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STATEMENT OF
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BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on the following bills: H.R. 64, which would extend the targeted jobs tax credit to employers who hire displaced homemakers; H.R. 724, which would allow property seized for the collection of taxes to be released to the property owner in certain cases; H.R. 1622, which would exclude from income the value of lodging located in the proximity of an educational institution and rented by the institution to its employees at cost; H.R. 1667, which would allow amortization of certain freight forwarder operating authorities; H.R. 1733, which would allow amortization of bus operating rights; H.R. 2473, which would deny a deduction for amounts paid as restitution or other damages for violations of law involving fraud; H.R. 4575, which would prevent the avoidance of certain pension requirements through the use of leased employees; H.R. 4578, which would require that the full amount of excise taxes imposed on rum produced in the Virgin Islands be covered over to the Virgin Islands; H.R. 4596, which would make certain changes with respect to the Tax Court; H.R. 4597, which would make certain changes relating to the administration of the excise taxes on alcohol, tobacco, and firearms; and H.R. 4603, which would treat certain costs of a private foundation incurred in removing hazardous substances as qualifying distributions under section 4942.

B-574

I will discuss each bill in turn.

H.R. 64

Tax Credit for Hiring Displaced Homemakers

Current Law

Enacted in 1978, the targeted jobs tax credit (TJTC), as most recently amended, is available to taxable employers who hire individuals from any of nine targeted groups. The nine targeted groups are: vocational rehabilitation referrals; economically disadvantaged youths (ages 18-24); economically disadvantaged Vietnam-era veterans; Supplemental Security Income (SSI) recipients; general assistance recipients; economically disadvantaged youths participating in cooperative education programs (ages 16-19); economically disadvantaged ex-convicts; certain work incentive employees (AFDC recipients and WIN registrants); and economically disadvantaged summer youth employees (ages 16-17).

The nonrefundable credit generally is equal to 50 percent of the first $6,000 of wages paid to a member of a targeted group in the first year of an individual's employment with the employer. In the second year, the employer is allowed a 25 percent credit, again limited to the first $6,000 of wages. No credit is allowed for wages paid after the second year of employment with the employer. The maximum credit is thus $3,000 per individual in the first year of employment and $1,500 in the second year. 1/

As originally enacted, the TJTC was scheduled to expire in 1981, but was successively extended in 1981, 1982, and 1984. Under present law, the credit is not available for wages paid to an individual who begins work for the employer after December 31, 1985. H.R. 3838, as passed by the House of Representatives on December 17, 1985, would extend the TJTC for two years, but eliminate the credit for second year-wages and for certain short-term employees. H.R. 3838, as approved by the Senate Finance Committee on May 6, 1986, would similarly extend the TJTC.

Description of H.R. 64

Under H.R. 64, the TJTC would be extended to employers who hire "displaced homemakers." The bill defines a displaced homemaker as an individual who has not worked in the labor force

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1/ For economically disadvantaged summer youths, the credit is equal to 85 percent of up to $3,000 of wages (a maximum credit of $2,550).

for a substantial number of years, but who has provided unpaid services for family members in the home during those years. In addition, the homemaker must either (a) have been dependent on the income of another family member or public assistance and no longer be receiving that income, or (b) be receiving public assistance because of dependent children at home. Under the bill, the TJTC with respect to displaced homemakers would not be subject to a sunset provision.

Discussion

Although the Treasury Department recognizes the problems faced by displaced homemakers attempting to enter the work force, we oppose H.R. 64. In particular, we do not believe that a tax credit for hiring displaced homemakers is a cost effective form of assistance. In addition, we believe that H.R. 64, as presently drafted, is unduly vague and overbroad.

The TJTC would be an effective means of assisting displaced homemakers only if it increased employment opportunities for such individuals. Available data with respect to the TJTC indicate that it has not been an effective subsidy for most targeted groups. Most importantly, the TJTC has been claimed for many individuals who would have been hired even if the credit were not available. In addition, at least one study has indicated that the TJTC actually has served to discourage some firms from hiring members of targeted groups because a stigma attaches to job applicants who are members of those groups.

