev. at 408 and n.24. Thus, economic efficiency would call for universal rollover. See authorities cited in Kornhauser, 60 So. Cal. L. Rev. at 411 n.31; Bloom, Rollover: An Alternative Treatment of Capital Gains, 41 TAX L. Rev. 383 (1986). In 1987 the Joint Staff’s concern focused on continuity of investment, arguing for a § 1033 standard, to prevent (a) significant alternation of economic position and (b) favoring of real estate with its broadest definition of “like” over personally divided into a host of dissimilar investments. See also Kornhauser, 60 So. Cal. L. Rev. at 409-11. The general mobility of capital argument cuts too broadly in that it would call for a general rollover of asset approach (thus fatally eroding distributional equity as well as vertical and horizontal equity). See Kornhauser, 60 So. Cal. L. Rev. at 410. And if incentives for investment are desired—and advisable—better techniques can be designed. Id. at 449-50 (IRA-like 90-day rollover technique).

The House Ways & Means Committee in 1987 modified the Joint Staffs’ alternative of proscribing real estate from § 1031 exchanges by capping at $100,000 the amount of gain from a like-kind exchange of real estate (other than involuntary conversions and exchanges of principal residences) any taxpayer could have deferred in any one taxable year (presumably responding to the outcry liberal application of the like-kind standard to real estate and possibly to fact that most of the abuse was here). H.R. 3445, 100th Cong., 1st Sess. § 10105 (1987). The Committee looked as much at deferral at high income levels as at the traditional continuity of investment criterion (economic similarly to cash or property not of a like-kind). H.R. Rep. No. 391, 100th Cong., 1st Sess. 1039 (1987). Probably the former concern relates to the distributional equity of the 1986 Code. However, the 1987 House bill attracted significant attention from real estate professionals who launched an active and successful lobbying effort against the measure. 15 J. REAL EST. TAX’n at 267. Such distributional and special interest group concerns are matters of tax politics more than policy. Here too the picture is mixed. Governor Clinton’s primary income tax theme in the 1992 Presidential Campaign was “fairness” or increasing individual income taxes only on the rich. Restricting the scope of like-kind exchanges of investment and business real estate surely would have that effect. On the other hand President Clinton’s goal was to couple rate increases at the top with “offsetting incentives to invest.” See Lee, President Clinton’s Capital Gains Proposals, 59 TAX NOTES 1399, 1410 n.62 (June 7, 1993). Similarly while real estate interests successfully opposed in 1987 the $100,000 cap on deferred gain in § 1031 exchanges of real estate and the 1989 extension of the § 1033 standard to real estate exchanges under § 1031, at the time such exchanges were highly touted as the only intact individual real estate preference with the repeal of any capital gains preference and imposition of § 469’s Passive Activity Loss disallowance rules. OBRA 1993 restored a substantial capital gains preference and carved out from PAL real estate losses of those in the industry. See Lee, supra. Thus the political case of the real estate sector is weakened. (As an aside, it would have made better policy and politics to have used the revenues from restricting § 1031 to help pay for the PAL changes rather lengthening the depreciable life of real estate so much.)

Commentators and the courts themselves agree that the trend in judicial interpretation of § 1031 (as to “exchange” and “holding” as well as the like-kind standard as to real estate) has been liberal. See Bryce, supra 56 Tul. L. Rev. at 38 (citing Starker); Note, Section 1031 Nonrecognition of Gains for Deferred Exchanges—Starker v. United States, 16 WAKE FOREST L. Rev. 645, 650-53 (1980); Starker v. Comm’r, 602 F.2d 1341, 1352 (9th Cir. 1979). The above discussion shows that the like-kind deferral of investments from its inception was based on benefiting private interests (helping businesses
and high income individuals maintain their capital while maintaining the "facade of progressive rates") especially as to like kind exchanges of investments, and indisputably in 1987 and 1989 was maintained as a preference for private interests. Some but not all academic writers believe that in such circumstances special interest legislation should be strictly construed. I would apply this "strict construction" notion to exchanges of investment property. To the contrary the liberal § 1031 "exchange" judicial precedents, coupled with the regulation's broad classification ab initio of all real estate as "like" long firmly emblazoned in the case law, violate both sound tax policy—economic efficiency (tax rules encourage real estate swaps over other swaps and sales); horizontal equity (disparate treatment of taxpayers holding investment real estate and swapping real estate while diversifying risk), and vertical equity (benefits concentrated in high bracket taxpayers). A rationalized post-Liski Records SORISOU test applied under §§ 1031 and 1033 (probably more liberally under the latter) to all types of property would help maintain continuity of investment/business characteristics parallel to unrealized appreciation in non-exchanged property.

IV. Proposed Modifications to § 1031 Standard

I respectfully urge this Subcommittee to revise the § 1031 standard for exchange to the SORISOU standard of §1033 because the current generosity to voluntary real estate exchanges violates sound tax policy and comes from tainted historical origins as to investment property swaps. More importantly I implore it not to just adopt the § 1033 "similar or related in service or use" standard (perhaps with a "like kind" standard exception for involuntarily converted real estate), but instead address in the legislative history how a standard comparing risk and management activities (and any other appropriate factors) should be applicable in voluntary and involuntary exchanges.16 Congress should direct in revised §§ 1031 and 1033 (or combined into a single section covering voluntary and involuntary conversions and exchanges) implementation of such policies through revenue rulings which would evolve into regulations employing a "structured discretionary justice" approach. Detailed regulations promulgated by an administrative agency, here Treasury and the Service, increase the principled discretion of the agency as a decision maker, according to Professor Davis' landmark book "DISCRETIONARY JUSTICE – A PRELIMINARY INQUIRY" and subsequent administrative law scholarship.17 Moreover, Professor Davis posits that such detailed rules channeling agency exercise of discretion can develop from first considering one concrete problem at a time, announcing the hypothetical cases as rulings and refraining from generalizing; then fashioning generalized principles or standards from this experience; and finally formulating regulations to implement the standard in the form of structured discretion.18

* On another thought, the narrower the range of permitted exchanges under revised § 1031, the stronger the case for permitting reinvestment within a stated period (say 90 days) of cash proceeds in qualifying replacement property under such revision.

Most importantly the Subcommittee should take advantage of this opportunity and address in the legislative history known problems under §§ 1031 and 1033 including the areas set forth below. The cast of players in the following hypotheticals include A who holds the "exchange property" and B, the other party to the exchange who holds the "replacement property", except in some 3 or 4 cornered or party exchanges, and who always winds up holding the exchange property.

J. Built-to-Suit. A's transfer of real property in exchange for B's construction of improvement on other property held by A does not qualify under § 1031. Bloomingston Coca-Cola Bottling Co. v. Comm'r, 189 F.2d 14 (9th Cir. 1950); Wasserman, supra 65 Taxed at 979; P.L.R. 8701015. What if to avoid these tax results, B makes the improvements on parcel X, not previously owned by A, and then exchanges improved parcel X for a parcel of real estate (usually unimproved) held by A. OK. J. H. Baird Publishing Co. v. Comm'r, 39 T.C. 608 (1962), acc. 1963-2 C.B. 4 (A picked parcel X); accord, Coastal Terminal, Inc. v. United States, 320 F.2d 333 (4th Cir. 1963). B is not entitled to like-kind treatment on exchange of parcel X. Rev. Rul. 75-291, 1975-2 C.B. 332. For

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16 In involuntary conversions but not voluntary exchanges difficulty of replacement could and should be a factor. See Davis v. United States, 589 F.2d 449, 450 (9th Cir. 1979). Similarly construction of improvements on already owned property might qualify in an involuntary conversion but all of the current built-to-suit techniques for like-kind exchanges might be denied deferment in a voluntary exchange.

17 Davis, DISCRETIONARY JUSTICE, A PRELIMINARY INQUIRY, at 103 (LSU Press 1969); see also Marshaw, BUREAUCRATIC JUSTICE, MANAGING SOCIAL DISABILITY CLAIMS 103-22 (Yale Univ. Press 1983); Leo, Structured Discretionary Justice Under Section 351, 44 TAX NOTES 1029, 1030 (August 28, 1989). An agency issuing regulations (rule making) setting forth specific factors to be used in balancing tests implementing the desired standards and policies can implement standards effectively while maintaining the desirable bureaucrat's discretionary judgment in application. Id at 1032.