It is also important to recognize that to the extent that the TJTC is directly responsible for the employment of members of targeted groups, the TJTC may adversely affect employment opportunities for ineligible individuals. The credit may thus result in a reallocation of employment between new targeted members who qualify for the credit and previously employed targeted members who do not, in which case there would be no net increase in targeted employment. Alternatively, there may be an increase in targeted employment, but it may come at the expense of nontargeted, but nevertheless low paid, individuals who are displaced by the targeted individuals.

The TJTC also entails significant revenue costs. We estimate that expansion of the TJTC to include displaced homemakers would lose $539 million in revenue from 1986 through 1991. Such an expenditure is inappropriate for a program whose effectiveness has not been demonstrated. If a subsidy is to be provided to displaced homemakers, the Treasury Department believes that programs that help such persons develop skills to enter and progress in the work place would be more cost effective.

We also note that the definition of a displaced homemaker in H.R. 64 requires clarification to limit the subsidy to economically disadvantaged individuals. By including within the definition of displaced homemaker a person who has been dependent on the income of another family member but who is no longer receiving that income, the bill appears to include persons who are financially secure, such as certain widowed or divorced individuals.

Finally, we believe that any expansion of the TJTC to include other groups should be subject to any sunset provision generally applicable to the TJTC. Unlike direct expenditure programs, tax subsidies such as the TJTC are not required to be reviewed annually as part of the appropriations process (although we recognize that the tax-writing committees may review these matters from time to time). Sunset provisions insure that the usefulness and effectiveness of such programs will be reviewed periodically.

H.R. 724

Property Seized for the Collection of Taxes

Current Law

The Internal Revenue Service generally is authorized under section 6331 to seize the property 2/ of any person who does not pay his taxes within 10 days after notice and demand for payment is made. Under section 6337, personal property that has been seized can generally be returned to the owner only if the taxpayer pays the amount due, together with expenses of the proceeding, prior to the sale of the property. Real property, by contrast, can be redeemed by the owner if the amount due is paid within 180 days of sale.

Before seized property is sold, section 6335(e) requires the Internal Revenue Service to determine a minimum sales price (taking into account the expenses of the seizure and sale) for the property. If no person offers the minimum price at the sale, the property must be purchased at the minimum price by the United States.

Description of H.R. 724

H.R. 724 would permit the Internal Revenue Service to return property seized for the collection of delinquent taxes to the owner if no person offers the minimum price established by the Internal Revenue Service. As under current law, the Internal Revenue Service would determine the minimum price for which the property could be sold (including Internal Revenue Service expenses). In addition, the Internal Revenue Service would

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2/ Section 6334 identifies several classes of property, such as certain personal effects, that are exempt from seizure.

determine whether it would be in the government's best interest to purchase the property at that price. At the sale, the property would go to the highest bidder at or above the minimum price. If no person offered the minimum price, the government could purchase the property at that price, but would not be required to do so if it had previously determined that such a purchase would not be in the government's best interest. Instead, the property could be released to the owner. In such cases, the expenses of the seizure and sale would be added to the property owner's tax liability. H.R. 724 would apply to sales of seized property after December 31, 1984.

Discussion

The seizure and sale of property of delinquent taxpayers are governed by a number of procedural rules. The purposes of these rules are to ensure that the rights of taxpayers are protected, that property is preserved, and that Federal tax liabilities are paid.

In many cases, these purposes are not served by requiring the Internal Revenue Service to expend government funds to purchase property that can not be sold for the minimum price. H.R. 724 would give the Internal Revenue Service the option, but not the obligation, to return seized property to the owner if no bid meets or exceeds the minimum price and if the government has determined that purchase by the government would not be in its best interests. The taxpayer would remain liable for payment of any tax, and in addition would be liable for the costs of the seizure and attempted sale. Thus, the existing incentive for delinquent taxpayers to sell their property and meet their tax obligations before seizure would not be affected. Recognizing the need to expand the Internal Revenue Service's options when seized property cannot be sold, the Treasury Department supports H.R. 724.