18 Leo, supra note 17 at 1032.
a perverse § 1031 flip-flop here by Government see Barker v. United States, 668 F. Supp. 1199 (D.C. Ill. 1987) (Government argued for like-kind exchange). When if A locates and negotiates for property to be acquired? OK. Copple v. Comm'r, 52 T.C. 394, 405-09 (1969), acqu. in result only. Overseen improvements on land to be acquired? J.H. Baird, supra. See generally Guerin, A Proposed Test for Evaluating Multi-Party Like Kind Exchanges, 35 Tax L. Rev. 545, 612 (1980); Rev. Rul. 75-291, 1975-2 C.B. 332. A 1980s ploy was for A to sell high basis parcel X to B, who concurrently contracted with A to build the improvements and then to transfer improved tract X to A in exchange for A's low basis (usually unimproved) parcel Y. Again B does not qualify for deferral under § 1031. Goldstein & Lewis, supra 5 REV. OF TAX'N OF ENDV'N'S at 207. But A does, so long as risk of economic loss as to parcel X + B between acquisition and exchange. P.L.R. 7823035 (B bears the fundamental risk of ownership of, the property and of the construction to take place thereon); accord, P.L.R. 8217106 (“including, but not limited to, liability for real estate taxes or for obligations under the loan or construction agreements, and Corp A will not be entitled to any income, insurance proceeds or condemnation proceeds prior to the exchange date.”); Goldstein & Lewis, supra 5 REV. OF TAX'N OF ENDV'N'S at 207. Query, was risk of loss truly on B? See Wasserman, supra 65 TAXES at 980. Also the Eighth Circuit went on similar ways on facts under the step-transaction doctrine. Smith v. Comm'r, 537 F.2d 972 (8th Cir. 1976). What if B does not buy parcel X, but instead becomes tenant on a 30-year ground lease? See Wasserman, supra 65 TAXES at 980-81; 1984 Tax Shelter Hearings, supra at 159 (Statement of Professor Martin Ginsburg). If B is related to the taxpayer, new problems emerge. The deferred exchange regulations contemplate built-to-suit exchanges. Treas. Reg. § 1.1031(k)-1(e)(3)(i) and (iii). Congress should provide that if the improvements are made on property owned by A within the last previous 2 years, an exchange of that property back to A will not qualify under § 1031.

In Davis Regulator Co. v. Comm'r, 36 B.T.A. 437, 443 (1937), the Board relying on remedial nature of the predecessor to § 1031 permitted tax-free reinvestment of the proceeds of an involuntary conversion of a leasehold interest in improved real estate used in the taxpayer's manufacturing business in construction of a plant to continue business on property already owned by the taxpayer. Accord, Davis v. United States, 389 F.2d 446 (9th Cir. 1979). Contra P.L.R. 8119029. To the contrary, going from raw land used in a cemetery business to construction of an administrative office for the business on retained land did not qualify under the since-discredited "functional or end use" test. United Development Co. v. United States, 212 F. Supp. 664, 667-67 (E.D. Mo. 1962)(Effect of investing in an administration building is to replace the old building and to enhance the remaining property of the corporation; not a replacement of its income producing asset, the condemned land). Please address this in the Report.

2. Purpose for Holding. Problems have arisen as to the purpose for holding when the taxpayer has recently acquired the exchange property (typically in an exchange basis transaction) to exchange it or disposed of the replacement property shortly after the exchange. The "holding requirement" corresponds to the Subchapter C "continuity of interest" doctrine. Therefore, acquiring property for an exchange (at least in a cost-basis acquisition) fails the "holding" requirement. Rev. Rul. 75-291, supra. Conversely, immediate sale of the property received in the exchange may equally cause such replacement property to fail the "holding" test and, hence, the exchange to fail § 1031. See Black v. Comm'r, 35 T.C. 90 (1960); Regents Realty Co. v. Comm'r, 43 B.T.A. 194 (1940), acqu. 1931-1 C.B. 9, aff'd, 127 F.2d 931 (2d Cir. 1942). A 2-year qualified "holding" before and after probably will suffice. See Section 1031 applied to property held two years, 61 J. TAX'N 224 (Oct. 1984). The Tax Court views holding the replacement property for a gift as failing the "holding" test where the "step transaction" doctrine applies. Compare Cich v. Comm'r, 78 T.C. 225, 232-34 (1982)(tax plan to give residences to children plan was completed 7 months after exchange of ranch for residences) with Wegeners v. Comm'r, 74 T.C. 653, 660 (1980)(taxpayer had eventual goal but no "concrete" plans to make gift of replacement ranch property; discussions with tax advisers only after exchange; gift made 9 months after exchange). Clearly a bright-line say 1-year before- and after-exchange holding period as called for by the House in 1989 is infinitely preferable to the current unpredictability. H.R. Rep. No. 247, 101st Cong., 1st Sess. 1339-40, 142 (1989).

3. Taxpayer Involvement in Acquisition of Replacement Property.

Taxpayers understandably often want to play a major part in the acquisition of the replacement property. The taxpayer may want to locate the replacement property and negotiate and (or at least approve) the terms of the replacement property contract and any financing to be secured by the replacement property. See Rev. Rul. 77-297, 1977-2 C.B. 304. However, if a taxpayer is too actively involved, it may appear that B (in a 3-party exchange) or D (the "intermediary" in a 4-party exchange) is acting as the taxpayer's agent. Guerin, supra at 603. Cases have unquestionably allowed the taxpayer to advance money to the exchange "intermediary" towards the purchase price of the replacement property. Biggs
SOIL REMEDIATION COSTS: TAMS, TAXES, TOXINS AND BEYOND

I. Introduction

Treasury's highest regulatory priority is the tax accounting treatment of environmental cleanup costs because it hopes to avoid tremendous litigation costs down the road. 1 The [high-end] estimate of such cleanup costs is in the $1 trillion range over 30 years. 2 I hope that this Subcommittee will take the first steps to head off another costly imbroglio like the amortization of intangibles/Newark Morning Ledger mess Congress just cleaned up after with the § 197-prospective fix. This time Congress has the opportunity to lock the barn door in time to prevent wasteful Government and taxpayer litigation costs over the deductibility of soil remediation costs (and of expenditures with some future benefit in general). From both a policy and political perspective, the proper tax accounting for most taxable waste removal or cleanup costs surely is amortization as self-created intangibles over a stated period. Such costs are substantial which tends to distort income if allowed as a deduction in one year and usually yield a future benefit by permitting business operations to continue. 3 Handy models for such amortization are either

1 Avakian-Martin & Carson, Environmental Cleanup Issue: A Recurring Theme at ARA Meeting, 60 TAX NOTES 925, 926 (August 16, 1993)(Treasury estimate of $1 trillion).
2 JEH Note, Revised Requests Guidance on Proper Treatment of Environmental Cleanup Costs, 93 TAX NOTES 148-23 (July 15, 1993)("trillion dollar" range at 37,000 hazardous waste sites based on Associated Press Release, December 9, 1991). Needs research discussed at such AP release. The actual source appears to be a University of Tennessee study. Butler, UT Researchers Release Report on EPA Superfund, Common News Service (Monday December 9, 1991)(December 6, 1991 University of Tennessee Study, Revised Waste Remediation: The Task at Hand, estimates costs from $500 billion (containing or managing waste in place) to $1.2 trillion (destroy more site contamination, e.g., more remediation) over the next 30 years, with the "best guess" figure being $750 billion (accumulation of current cleanup policies under Superfund, Resources Conservation and Recovery Act, federal facilities, underground storage tanks, waste, and private cleanup efforts); study estimated that it will cost about $111 billion to correct current and future problems at the highly publicized Superfund sites, which could be dwarfed by work needed at more than 37,000 hazardous industrial sites and landfills covered by RCRA; cleaning up leaking underground storage tanks alone could cost $67 billion; and $240 billion needed to clean up DOE's nuclear weapon production facilities). In short the "deductible" cost of cleanup costs paid by taxable entities is likely to be less than $500 billion over 30 years.
3 Environmental Cleanup Guidance May Be Out By July, Official Spt. 1993 DAILY TAX REPORT 89-119 (July 11, 1993) IRS effectively told taxpayers in the TAMS, citing the Wheaton case, that you can't wait until Year 10, bunch your deduction and interest losses, when this large cost is going to have a tax effect over the remaining useful life of the property,' Carlton said."(Note to Chief Counsel, Individual and Tax Accounting, Avakian-Martin). Does the IRS need to clean up its rulings on cleanup costs? 49 TAX NOTES 724, 725 (May 10, 1993);"Lee said the regime properly prevents a taxpayer from deducting costs when a deduction would result in the distortion of income. According to Lee, if a taxpayer is permitted to immediately deduct large extraordinary expenses, such as multimillion dollar
(a) 60 months as Congress usually provides for Government-required environmental, safety-based, etc., capital expenditures such as rapid amortization of pollution control devices4 or coal mine safety equipment (repealed)5, which arguably added no value to the taxpayer's property, or as a compromise between hotly litigated extreme all-or-nothing positions as in § 195, or less likely politically (b) 15 years as new § 197 provides for purchased intangibles. (Such a long period is not needed for revenue neutrality here. Amortization over any period longer than 1 year would generate revenue since cleanup costs appear universally to have been currently deducted or expensed.)6 Where Congress has provided a current deduction for such Government required capital expenditures, as in the costs of removing barriers to the elderly and the handicapped, it has imposed a low cap ($15,000).7 Current deductibility might be appropriate in the case of cleanups of waste sites abandoned or no longer owned by the taxpayer or less likely where the costs exceed the fair market value of the property. I urge this Subcommittee not to stop with cleanup costs, but address as well the looming question of tax accounting for self-created intangibles in general also likely to be a big ticket item in time and money soon if not already.