H.R. 1622

Lodging Rented by Educational Institutions to Employees

Current Law

Section 119 of the Internal Revenue Code excludes from the gross income of an employee the value of lodging provided by the employer if (1) the lodging is furnished for the convenience of the employer, (2) the lodging is on the business premises of the employer, and (3) the employee is required to accept the lodging as a condition of employment. Several courts have held that on-campus housing furnished to faculty or other employees by an educational institution does not qualify for the section 119 exclusion. Thus, in such cases, the fair rental value of the housing (less any amounts paid for the housing by the employee) is includible in the employee's gross income and constitutes wages for income tax withholding and employment tax purposes.

Schools and universities have argued that special statutory rules should govern the tax treatment of housing furnished to their employees. To allow further time for consideration of such arguments, Congress, in the Deficit Reduction Act of 1984 (DEFRA), prohibited the Treasury Department from issuing, prior to January 1, 1986, any income tax regulations that would treat as income the excess of the fair market value of qualified campus lodging, over the greater of (1) the operating costs paid in furnishing the lodging, or (2) the rent received. This moratorium on regulations was applicable only to qualified campus lodging furnished after December 31, 1983, and before January 1, 1986. Qualified campus lodging was defined as lodging located on (or in close proximity to) a campus of a school, college, or university, and furnished to any of its employees, including nonfaculty employees, or to the employee's spouse or dependents. The moratorium did not apply to any amount for lodging if such amount was treated as wages or included in income when furnished.

Description of H.R. 1622

H.R. 1622 would exclude from the taxable income of an employee of an educational institution the value of lodging located on, or in the proximity of the institution's campus, if the housing is rented to the employee, or to the employee's spouse or dependents, by or on behalf of the institution, except to the extent that the institution's direct operating costs for the lodging exceed amounts paid by the employee for the use of such lodging. This provision would apply to taxable years beginning after December 31, 1972.

Discussion

The Treasury Department believes that both educational institutions and the Internal Revenue Service would benefit if workable valuation rules were established to resolve the continuing disagreements over the treatment of housing provided to employees of educational institutions. Accordingly, the Treasury Department supports the provisions of H.R. 3838, as approved by the Senate Finance Committee on May 6, 1986, and S. 1730, the Senate version of the Budget Reconciliation Act, that establish guidelines for determining the fair rental value of employee housing provided by educational institutions. Under those bills, the fair rental value of lodging provided by certain educational institutions would be treated as no greater than five percent of the appraised value of such lodging for the year in question, provided that an independent appraisal by a qualified appraiser is obtained. Based on available data concerning rent to value ratios, we believe the five percent presumption included in S. 1730 and the Senate Finance Committee version of H.R. 3838 provides a reasonable, if conservative, measure of rental value, and would provide for a fair resolution in this area. 3/

The Treasury Department, however, does not support H.R. 1622, because it does not properly measure (even conservatively) the fair market value of the benefit transferred in the form of employee housing. Many older universities have very low direct operating costs for housing, which in many cases have no relationship to the housing's rental value. Moreover, H.R. 1622 would create a competitive disadvantage for those, typically newer, universities that have relatively high direct housing costs, and would thus be required to charge higher rents in order to avoid imputation of income to their employees.

H.R. 1667

Deduction for Loss in Value of Freight Forwarder Operating Authorities

H.R. 1733

Deduction for Loss in Value of Bus Operating Authorities

Current Law

On July 1, 1980, the Motor Carrier Act of 1980 was enacted to reduce regulation of the interstate motor carrier industry. The Act made it easier for motor carriers to obtain operating authorities from the Interstate Commerce Commission (ICC). The legislative deregulation of the motor carrier industry only applied to motor contract carriers and motor common carriers, and not to freight forwarders.

The activities of freight forwarders are closely related to those of other common carriers; a forwarder takes freight from

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3/ The Treasury Department is concerned with disposition of the unresolved disputes that were created by the uncertain tax treatment of housing of educational institutions' employees during the years that the moratorium on regulations was in effect as well as prior years. In particular, it may be difficult to determine the appraised value of housing for past years. If legislation is enacted along the lines of the provision contained in the Senate Finance Committee version of H.R. 3838 and S. 1730, we would favor an approach for taxable years prior to the date of enactment that would permit educational institutions to rely on the value of the property as assessed by State or local tax authorities for property tax purposes as if it were the value determined by a qualified appraisal.

shippers, usually in small shipments, combines it with freight of other shippers, and sends it via some other carrier, usually a motor common or contract carrier. The ICC, on its own initiative, and concurrently with the enactment of the Motor Carrier Act, substantially reduced entry restrictions for freight forwarders. As a result of this legislative and administrative easing of regulation, the value of operating authorities held by motor carriers and freight forwarders has declined.

Similarly, the Bus Regulatory Reform Act of 1982 (enacted on November 19, 1982), by deregulating the intercity bus industry, substantially eased entry into the intercity bus business. As a result of deregulation, the value of bus operating authorities has declined.

Under section 165(a) of the Code and the regulations thereunder, a deduction is allowed for any loss incurred in a trade or business that is evidenced during the taxable year by a closed and completed transaction and fixed by an identifiable event. The amount of any deduction allowed may not exceed the adjusted basis of the property involved. No deduction is allowed, however, for a mere decline in value of property. These rules have been applied by the courts to deny deductions for the diminution in value of an operating permit or license in circumstances closely comparable to those presented by the reduced regulation of interstate freight forwarders and intercity bus operators.

After the interstate motor carrier industry was legislatively deregulated, Congress enacted section 266 of the Economic Recovery Tax Act of 1981 (ERTA) as a special relief provision for taxpayers who held motor carrier operating rights at that time. Under that provision, a taxpayer who held one or more motor carrier operating authorities on July 1, 1980 is allowed a deduction ratably over a 60-month period for an amount equal to the aggregate adjusted basis of all motor carrier operating authorities held by the taxpayer on July 1, 1980 or acquired pursuant to a binding contract in effect on July 1, 1980. The 60-month period begins with the month of July 1980 (or, if later, the month in which the operating authority was acquired), or, at the election of the taxpayer, the first month of the taxpayer's first taxable year beginning after July 1, 1980. The term "motor carrier operating authority" is defined as a "certificate or permit held by a motor common or contract carrier of property and issued pursuant to subchapter II of Chapter 109 of title 49 of the United States Code." Section 266 of ERTA provides no relief for taxpayers that held operating authorities as freight forwarders. Similarly, no special provision has been enacted to provide relief to holders of intercity bus operating authorities.

Description of H.R. 1667

H.R. 1667 would amend section 266 of ERTA to define the term "motor carrier operating authority" to include a certificate or permit held by a freight forwarder. The amount of the deduction would equal the aggregate adjusted basis of all freight forwarder operating authorities held by the taxpayer on that date or acquired subsequently under a binding contract in effect on July 1, 1980. Thus, the bill would allow an ordinary deduction ratably over a 60-month period for taxpayers who held freight forwarder authorities on July 1, 1980. The bill would be effective for taxable years ending after June 30, 1980.

Description of H.R. 1733

In a manner similar to H.R. 1667 and section 266 of ERTA, H.R. 1733 would allow an ordinary deduction ratably over a 60-month period for taxpayers who held one or more bus operating authorities on November 19, 1982, the date the intercity bus industry was legislatively deregulated. The amount of the deduction would be the aggregate adjusted bases of all bus operating authorities that were held by the taxpayer on November 19, 1982, or acquired after that date under a binding contract. The bill would limit the aggregate deduction to $5 million per taxpayer. For purposes of the $5 million limitation, a corporation that is a member of an affiliated group would be treated as a separate taxpayer. Special rules would be provided to allocate basis to bus operating authorities in cases in which a corporation acquired stock in another corporation that held bus operating authorities. The bill would be effective for taxable years ending after November 18, 1982.

Discussion

The Treasury Department opposes H.R. 1667's extension of the special amortization rule provided by section 266 of ERTA to freight forwarders, and also opposes the similar rules that would be provided for holders of bus operating authorities under H.R. 1733. The Treasury Department opposed the enactment of section 266 of ERTA and similarly opposes any attempt to expand its reach further for several reasons. First, the special amortization rule provided by section 266 of ERTA is inconsistent with the general principle of Federal income taxation that gains are taxed and losses deducted only when those gains or losses are fixed by an identifiable event. In the case of gains or losses attributable to property, this typically occurs upon the sale, exchange or other disposition of the property. Permitting a current deduction for a decline in the value of assets prior to disposition, while not taxing unrealized gains, is contrary to our present system of taxation and sets an unfortunate precedent.