- Over the past 15 years, Congress has carved out "self-created intangibles" from its capitalization/amortization reforms, viz., §§ 195, 263A and 197. I understand that at least initially a reason for such carve out was preservation of court victories permitting current deduction of expenditures producing intangibles with future benefit won by special interest taxpayers (e.g., banks) under the "separate asset" rubric (recently and fatefuly overruled by the Supreme Court in INDOPOCO). Roughly 1/4 of the 125 "significant issues" in the IRS Industry Specialization Program involve capitalization/amortization versus expense issues. And capitalization issues account for one Code Section (§263) and a subissue under another ($162 of course) out of the 14 Code Sections identified by GAO as accounting for almost half of the 12,000 appealed issues awaiting resolution in court.8 While the revenue now involved in such appeals appears to be at the median, I expect that absent Congressional intervention the revenue adjustments set up and ensuing Government and private sector litigation costs will explode as auditing agents apply INDOPOCO and the capitalization ISPS. I propose an easy fix here too: Congress should authorize legislative regulations to be formulated by the experience the IRS gains from "rulinga" applying capitalization factors which either a code

cleanup costs, this would cause a taxpayer to underestimate income for the year. If large expenditures are incurred every year, or every few years, however, deducting the expenditures would not distort income, Lee maintained. ... Lee argues that cleanup costs do create future benefits because they allow the taxpayer to continue operating its business in future years.

3. This is a largely intuitive assumption supported by anecdotal evidence and the fact that the types of amortizable intangibles challenged by the IRS according to the GAO do not appear to encompass capitalization remediation costs. Government Accounting Office's Report to the Joint Committee on Taxation, Issues and Policy Proposals Regarding Tax Treatment of Intangible Assets (August 9, 1991)Apdx. 1, Taxpayers owned Intangible Assets (Electronic reprinted), 91 TAX NOTES TODAY 169-1 (August 1991). Whether any such revenue should be used to fund a "Member's provision", see Unofficial Transcript of this Subcommittee's Hearings on September 8, 1993, electronically reproduced 93 TAX NOTES TODAY 190-32 (September 14, 1993 (Statement of Chair Rangel)"We have had four hearings that focused on these matters. All of those were the revenue losing issues. ... At this time, we will concentrate on those issues that raise revenue. As those of you who are familiar with the committee are aware Chairman Rostenkowski and our committee have a strong commitment to deficit reduction and responsible fiscal policy and in keeping a long tradition any miscellaneous issue that the committee brings up, the member must offset it by appropriate revenue raising items," as contrasted with a related reason need like funding DOE cleanups, is another question.
4. § 190.
5. GAO, Report to the Chairman, Subcommittee on Oversight, Recurring Tax Issues Tracked by IRS, Office of Appeals (GAO/GGD-93-93-101Br May 4, 1993). Fourteen tax code sections account for almost half of the 12,000 appealed issues awaiting resolution in court. Such sections account for more than half of the $100 billion in proposed adjustments being disputed by corporations, partnerships, estates, and individuals. "We found that 14 tax code sections account for about 45 percent — 5,279 — of those issues and 57 percent — $36 billion — of the proposed adjustment amount." GAO also identified the 53 subsections within the 14 code sections that were most frequently appealed or had the highest dollar amount of proposed adjustments. Section 263A mandating capitalization of capital expenditures was one of the 14. Additionally at least one subsection under Section 162, number of the 14, most controversial among provisions, involved capitalization. "Data also show that issues related to these 14 code sections accounted for an average of 44 percent of all issues resolved or closed by Appeals during fiscal years 1991 and 1992, 52 percent of the proposed adjustment amounts, and 39 percent of the proposed adjustment amounts sustained by Appeals. Further, 53 subsections within these 14 code sections occur the most frequently or accounts for the highest dollar amount of proposed adjustments. Each of the 53 subsections accounts for 1 percent or more of the number of open issues and proposed adjustments for all the issues at stake in addition, data on issues closed in fiscal years 1991 and 1992 show that the 53 subsections represent a disproportionate amount of the open issues and proposed adjustments. About 2/3 of the 327 billion proposed adjustment amounts and 59 percent ($13 billion) of the $21 billion in proposed adjustment amounts sustained by Appeals. Capitalization involved, for between $27,047,000 and $32,232,000 of the $68,000,000 in proposed adjustments under the 14 Code sections (and $29,034,000 in total proposed adjustments) of September 20, 1993 or 20% to 26% of the proposed adjustments under the 14 Code sections. Adjustments under §1231 show that was the 4th largest. The Servic's rate of issues on capitalization was conservatively low, but this data drastic the situation prior to INDOPOCO. Committed writing reviewed by the IRS, benefits that proposed actions would generally be sustained, and I suspect that the IRS rate will rise too will improve greatly current position.
Section or the legislative history would supply.

I have in mind capitalization/expense factors that some Service officials insist is comfortable and are supported by a few "straws in the wind": Wolfson & Land & Cattle Co., v. Comm'r, 72 T.C. 1, 13 (1979); substantially maintenance-type expense [dredging irrigation canal] restoring subject with indefinite life to original operating condition which need be repeated only every 10 years created "a freestanding intangible asset with an amortizable 10-year life."); NCNB Corp. v. United States, 651 F.2d 942, 962-63 (4th Cir. 1981), vacated and remanded on banc, 684 F.2d 282 (4th Cir. 1982). The en banc NCNB decision in turn was overruled by INDOPCO, Inc. v. Comm'r, 112 S. Ct. 1039 (Feb. 6, 1992).

10 424 F.2d 563, 572-73 (Cl. Ct. 1970)(expending small amounts ($500), pursuant to regulatory requirements, did not distort income and burden of capitalizing and amortizing would be great); accord, Shuron v. Comm'r, 66 T.C. 515, 527 (1976), aff'd, 591 F.2d 1273 (7th Cir. 1978), cert. denied, 42B U.S. 941 (1979).

11 582 F.2d 604, 618 (Cl. Ct. 1978)(surveys of oil reserves subject to change at anytime [due to shifting of underground oil and water due to nearby drilling and other factors] used in management planning currently deductible; have to be updated every few years so that useful life very uncertain. "In such circustances, it is not necessary to amortize such a recurring item over a fixed time-interval. Neither is it appropriate to require capitalization without amortization; such a requirement would clearly distort Southland's income."); Encyclopaedia Brittanica, Inc. v. Comm'r, 685 F.2d 212, 215 (7th Cir. 1982)(dictum)(Posner, J.)"practical reason for allowing author's recurring expenditures with future benefit to be currently deductible: (a) hard to allocate among specific book; and (b) "allocating these expenditures among the different books is not always necessary to produce the temporal matching of income and expenditures that the Code disfavors, because the taxable income of the author ... who is in a steady state (that is, whose income is neither increasing nor decreasing) will be at least approximately the same whether his costs are expensed or capitalized. Not the same on any given book-- on each book expenses and receipts will be systematically mismatched-- but the same on the average. Under these conditions the benefits of capitalization are unlikely to exceed the accounting and other administrative costs entailed in capitalization.").