Second, we noted in 1981 that even though the deregulation of the trucking industry caused a decline in the value of the operating rights of motor carriers, those rights continue to have value, since the ICC continues to require a taxpayer to secure such rights in order to conduct a trucking business. We pointed out that if special tax relief was to be given to affected motor carrier operators, the proper amount of the loss deduction would be the excess of the taxpayer's basis in the operating rights over the post-deregulation value of those rights, not the full amount of the taxpayer's basis in the operating rights.

It should also be emphasized that the deregulation of motor carriers (including freight forwarders) and intercity bus operators is not materially different than any other regulatory action that causes a diminution in value of a license or operating right. Other industries, most notably the airline industry, have been deregulated without the grant of special tax relief for any reduction in value of the assets. Thus, while it may be difficult as a matter of tax policy to draw meaningful distinctions between the deregulation of motor carriers, freight forwarders, and bus operators, if H.R. 1667 and H.R. 1773 are enacted, other deregulated industries may seek similar relief.

Additionally, with respect to H.R. 1773, we are concerned that treating members of an affiliated group of corporations as separate taxpayers for purposes of the $5 million limit would create an unwarranted distinction between a parent corporation that purchased (before November 19, 1982) a controlling interest in a single subsidiary holding multiple bus operating authorities and a parent corporation that purchased (before November 19, 1982) multiple subsidiaries that each held a single bus operating authority. Similarly, an unwarranted distinction would exist between a corporation that acquired bus operating authorities directly, and one that acquired operating authorities indirectly by purchasing the stock of corporations already holding operating authorities. In both cases, more favorable treatment would be given to the affiliated group that had more members holding operating authorities. Accordingly, we oppose the provision of H.R. 1773 that treats members of an affiliated group as separate taxpayers for purposes of the $5 million limit.

H.R. 2473

Denial of a Deduction for Amounts Paid as Restitution or Other Damages for Violations of Law Involving Fraud

Current Law

Section 162(a) of the Code allows a deduction for all ordinary and necessary expenses paid or incurred in carrying on a trade or business. Prior to 1970, several court cases disallowed deductions for payments that were believed to frustrate public policy by encouraging unlawful conduct. In 1969, Congress enacted section 162(f) of the Code, which provides that no deduction shall be allowed as an ordinary and necessary business expense for any fine or similar penalty paid to a government for the violation of any law, and section 162(g) of the Code, which denies a deduction for two-thirds of treble antitrust damages paid by a taxpayer who has been convicted of a criminal violation of the antitrust laws or has had accepted a plea of guilty or nolo contendere to an indictment or information charging such a violation. Legislative history to these provisions indicates that they were "intended to be all inclusive." S. Rep. 91-552, 1st Sess., p. 274 (1969). Thus, payments for compensatory and punitive damages made to defrauded parties have been held to be deductible as an ordinary and necessary business expense, since they do not fall within the language of section 162(f) or (g).

Description of H.R. 2473

H.R. 2473 would deny a deduction for any payment for restitution or other damages to a party injured by fraud if the taxpayer making such payment is convicted of a violation of law involving fraud, or the taxpayer's plea of guilty or nolo contendere with respect to such a violation is entered or accepted in any proceeding. The bill would apply to amounts paid after May 15, 1985, in taxable years ending after such date.

Discussion

The Treasury Department opposes H.R. 2473 for several reasons. 4/ First, we believe disallowance of a deduction for restitution payments misconceives the historical purposes of restitution. The legal remedy of restitution is intended to prevent unjust enrichment. Thus restitution is required where a person benefits by reason of an infringement of another person's interests, or by reason of another person's loss. Although restitution may in some cases deter misconduct and compensate an aggrieved party for a loss suffered, those are not its primary concerns. A given set of circumstances may give rise to both an obligation to make restitution and liability for other damages or penalties.

4/ The Office of Management and Budget has advised that time limitations have precluded it from advising on the relationship of H.R. 2473 to the program of the President. Consequently, the views expressed on this bill are solely those of the Treasury Department. The Subcommittee may wish to solicit the views of the Justice Department regarding the bill's possible impact on areas of concern to that department.

The tax treatment of restitution payments under current law is consistent with these principles. The unjustly enriched party includes the original receipt in gross income and is entitled to a deduction when restitution is made. The offsetting inclusion and deduction corresponds to the party's economic position, since the party required to make restitution retains no economic gain. If a deduction were denied for the restitution payment, the requirement of restitution would, contrary to its historical purpose, entail a significant financial penalty.

Similarly, the purpose of compensatory damages is to compensate a party that has been injured by the wrongful act of another. Compensatory damages are not intended to punish the wrongdoer, although that would be their effect if a tax deduction were denied. As a matter of tax policy, we believe it is inappropriate to deny categorically a deduction for payments not intended as penalties.

Where the law intends to punish a wrongdoer, it either imposes a fine or penalty payable to a government or imposes punitive damages payable to the injured party. In the case of penalties payable to a government, a deduction is denied under current law. On the other hand, current law denies a deduction for punitive damages only in the narrowly defined case of treble antitrust damages under section 4 of the Clayton Act. There, the class of actions and the amount of damages subject to the disallowance rule is clearly specified by statute. Although there may be other situations where it would be appropriate to deny a deduction for punitive damages, we would oppose H.R. 2473 even if it were limited to payments of punitive damages. H.R. 2473 would apply to any violation of law involving fraud, which would leave substantial uncertainty as to the class of actions affected. Our views might be different with respect to a narrowly drawn bill, where the violations of law intended to be covered and the public policies at issue could be carefully considered.

Finally, because H.R. 2473 would have the effect of imposing penalties indirectly through the tax law, the Treasury Department opposes the retroactive effective date in H.R. 2473.

H.R. 4575

Preventing the Avoidance of Certain Pension Requirements Through the Use of Leased Employees

Current Law

Section 414(n) of the Code provides that if an employer uses the services of a leased employee, that leased employee is generally considered an employee of the employer for purposes of certain pension plan requirements. A leased employee is generally an individual who is not technically an employee of the employer, but who has performed, on a substantially full-time basis for at least a year, services historically performed by employees in the employer's business field. An individual will not be considered a leased employee, however, unless his or her services are performed pursuant to an agreement between the employer and the company leasing the individual to the employer. In addition, an individual will generally not be considered a leased employee if the company leasing the individual to the employer covers the individual under a money purchase pension plan providing immediate participation and 100 percent vesting and at least a 7 1/2 percent nonintegrated contribution rate. The pension plan requirements for which a leased employee is considered an employee are generally: nondiscrimination, vesting, the top-heavy rules and the limitations on contributions and benefits.

Section 414(n) of the Code was intended to prevent avoidance of the rules governing qualified pension plans through leasing of employee services. The typical factual scenarios involved an employer leasing individuals to perform rank and file services, rather than hiring such individuals as employees. For example, a doctor could lease nurses and other staff personnel. Before the enactment of section 414(n), a qualified retirement plan could be established that applied to the doctor but not to the leased nurses or staff. Since the doctor technically had no other employees, such a plan would not be discriminatory. Section 414(n) addressed this problem by generally deeming the leased employees to be employees of the employer for purposes of certain requirements including nondiscrimination.

Description of H.R. 4575

H.R. 4575 would modify section 414(n) of the Code in several respects. First, H.R. 4575 would repeal the rule generally providing that an individual is not a leased employee if the leasing company provides the individual with a 7 1/2 percent contribution under a money purchase pension plan. Second, H.R. 4575 would eliminate the current law rule that an individual will not be considered a leased employee unless the services the individual performs for the employer are pursuant to an agreement between the employer and the leasing company. Third, H.R. 4575 would provide that an employer could not use the historically performed test to avoid having an individual characterized as a leased employee if a substantial amount of the same type of service was performed for that employer by at least one individual during each of the previous three years. Finally, H.R. 4575 would require that regulations be issued that minimize the recordkeeping requirements of section 414(n) of the Code in the case of an employer using nonemployees for only a small portion of its workload and only on a short-term basis.