12 Treas. Reg. § 1.162-12(a); see authorities cited in note 10 supra.

13 Official Gossip Update on Series of Guidance on Tax Accounting Issues, 1993 DAILY TAX REPORT 46 (March 11, 1993)(Electronically reproduced)(""As Wolfson pointed out, if the taxpayer had cleaned the PCs every year, it would have been deductible. But if you've waited four or five years, it's not. I gotta draw the line. I've got to say, 'If you do it every second year, you're fine. If you wait six years, it's not.' That's a tough one. I haven't resolved in my mind," he said.) Statement of Glenn Carstensen, Asst. Chief Counsel, Individual and Tax Accounting); accord, Service Pensions Environmental Cleanup Costs: Carstensen Uncertain of Outcome, 93 TAX NOTES TODAY 102-10 (May 12, 1993)(""The TAM found that the cleanup expense was not nearly incidentally because the costs had been accumulating over many years, and that allowing the deduction of the entire cleanup costs in the single year would excessively distort the income in that year. Carstensen admitted that the bulk of the cleanup costs would have been deductible had it been incurred as part of a regular maintenance program."). See authorities cited in note 11 supra. See generally Lens, Start-Up Costs, Section 185 and Close Reflection of Income: A Tale of Tellimens, Taxed-On Tax Reg.'s, and a Touch of Basics, 6 VA. TAX REV. 1, 10-21 (1986); Lens, Doping out the Capitalization Rules After INDOPCO, 97 TAX NOTES 669, 679-83 (November 2, 1992).

14 See authorities cited in note 13 supra; Lens, supra note 13.

15 Service Pensions Environmental Cleanup Costs: Carstensen Uncertain of Outcome, 93 TAX NOTES TODAY 102-10 (May 12, 1993)(""Carstensen said those of the four tests to determine whether a cost is capital are stated in reg. sec. 1.263(a)-1(b): Whether the cost materially increases the value of the property, whether it substantially prolongs the useful life of the property, and whether the costs are necessary to adapt the property to a new and different use. The fourth test is derived from Wolfson Land & Cattle Co. v. Comm'r, 72 T.C. 1 (1979), which says whether the repairs are merely incident to continued operation or are more of a replacement. The TAM found that the cleanup expenses were not merely incident to continued operation because the costs had been accumulating over many years, and that allowing the deduction of the entire cleanup costs in the single year would excessively distort the income in that year. Carstensen admitted that the bulk of the cleanup costs would have been deductible had it been incurred as part of a regular maintenance program."). Lens, supra TAX NOTES at 67-9 (distortion of income should be key to repair but by-and-large repair cases didn't go that way except for Wolfson and Johnson.)
The immediate source of the current controversy over the tax accounting treatment of the costs of toxic waste removal is Technical Advice Memorandum 9315004.14 Years ago the taxpayer there had dumped PCB-contaminated waste, generated by using PCB-laced oil to run its equipment hotter, in pits and trenches on its property out back. About 10 years after the taxpayer’s last such dump, the Environmental Protection Agency sued it, PCBs having turned out to be powerful carcinogens. Pursuant to an agreement with the EPA, the taxpayer began to clean up the toxic waste site, spending millions for remediation, transportation, and disposal of the PCB-contaminated soil. The taxpayer expensed the cleanup costs as a repair cost. Upon audit, the Service ruled in TAM 9315004 that the cleanup costs were not incidental repairs and should be capitalized. In a “surprisingly friendly” manner,17 the TAM permitted the expenditures to be added to the cost of the taxpayer’s piping system and deducted over its remaining useful life.18 Nevertheless, tax lawyers and accountants immediately criticized19 the IRS’ attempt to be “nice”, in the words of one Treasury official. Had he capitalized the costs, he would have added them to the cost of the taxpayer’s land— presumably amortizable over the hopefully billions of years remaining in the Earth’s useful life. This is where I first came in.

Twenty years ago this coming winter while a practitioner, I first began to describe in articles the then inequity in the start up cost area (capitalization of short-lived or recurring expenditures with no amortization) and how that lead some, but of course not all, tribunals to permit a current deduction of such costs under the “separate asset” doctrine.21 My article in THE TAX LAWYER supplied the definition of start-up costs used in the legislative history of § 195.22 (And now that I know about it, I thank you.) But special interests relying on their judicially sanctioned deductions under the “separate asset” doctrine obtained a carve out for business expansions costs in § 195,23 a kind of self-created intangible. I collaborated with Professor Bittker on his treatise in the description of that doctrine in the “Capital Expenditures” section of the Business Expenses Chapter of I B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS,24 which in turn provided the conceptual foundation for the exclusion of self-created intangibles from § 263A as currently deductible.25 Similarly Congress

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18 Avakian-Martin, Does the IRS need to clean up its ruling on cleanup costs?, 59 TAX NOTES 728 (May 10, 1993).
16 Environmental Cleanup Costs Addressed at two ABA Tax Section Meetings, 93 TAX NOTES TODAY 165-7 (August 6, 1993)(“Carrington also said he still finds persuasive the reasoning used in a recent technical advice memorandum concerning the cleanup of PCBs, which relies on the Wolfsen case. He let it slip that in that TAM, the cleanup costs were amortized to the piping system. That fact was blacked out when the TAM was released.”)(Emphasis supplied).
15 Avakian-Martin, Does the IRS need to clean up its ruling on cleanup costs?, 59 TAX NOTES 728-50 (May 10, 1993); Environmental Cleanup Guidance May be Out by July, Official Says, 1993 DAILY TAX REPORT 89 415 (May 11, 1993)(“Carrington said he still finds persuasive the reasoning used in a recent technical advice memorandum concerning the cleanup of PCBs, which relies on the Wolfsen case. He let it slip that in that TAM, the cleanup costs were amortized to the piping system. That fact was blacked out when the TAM was released.”)(Emphasis supplied).
14 Avakian-Martin & Carvone, supra note 1 at 927 (“Kilinski [Treasury official] 5 also said he disagreed with the conclusion in the PEB TAM. According to Kilinski, if the costs in consideration in that TAM should be capitalized, they should be capitalized to the land. The IRS was trying to be ‘nice’ in reaching the conclusion ‘that costs were not capitalized to the land; he said, and yet the IRS still was criticized.’”)
13 Lee, Pre-Operating Expenses and Section 174: Will Supra Fall?, 27 TAX LAW. 381, 390-401 (1974); see also Lee, A Blend of Old Wines in a New Winchell: Section 183 and Beyond, 29 TAX L. REV. 347, 454-64 (1974).
11 See Lee, supra 6 VA. TAX REV. at 79 and n.337.
9 The Senate Committee Report stated that § 263A was not intended “to modify present-law principles governing the determination of whether an expenditure results in a separate and distinct asset that has a useful life substantially beyond the tax year. See Treas. Reg. sec. 1.263A-1(a), (b)(3); Commissioner v. Lincoln Savings and Loan, 403 U.S. 345 (1971). Then, if the costs of producing an intangible item such as goodwill are deductible under current law, such costs will continue to be deductible under...” (Bennett 263A). The uniform capitalization rule merely will prescribe which costs associated with an asset required to be capitalized must be included in its basis or otherwise capitalized. S. Rep. No. 313, 99 Cong., 2d Sess. 141 and n.30 (1986)(emphasis added to text). The Senate provision reached, however, production of intangible property as well as
just a few months ago carved out self-created intangibles from § 197.