Discussion

The Treasury Department supports H.R. 4575 with one important reservation that is discussed below. First, we support repeal of the rule providing that an individual is not a leased employee if the leasing company provides the individual with a 7 1/2 percent contribution under a money purchase pension plan. The 7 1/2 percent rule of current law allows a substantial amount of the discrimination permissible prior to the enactment of section 414(n). In other words, if a leasing company provides the required 7 1/2 percent contribution, the lessee employer can provide its highly compensated employees with a much greater contribution and or benefit. For example, an employer could provide its highly compensated employees with a contribution equal to 25 percent of compensation, <u>and</u>, in some cases, a benefit under a defined benefit plan as well. Because the 7 1/2 percent rule allows substantial discrimination of this type, we support its repeal in H.R. 4575.

The Treasury Department also agrees with the bill's elimination of the requirement of an agreement between the employer and the leasing company. This requirement serves little purpose. Almost by definition, there is an agreement of some form in any commercial transaction.

The Treasury Department also supports modification of the requirement that, to be a leased employee, an individual must perform services historically performed by employees in the employer's business field. Although we believe that the requirement serves an important function, we recognize that due to its vagueness, it has been abused in certain instances. For example, some employers interpret the term "business field" so narrowly that their business is unique and, thus, it is only their own experiences that determine whether services have historically been performed by employees. This narrow interpretation enables such businesses to avoid section 414(n) altogether if they have always leased their staff. Rather than modify the historically performed test, H.R. 4575 provides an alternative rule under which the historically performed test need not be satisfied if, during the prior three years, a substantial amount of the same type of service was performed for the employer by at least one individual. We support this general approach, since it accomplishes objectives similar to those intended by the historically performed test, but in a way that is more administrable and less susceptible to abuse.

Finally, the Treasury Department supports the general intent of the requirement that regulations be issued minimizing the recordkeeping requirements for certain employers. We recognize that for certain employers that do not engage in the type of practices which gave rise to section 414(n), the social value of strict adherence to all the requirements of section 414(n) may be outweighed by the administrative costs of such strict adherence. It is appropriate to reduce the burdens on such employers.

We believe it appropriate also to extend relief to employers who use a relatively small number of nonemployees on more than a short-term basis. In general, we would support a provision to minimize the burdens of section 414(n) for an employer if (1) it does not have any top-heavy plans, and (2) nonemployees performing extended service for the employer constitute only a small percentage of the employer's total workforce. In addition, rules should be developed that allow employers to determine with little burden the number of employees performing extended service. We believe such rules are consistent with the spirit of H.R. 4575.

For example, we believe that it would be appropriate to allow sampling of the workforce. Also, employers should generally not be required to assemble data from geographically separate divisions with regard to common nonemployees. Finally, we would expect that agreements between employers and leasing companies would require the leasing companies, which generally maintain detailed records, to provide their customers with the data necessary to determine if the customer qualifies for the relief. With these developments, we believe that the number of nonemployees performing extended service may be identified with relatively little burden.

In summary, we believe that H.R. 4575 modifies section 414(n) in such a way as to achieve its original purpose more effectively. H.R. 4575 would eliminate certain inappropriate means of avoiding leased employee status. At the same time, H.R. 4575 would better focus the burdens imposed by section 414(n) on the employers whose practices were the basis for Congress' original action. Thus, we support the purposes of the bill.

H.R. 4578

Excise Taxes Imposed on Rum Produced in the Virgin Islands

Current Law

The United States has long imposed an excise tax on distilled spirits produced domestically or imported from abroad. Section 7652 of the Code imposes a special excise tax on articles, including distilled spirits, coming into the United States from the Virgin Islands (and Puerto Rico). This tax is equal to, and in lieu of, the tax that would be imposed if the articles were produced in the United States.

Section 7652 of the Code since 1954 has required the United States to pay over to the Treasury of the Virgin Islands the excise tax it collects with respect to articles produced in the Virgin Islands. This covering over of excise taxes into the territorial treasury corresponded to a similar system that was introduced for the benefit of Puerto Rico in 1917, when that jurisdiction faced a loss of customs revenues because of the disruption of trade caused by World War I.

In addition, section 7652 of the Code requires the United States to pay over to the Treasuries of the Virgin Islands and Puerto Rico, in accordance with a formula prescribed by the Secretary of the Treasury, the excise taxes it collects with respect to rum imported into the United States from foreign countries. This additional cover-over was enacted in 1983 to protect those jurisdictions from potential revenue losses they might have faced as a result of the removal of the duty on rum coming into the United States from Caribbean countries.