The special interests’ victories proved ephemeral, just as one witness warned in the § 195 hearings of the possible expansion of capitalization doctrines in the business expansion area. And so it happened, first with business expansion costs at the circuit court level and then with INDOPCO at the Supreme Court level as to self-created intangibles in general. Enlightened by Professor Gunn’s The Requirements that a Capital Expenditure Create or Enhance an Asset77 discovered in researching for the Bittker Treatise and the case law business expansion cases of the late 1970s and early 1980s and especially Wolfsen Land & Castle and NCNB I, I then described in 1986 in the VIRGINIA TAX REVIEW (1) the conceptual and policy weaknesses of the “separate asset” doctrine in business expansion and elsewhere; (2) developed the minimum distortion of income model for distinguishing ordinary deductions from capital expenditures, set forth above, along with its case law and policy support; and (3) in particular noted the judicial tendency to reject an income distorting “nothing” under capitalization without adequate capitalization and to choose instead an also income distorting immediate deduction.78

I also criticized on a technical basis § 195 far more than with hindsight I would today.79

Last year responding to the post-INDOPCO practitioner panic, the Service announced that it would address INDOPCO in its 1992 Business Plan. I took the opportunity to present my research and minimum distortion of income model in TAX NOTES,80 a copy of which I enjoyed the opportunity of handing to Glenn Carrington, IRS Assistant Chief Counsel, Individual and Tax Accounting, at a Virginia Tax Group meeting about 6 weeks before the TAM was issued. Carrington has said that he “heard about the TAM on the way out the door.”81 I believe that the Service provided in the TAM amortization (over the remaining life of the taxpayer’s piping system it turns out82) in part in order to avoid the all-or-nothing dichotomy (current expense or capitalization without amortization) which was my principal object in writing the article.83 The key rationale of the TAM, that the cleanup expense was not merely “incidental” because (a) the costs had been accumulating over many years and (b) allowing the deduction of the entire cleanup costs in a single year would excessively distort the income in that year was bottomed on the distortion of income notion of Wolfsen Land & Castle.84

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**Tangible personal property.** The earlier Treasury Proposals had excepted (without explanation) from the Uniform Capitalization Rules marketing, selling, and advertising expenses and research and development costs unrelated to particular production activities.

2 TREASURY REPORT TO THE PRESIDENT, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH 207 (1984); THE PRESIDENT’S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY 265 (1985). The Joint Committee Staff had read Lincoln Savings & Loan as adopting “a rule of reason” approach to applying section 263, tacitly acknowledging the impracticability of requiring that every cost with some conceivable future benefit be capitalized. Joint Comm. Staff, Tax-Proposal: Accounting 50 (1985)."Case law has generally adopted a rule of reason approach in applying section 263, tacitly acknowledging the impracticability of requiring that every cost with some conceivable future benefit be capitalized. In Comm'r v. Lincoln Savings & Loan Ass’n, the U.S. Supreme Court stated that capitalization was required under section 263 only if the expenditure serves ‘to create or enhance ... what is essentially a separate and distinct additional asset ...’. The Court held that ‘the regulations [that may have some future aspect] are not controlling,’ noting that ‘many expenses concededly prospective effect beyond the taxable year.’"Xenaphrasing 1 B. BITTER, supra at 20-67 (1st Ed. Warren Gorham & Lambot 1981). The Conference Report attempted to “clarify” with the ill-posed statement “that, in addition to the costs specifically excepted from capitalization under the conference agreement (e.g., research and experimental costs, selling, marketing, advertising, and distribution expenditures) are not subject to capitalization under the uniform capitalization rules.” H.R. Rep. No. 841, 99th Cong., 2d Sess. II-305 (1986). The Bluebook shifted to a new rationale and proves that the parenthetical was meant to close with “experimental costs.”[C]ompliance with the long-term contract regulations under section 471, selling, marketing, advertising, and distribution expense were not intended to be subject to capitalization under these rules. Joint Committee Staff, General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress, Pub. L. 99-314, 100th Cong., 1st Sess. 510 (Comm. Prt 1987). But even more directly, the Conference Bill modified the Senate bill by adding “tangible” as a limitation on produced personal property.


42 See supra 57 TAX NOTES 669.

43 Environmental Cleanup Guidance May Be By July, Official Says, 1993 DAILY TAX REPORT 89 d15 (May 11, 1993)(Electronic Reproduction). This is why he asked for a notation on the public version of the TAM stating that the memo was being reviewed in connection with an IRS study project on environmental cleanup costs. Id.

44 Avdisian-Martin & Caruso, supra note 1 at 926. I had earlier implied that the Service should pick a number, any number, for period of amortization so as to as small taxpayers. Lea, supra 57 TAX NOTES at 683 and note 124.

45 See Lea, supra 57 TAX NOTES at 670, 677; Avdisian-Martin, supra note 3 at 720 (quoting John Lea).

III. Approaches under IRS/Treasury Consideration

Treasury and Service officials are debating "the form the guidance [on INDOPCO] should take - whether rulings, regulations, or legislation - and what position the government ought to adopt with respect to cleanup costs - whether deductible in all cases, capitalize with no recovery, or capitalize it with some sort of recovery." After repeatedly requesting practitioner guidance and receiving about 25 written comments, Treasury officials have outlined several practitioner suggestions under consideration: (1) a series of factual rulings; (2) capitalization of almost all cleanup costs with amortization over a fixed period such as 60 months, and (3) following Generally Accepted Accounting Principles. The Service also has indicated circumstances in which the costs of soil remediation or other expenditures should be currently deductible: (a) prior abandonment of the property, and (b) where the future benefit occurs at some immeasurable point in the future.

1. Factual Rulings to establish "Bright Line" Rules.

One approach is to issue revenue rulings dealing with typical fact patterns establishing bright-line tests. This lends itself best to current deduction situations such as advertising or garden variety repairs. While a few such rulings might account for 75% or so of the cases, they are less likely to reach the grey areas, particularly where capitalization and amortization are appropriate. An underlying problem here is that published Revenue Rulings are generally thought to reflect the Service's understanding of primary authorities, such as Code, Regulations and cases. In the above "straws in the wind" are just that - a few probably destined to be leading cases among a sea of conflicting and often directionless cases. Repair precedent in particular is creaky, with the main exceptions of (a) Mess v. Comm'r, where the Ninth Circuit endorsed currently deducting replacements (repainting and repapering) concentrated in a single year of a 3 to 5 year cycle consistent with Southland Royalty, and (b) Wolfsen Land & Cattle.

2. Fixed Amortization Period.

Practitioners have recommended and the Service is studying establishment of an amortization period until Year 10, bunch your deduction and distort income, when this large cost is going to have a beneficial effect over the remaining useful life of the property,\textsuperscript{59} Carrington said.\textsuperscript{59}

1993 DAILY TAX REPORT 88 423 (May 10, 1993)(Electronically Reproduced)\textsuperscript{(TA)}n administrative solution may not be ideal, Kiliński said. "Frankly, I think the better solution is a legislative solution. We at Treasury would like to work with you to come up with a solution that you can live with, and that gets to the right move," Kiliński said.\textsuperscript{60}


1993 DAILY TAX REPORT 89 415, supra (electronically reproduced)\textsuperscript{61} Inquired whether the result in the TAM would have been different if the taxpayer involved had abandoned the property, Carrington said perhaps, because no future income would exist for matching the expense. "People have argued that the land fill cases are deductible because more or less when you do this land fill, you are closing the door," he said.\textsuperscript{62}

Environmental Cleanup Costs Addressed at two ABA Tax Section Meetings, 93 TAX NOTES TODAY 165-7 (August 6, 1993)("Carrington said a few bright-line tests, suggested by commentators, are stirring interest among government officials. He said one such proposal would permit a deduction, rather than capitalization, of the cost of cleaning up property whenever the taxpayer does not own the land. Another proposal generating interest would permit a deduction for cleanup costs when a taxpayer owns the land but stops production on the land. A third bright-line test, said Carrington, would permit a deduction for remediation costs to the extent that the costs exceed the value of the land. He added that the issues are far from resolved within the government.\textsuperscript{63}

1993 DAILY TAX REPORT 152 64 (August 10, 1993)(Electronically Reproduced)\textsuperscript{64} Carrington, Carrington University of Avalanche, 93 TAX NOTES TODAY 162-6 (May 12, 1993)(Electronically Reproduced); Treasury Official Sees Environmental Cleanup Guidance This Year at Warnrent, 1993 DAILY TAX REPORT 89 415 (May 11, 1993)(Electronically reproduced); Treasury Official Sees Environmental Cleanup Guidance This Year at Warnrent, 1993 DAILY TAX REPORT 88 423 (May 10, 1993)(Electronically reproduced);\textsuperscript{65} Carrington said a few bright-line tests, suggested by commentators, are stirring interest among government officials. He said one such proposal would permit a deduction, rather than capitalization, of the cost of cleaning up property whenever the taxpayer does not own the land. Another proposal generating interest would permit a deduction for cleanup costs when a taxpayer owns the land but stops production on the land. A third bright-line test, said Carrington, would permit a deduction for remediation costs to the extent that the costs exceed the value of the land. He added that the issues are far from resolved within the government.\textsuperscript{68}

IRS to Issue Additional Technical Advice on Environmental Cleanup, Official Says, 1993 DAILY TAX REPORT 152 64 (August 10, 1993)(Electronically Reproduced)\textsuperscript{69} Carrington, Carrington University of Avalanche, 93 TAX NOTES TODAY 162-6 (May 12, 1993)(Electronically Reproduced); Treasury Official Sees Environmental Cleanup Guidance This Year at Warnrent, 1993 DAILY TAX REPORT 89 415 (May 11, 1993)(Electronically reproduced); Treasury Official Sees Environmental Cleanup Guidance This Year at Warnrent, 1993 DAILY TAX REPORT 88 423 (May 10, 1993)(Electronically reproduced); Carrington said a few bright-line tests, suggested by commentators, are stirring interest among government officials. He said one such proposal would permit a deduction, rather than capitalization, of the cost of cleaning up property whenever the taxpayer does not own the land. Another proposal generating interest would permit a deduction for cleanup costs when a taxpayer owns the land but stops production on the land. A third bright-line test, said Carrington, would permit a deduction for remediation costs to the extent that the costs exceed the value of the land. He added that the issues are far from resolved within the government.\textsuperscript{68}

281 F.2d 853, 863 (9th Cir. 1967).
period, such as 5 or 10 years, and writing off the cleanup expenses over that period. The Service recently took a similar approach as to the cost of package design. The question here is whether the industry will sign on to such an approach. With a revenue procedure or ruling format the Service would not be able to require all taxpayers with toxic waste cleanup costs to capitalize and amortize. The likely result, following Treasury's reasoning as to § 197, would be that taxpayers with really questionable deductions would choose capitalization and amortization while the stronger cases would continue to deduct currently. Therefore Congressionally mandated capitalization with amortization is advisable as in § 197 and the 1984 version of § 195.

Additionally some have questioned whether the Service can just pick an amortization period without statutory authority. While it has done so in the past, absence of a statutory mandate surely would lead to many taxpayers ignoring the amortization/ certainty option. This was the case with the original version of § 195.

3.

GAAP.

Another approach is to follow "generally accepted accounting principles" for the tax treatment of cleanup expenditures. But this might not be popular among those seeking current deductions for cleanup costs since GAAP may require capitalization in many cases. The Fourth Circuit panel decision in NCNB I offers a glimpse into the dangers of trying to resolve capitalization/amortization versus expensing by GAAP. There the panel adopted the GAAP hierarchy of expense recognition in descending order of preference: (1) by cause and effect with revenue generated, (2) by systematic rationale, and (3) year of expenditure. This lead to a impermissible allocation between current and future years on actual use, where as amortization of an intangible property properly is straightline for the number of years in the property's useful life.

4. Abandonment

A few bright-line tests, suggested by commentators, are stirring up interest among government officials but are far from resolved. Commentators have suggested that abandonment of the toxic waste property (or whenever the taxpayer no longer owns the contaminated real estate) should give rise to ordinary deduction on the grounds that no future income could exist for matching the expense. A

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41 IRS Said Seeking Bright-Line Tests in Review of Environmental Cleanup TAM, 1993 DAILY TAX REPORT 102 06 (May 28, 1993)(Electronic Reproduction);
42 Rev. Proc. 90-43, 1990-2 C.B. 664, offers taxpayers three alternative methods of accounting for package design costs; (1) capitalization, (2) design-by-design capitalization and 60-month amortization, and (3) post-cost capitalization and 48-month amortization. See Environmental Cleanup Costs Addressed at two ABA Tax Section Meetings, 93 TAX NOTES TODAY 165 7 (August 6, 1993)(Statement of Carrington)("IRS is concerned that many taxpayers would not buy into that system, he said. 'It may help people in the very grey area and other people would continue to do what they're doing and it won't be useful, ... Carrington said.""). Aside whether IRS believes this regulatory authority to 'arbitrarily' require capitalization over a fixed period, such as five years or 10 years, Carrington responded, 'It would be arbitrary, but we've done arbitrary—reasonably arbitrary—things in the past.") See note 33 supra.
43 Service Providers Environmental Cleanup Costs; Carrington Uncertain of Outcome, 93 TAX NOTES TODAY 102 10 (May 12, 1993).
45 See note 42 supra.
46 IRS Said Seeking Bright-Line Tests in Review of Environmental Cleanup TAM, 1993 DAILY TAX REPORT 102 06 (Friday May 28, 1993)(Electronic Reproduction); Environmental Cleanup Costs Addressed at two ABA Tax Section Meetings, 93 TAX NOTES TODAY 165 7 (August 6, 1993)("Third, IRS is exploring the adoption of the presumption that taxpayers would capitalize the expenditures if they already would capitalize them under the rules generally accepted accounting principles, according to Carrington. 'We hear that agents are ruling ad hoc and long term benefits and really causing problems out there and maybe we should look at what you're doing and if you're saying it's capitalized and you're following the GAAP rules maybe that's what we should use. Maybe that's a good bright line test," he said. Carrington acknowledged that normally the GAAP rules do not control the purpose of the tax code, but that IRS would be looking at these rules to see whether they 'are somewhat in line with what we think the law is.").
47 Environmental Cleanup Costs Addressed at two ABA Tax Section Meetings, 93 TAX NOTES TODAY 165 7 (August 6, 1993)
48 611 P.2d at 932-3, 942-43. For a criticism of this notion see Lea, supra 6 V.A. TAX REV. at 20-4, 38-41.
49 Environmental Cleanup Guidance May Be Out By July, Official Sony, 1993 DAILY TAX REPORT 89 415 (May 11, 1993)(Electronically reproduced),"People have argued that the hard fill areas are deductible because more or less when you do this test fill, you are dealing the same," he Carrington said."). Two of the 5 possible factors looked at early by the Service ("(2) whether the property is derived from the natural resources; (3) whether the property which the expenditure relates to generates future income", see Averitt-Mayr, Does the IRS need to clean up its ruling on cleanup costs?, 59 TAX NOTES TODAY (May 10, 1993)), appear related to this notion. These five factors "may or may not be relevant in deciding these issues," he
similar proposal would permit a current deduction for the cost of cleaning up property whenever a taxpayer owns the land but has stopped production on the land. A third bright-line test would permit a deduction for remediation costs to the extent that the costs exceed the value of the land.\textsuperscript{90}

The policy for the abandonment exception is sound and consistent with precedent allowing an ordinary deduction for an abandonment loss. Property sold but for whose cleanup costs the taxpayer is liable (because in the chain of title or did the toxic dumping) fits the policy as well but not the current case law. Such cost would be associated with the sale of the property under both the origin of the claim doctrine for capitalization and if the sale was in a prior year (year 1) under the Arowmssmith doctrine.\textsuperscript{11} Whether the loss is a capital loss or an ordinary loss under conventional analysis turns first on whether the contaminated property was §1231 property. If so, as usually will be the case, then under the view that Arowmssmith provides a fictional sale in year 2, the loss is a §1231 usually ordinary loss but capital loss recapture could apply under the 5-year lookback. In my view Arowmssmith more matches the year 2 character with the year 1 character as the year 1 transaction is backed out by a balancing adjustment.\textsuperscript{12} So if the year 1 sale yielded a §1231 capital gain, at least that gain would be reversed by a capital loss in year 2. Add the fact that a §1231 gain has not been taxed at favorable rates to corporate taxpayers since 1986 but capital losses are treated harshly indeed, and none of this makes much sense as a matter of policy or in general. Some of these results could perhaps by obviated by treating the cleanup cost itself as an intangible asset (\textit{Wolsten Land & Castle}) which then could amortized over the appropriate period (even as short as 1 year if recurring but that would not be the case here). Congressional dictation of the answer on this point is essential.

Cost over value differs. The cost still may so large that current deduction would distort the taxpayer’s income and may yield future benefits in continuation of operations without shutdown by the EPA or whomever. Again the origin of the claim doctrine would seemingly require capitalization adding the cost to the non-amortizable land but treatment as a freestanding amortizable intangible might avoid this. Additionally, the Congressional pattern has been to provide 60-month amortization for mandated capital expenditures arguably providing no direct additional value.

At one time Service considered taking into account whether the property was already contaminated at purchase. Under conventional repair doctrine, making an otherwise deductible repair must be capitalized as an acquisition cost where the taxpayer acquired the property knowing of the defect. From the point of future benefit and income distorting amounts, the pre-existence of contamination is irrelevant. But it would be a factor in any analysis trying to allocate the cleanup costs between the taxpayer’s past operations and future operations since such pre-existing pollution could hardly be related to past operations.

\textbf{IV. Proposed Solutions to Soil Remediation Costs}

As a general prospective rule, by statute all substantial soil remediation costs should capitalized and then amortized over 60-months. Current deduction should be provided by statute for such costs incurred as to abandoned property, etc., as this Subcommittee deems appropriate.

\textbf{V. Proposed Solution to Capital Expenditure/Expense/Amortize of Self-Created Intangibles}

The welcome new spirit of cooperation between the Service and taxpayers and of effecting “rough justice”\textsuperscript{91}—manifested by the IRS National Office developments such as the annual “Business Plan”, release of ISPs, substantive participation by IRS and Treasury Officials in public (tax) conferences, and yet TAM 9315004— as well as the notion of “Re-Inventing Government in the air indicates that the time is ripe for Congress to try a different approach to rule making in an area that affects all business taxpayers big and small. Congress should establish the policies that capitalization is to effect, e.g., minimum distortion of income which would be illustrated in the legislative history to an amendment of § 263 authorizing legislative regulations by factors such as recurring, smallness, or whatever Congress deems appropriate. They could largely be extracted from the cases cited herein. So far this is exactly what Congress did in §385. To avoid the fate and probably complexities of the late\textsuperscript{10}

\textsuperscript{90} IRS Environmental Cleanup Guidelines May Be Out By July, Official Sages, 1993 DAILY TAX REPORT 89 415 (July 11, 1993); Avudaiam-Antin & Carones, ABA Tax Section Meeting: Environmental Cleanup Issues: A Repeating Theme at ABA Meetings, 68 TAX NOTES 925, 926 (August 16, 1993).

\textsuperscript{91} Environmental Cleanup Costs Addressed at two ABA Tax Section Meetings, 93 TAX NOTES TODAY 165-7 (August 6, 1993)(Statement of Carrington).

\textsuperscript{91} See Lee & Murphy, supra note 24 at 484-309.

§ 385 regulations, I propose a model of the Service first implementing the Congressionally sanctioned policies by issuing rulings (PLRs, TAMs, and then "published" rulings), which then would evolve into regulations employing a "structured discretionary justice" approach. All of this probably could be accomplished in a shorter time than the § 385 experience.

Detailed regulations promulgated by an administrative agency, here Treasury and the Service, increase the principled discretion of the agency as a decision maker, according to Professor Davis' landmark book "DISCRETIONARY JUSTICE - A PRELIMINARY INQUIRY" and subsequent administrative law scholarship. Moreover, Professor Davis posits that such detailed rules channeling agency exercise of discretion can develop from first considering one concrete problem at a time, announcing the hypothetical cases as rulings and refraining from generalizing; then fashioning generalized principles or standards from this experience; and finally formulating regulations to implement the standard in the form of structured discretion. The issue of general versus particularized statute and whether to implement through Treasury or Service discretion has been before Congress many times before, particularly in 1921/1923 and 1934. Similarly tax theoreticians, including in the late 50's and

53 Davis, Discretionary Justice, A Preliminary Inquiry, 103 (LSU Press 1969); see also Mashaw, Bureaucratic Justice, Managing Social Disability Claims 103-22 (Yale Univ. Press 1983); Lex, Structured Discretionary Justice Under Section 355, 44 Tax Notes 1029, 1030 (August 28, 1989). An agency issuing regulations (rule making) setting forth specific factors to be used in establishing standards and policies often implement standards effectively while maintaining the desirable bureaucrats' discretionary judgment in application. Id. at 1032.

54 Lex, supra note 53 at 1032.

55 See 1921 Confidential Senate Hearings, supra at 5 (Statement of Dr. T. S. Adams, Tax Advisor, Treasury Dept.; drafting goal of "a rather simple tax law that the average man can understand"). See Hearings on H. R. 6713 before the Sen. Comm. on Finance, 68th Cong., 1st Sess. 7, 57 (1924); statement of A. W. Gregg, Special Ass't to Treasury, "complications come primarily from a complicated policy," including reorganizations. "[T]he bill will cover a given case definitely and certainly. Under the existing law there are hundreds of cases where nobody knows the effect of the transaction upon the tax. This law is definite enough so that the taxpayers will be able to tell the effect of a given transaction ....

56 See Statement of the Acting Secretary of Treasury Regarding the Preliminary Report of a Subcommittee 9-10 (1934): The reorganization provisions are, as the subcommittee states, perhaps the most complicated and difficult to understand of any sections of the law. In addition to their complexity they are to come to the serious objection of being overinclusive. When they were adopted in 1934, the draftsmen attempted to state in minute detail exactly how each step of a reorganization should be treated for tax purposes. Although this method had the apparent advantage of enabling taxpayers and their lawyers to determine in advance exactly how proposed transactions would be taxed, it had the disadvantage of leaving the Department no leeway in the administration of the law. Consequently, State and local authorities could not ascertain what the law really was and the result was technical from a reorganization within the statutory definition, with resultant loss of revenue. The Treasury has sought a number of these cases through the courts, with results on the whole favorable. The courts have attempted to work out the general principles underlying the statute, and to interpret the specific sections in such a way as to carry out the general plan and to prevent avoidance.

In the light of this experience of 10 years, the Treasury has come to the conclusion that the present provisions should be completely redrafted. The purpose should be to express in the statute as simply as possible the general plan for dealing with these transactions, leaving to the Department or in other cases the power to make rules and regulations to supplement it. The draftsmen have already devised a method of drafting involved in this way, with excellent results so far. In the case of complicated subjects of this kind, it is almost impossible for everyone all the ingenious devices which lawyers will devise, and to provide against them expressly in the statute. The more effective plan is to place the responsibility squarely upon the Department administering the law from day to day. It can readily amend its regulations to cover new situations as they arise.

The question then is whether the present provisions should be amended in their entirety before a satisfactory substitute can be found. The committee should carefully consider several problems before this is done. In the first place, depreciation and depletion are now calculated for thousands of corporations on the basis of costs figured under the present reorganization provisions. These sections in general required the new corporation to take the same cost as if the old for depreciation and depletion purposes, even though the assets had greatly increased in value. In the provisions were shortened or increased, many of these taxpayers could and would claim largely increased amounts of depreciation and depletion, with resultant loss of revenue.

In the second place, reorganizations generally have been carried out in connection with the establishment of new business ventures. The result has been that the reorganization provisions would be used for the shareholders, and to be determined by each corporation to establish loans, even though they obtain and retain securities in a new enterprise which is substantially the same as their original investment. Even though it is required that such loans can only be deducted from capital gains, a wide door will be opened to reduction of tax liability. Finally, there are many legitimate reorganizations in which the present general policy of the law is sound ....

For these reasons, the Treasury believes that it would be wise to eliminate completely the exchange and reorganization provisions at this time. The Department is now working upon a substitute for the present provisions, which will be completed as soon as possible. The task is not easy, on account of the complexity of the transactions involved. Until the various alternatives can be carefully studied, and a plan worked out which will work smoothly and safeguard the revenue, it does not appear advisable to abolish completely the present statutory plan. The Department in conclusion, states that the present law would not only yield an additional yield of revenue but is a net loss.

By the time of the 1936 Revenue Act Dr. Roosevelt Magill had been appointed Assistant Secretary of Treasury. Unfortunately in the 1934 House Hearings on Revenue Revision Dr. Roosevelt Magill, representing Treasury, in fact failed to argue forcefully for a "legislative" regulatory approach, of which the 1933 Ways and Means Subcommittee Chairman Hill, D-Wash., was simplex anyway. Treasury instead argued for the status quo, as did public witnesses. Hearings on Revenue Revision 1934 before the House Ways and Means Comm., 74th Cong., 2d Sess. 26-7 (Magill responded that Treasury had
early 60's Harvard's Professors Brown and Surrey, have debated for some time the advantages of
generalized tax statutes, i.e., standards, versus detailed or rules-oriented tax statutes. The recent
majority of students of taxation follow the Surrey school of a more or less generalized tax statute
implemented and amplified, however, through indisputably detailed Treasury regulations, in large part
due to the greater flexibility in amending regulations than statutes in light of developing administrative
and judicial experience under the statute. Notwithstanding conventional wisdom, the case for
agency discretion was never fully made nor the notion of general statute with detailed regulations ever
fairly tested. This Subcommittee in this perhaps inauspicious context (the witnesses' tone is reminiscent
of the 1936 Ways & Means Hearings on the ill-fated Undistributed Profits Tax) has the opportunity to
start a grand experiment. Turn the Treasury and Service loose, with guidance. I trust they will effect
rough justice and substantially cut down on tax controversies in this most controversial of areas.

so re-drafted the regulations that "[w]e have not been able to, because the provisions with respect to reorganizations are so
detailed and specific there is no way for us to interpret them away from their obvious meaning. ... "); 287; 290-91 (capital
structures plus past legal history); 323 (fairness in bituminous industry)(1933).

Mr. HILL. Do you believe it is possible to write a provision in the statute permitting tax-free reorganizations without
opening the door to reorganizations purely for tax exemption purposes?

Mr. MAGILL. It undoubtedly would be a very difficult job, because, as I do not need to tell you, reorganizations are
the most complicated transactions anybody has to deal with.

To write a provision to catch the ones you want to catch and perhaps to let others through that are legitimate
is quite a job. I think that was probably as well done in 1924 as it could have been done. A great deal of thought was
spent on that, and it was done very carefully.

Mr. VINCOUR. We are 9 years past 1924, and we are able to see many doors and outlets through which taxpayers go
so avoid taxes, and it was our purpose to close some of those doors.

Ad. The House Ways and Means Committee permitted only statutory marginal.

57 Brown, An Approach to Subchapter C, 3 TAX REVISION COMPREHEND 1619, 1619-20 (1957)(detailed tax statutes tend
to decongestion and increase in complexity requiring even more intricate elaborations of pattern; fundamental source is attempt
to eliminate the necessity for responsible administration); Survey, Complexity and the Internal Revenue Code: The Problem and
Interpretation of Tax Draft, 24 LAW & CONTEMPORARY PROBS. 695-703, 763-67 (1960)(drafts between generalized and
detailed tax statutes --, backward bill is generalized statute with detailed regulations). Interestingly, the Tax Reform Act
of 1969, which was Sweeney's brainchild, see Law, supra 8 Wn. Tax Rev. at 122 at 346, rarely took this line (Section 265
contains a detailed amendment).

58 E.g. Complexity and the Income Tax, supra note 57 at 346-41. But see R. Cohen, Remarks, 26 Nat'l Tax J. 311-313
(1974). For an occasion, brief discussion of the present pattern, including the "events of all worlds . . . essentially detailed
statutes . . . with broad grants of regulatory authority . . . " , see Brown, The Condition of the Tax Legislative Process, 39 TAX
REVIE 1931, 1936. (June 27, 1960).
Chairman Rangel. Professor Tucker.

Mr. Tucker. When Professor Lee talks about the academic writers all agree—

Chairman Rangel. You are a professor, too.

Mr. Tucker. I am a professor at both Georgetown—I am not a full time professor. I also practice law.

Chairman Rangel. There is a difference.

Mr. Tucker. It may or may not make a difference. I have been teaching the income taxation, real estate transactions since 1970, at George Washington Law School and since 1990, at Georgetown Law School.

Chairman Rangel. Do you agree with Professor Lee?

Mr. Tucker. I also have a two-volume set on the Federal taxation of real estate transactions, published by Cartboard and Callahan, so I think I do have some credentials, OK? I have told them this for years, and I think that—Howard Levine is also an adjunct professor at Georgetown, and I think we have equal credentials with Professor Lee.

I would argue that that test is not too broad. It has been limited over the years by Congress in the deferred like-kind exchange area, foreign property for domestic property and the like, and I think that was too broad a statement, unfortunately.

Mr. Levine. I disagree with Professor Lee. I do not think the question of the continued liberalism of the courts is in issue these days. The IRS published regulations a couple years ago. It was a 1984 amendment. All of this was done to address a liberal trend in the courts.

I don’t think there is that concern now. I don’t think there is a concern on the part of the IRS. I don’t think there is a concern on the part of Treasury. Obviously, there is not. Treasury is opposed to any change because there is no need, there is no necessity to make this change. So I do not agree with the professor.

Chairman Rangel. Well, I think Mr. Lee makes a lot of sense. I mean full Professor Lee makes a lot of sense. I don’t know how this would—how the courts would possibly handle a narrower version. It is a factual question; you leave it up to the court. I don’t see how we can do that.

Mr. Lee. Chairman Rangel, I was not suggesting that we leave it to the courts. I was suggesting that you all, in determining what similar, related in service as used for real estate, for example, should mean, you all should decide it should focus on return, risk, and management activities or whatever other factors you want, and then not leave it to the courts but leave it to the service and then begin with that as a base for ultimately having legislative regs.

They first issue rulings as the facts come up, build up a little experience, then they build it into regs. The problem is right now that under 1033 or even the soil remediation, any of this, you cannot police it with substantial authority. There is enough stuff out there that on a one out of three, any of us can find authority on any side, and therefore people will take any side, and so what we need is more direction and then let the service do what it does best, but with authority.
When I say direction, I am really almost saying authority, and that is what I am really requesting. No, we don't want more litigation. You look at those cases, they haven't done it well.

Mr. Levine. Mr. Chairman, if this change is made, I think all that would be done here is substituting this situation for the amortization of intangibles situation in terms of the amount of litigation that would progress, the amount of the uncertainty, and that cannot be in anyone's interests.

Chairman Rangel. Well, Mr. Jacobs, any questions?

Let me thank the board. On something as important as this, the committee will not be moving until we get the professors back in to help us out on this.

We will break for 10 minutes and then Chairman Jacobs will start with the fourth panel.

Is Mr. Fay here?

Thank you.

[Recess.]

Mr. Jacobs [presiding]. The next panel is already in place. Does anybody want your names called for the record or shall we just proceed? Let's do that. In the order in which you are listed. Maybe you don't have the listing. So let's start with Mr. Fay.

STATEMENT OF KEVIN J. FAY, EXECUTIVE DIRECTOR, ALLIANCE FOR RESPONSIBLE CFC POLICY

Mr. Fay. Thank you, Mr. Chairman.

Mr. Chairman, my name is Kevin Fay, and I am executive director of the Alliance for Responsible CFC Policy. I would like to note for the record that I am not a professor, but my mother loves me just the same, adjunct or otherwise. I will submit my bona fides later, though, if you like.

On behalf of the alliance I am presenting testimony today in opposition to the addition of HCFCs to the existing list of taxable ozone-depleting compounds.

The alliance is a coalition of over 200 companies and industries and associations that produce CFCs, HCFCs and HFCs and products that use these chemicals. I have attached a list. The alliance has been instrumental in promoting an effective global approach to ozone protection, while minimizing costly and ineffective regulations on user industries. We have worked closely with Congress and EPA in developing technically and economically feasible Clean Air Act regulations.

I will summarize our three key points in opposition to this proposal. First of all, HCFCs are to be cautiously encouraged in their utilization. Both the Montreal Protocol and the Clean Air Act Amendments of 1990 encourage the rapid phaseout of CFCs. There is no disagreement among the international community, the Federal Government, and industry that HCFCs are necessary transitional compounds which must be made available in order to achieve this rapid phaseout of CFCs. In fact, the international and domestic policy supports the continued production of HCFCs for these applications on timetables ranging from 2003 to 2030, nearly 40 years.

EPA has worked on approving HCFCs, and in advocating their use has benefited society and industry in this transition. Clean Air