The excise tax on distilled spirits produced in or imported into the United States is imposed at a rate of $12.50 per proof gallon. The tax rate was increased to that amount from $10.50 per proof gallon on October 1, 1985 by the Deficit Reduction Act of 1984 (DEFRA). When it increased the rate, DEFRA specifically provided that the cover-over of the excise tax to the Virgin Islands and Puerto Rico should be limited to the prior-law amount of $10.50 per proof gallon.

Description of H.R. 4578

H.R. 4578 would require the United States to cover over to the Treasury of the Virgin Islands the full amount of the $12.50 per proof gallon distilled spirits excise tax imposed upon Virgin Islands rum brought into the United States.

Discussion

For the reasons discussed below, the Treasury Department believes that it is inappropriate to increase the amount of the rum excise taxes covered over into the Treasury of the Virgin Islands. We therefore oppose H.R. 4578.

DEFRA's explicit limitation on the amount of the distilled spirits excise tax that would be covered over resulted from basic policy concerns with the excise tax cover-over program. One such concern is that the program creates artificial incentives for the government of the jurisdiction receiving the cover-over to encourage either actual or apparent increases in the local production of the particular product which generates the excise tax.

For example, prior to DEFRA, the Government of Puerto Rico had initiated a redistillation program whereby spirits originally distilled in the United States were transported to Puerto Rico and redistilled there, after which they were returned to the United States for marketing. Because this redistillation was considered to be Puerto Rican production, the Puerto Rican Government received all of the excise taxes collected by the United States with respect to these redistilled spirits. The Puerto Rican Government was able to use part of this covered-over amount to subsidize the costs of U.S. distillers who participated in this program.

Whereas the Puerto Rican redistillation program sought an artificial increase in local production in order to generate increased excise tax cover-overs, the Virgin Islands Government has subsidized the local production of rum with a comparable result of higher cover-overs. In particular, the Virgin Islands subsidizes the purchase of molasses by local distillers and reduces their Virgin Islands tax liabilities.

The existence of such subsidies raises serious policy questions as to the advisability of the excise tax cover-over as an approach to providing assistance to the territories. The absence of any comparable cover-over to State governments of excise taxes imposed on articles produced within their States results in disadvantages to U.S. producers who are competing in the U.S. market with their subsidized Virgin Islands competitors.

Both the House and the Senate, in their consideration of DEFRA, proposed various methods of addressing these policy concerns. The House bill specifically prohibited the cover-over of tax collected on redistilled spirits, and it proposed a more general limitation on the cover-over of tax collected on products that either were subsidized by the territorial governments or were produced without a significant amount of local production.

The Senate bill also eliminated the cover-over with respect to redistilled spirits. Instead of a more general limitation on the cover-over with respect to subsidized products or products that failed the local value-added test, however, the Senate proposed the specific dollar limitation on the cover-over of excise taxes collected with respect to distilled spirits. In adopting this approach, the Senate Finance Committee Report states: "At the present time, the Committee decided not to address the overall question of whether cover over of Federal excise tax revenues to Puerto Rico or the Virgin Islands is appropriate in any circumstances when those revenues are not similarly covered over to the States."

The compromise that emerged from the Conference Committee drew upon the approaches of both bills. It retained that part of the House bill that limited cover-overs with respect to products that were locally subsidized or failed the local value-added test, but it did not include distilled spirits in these limitations. Instead, it retained that provision of the Senate bill that limited the cover-over of the excise tax on distilled spirits to the prior-law rate of $10.50.

The Treasury Department does not believe it would be appropriate to disturb the 1984 compromise by increasing the amount of the cover-over of excise taxes on Virgin Islands rum to reflect the $2.00 increase in the excise tax that was enacted in 1984. It is clear from the 1984 legislative history that Congress believed the practice of covering-over should not be expanded, even in light of an increase in excise taxes, absent a thorough examination of the overall issue of cover-overs. The serious policy concerns that existed in 1984 with respect to the practice of covering-over remain just as strong today. In particular, we are troubled by the tendency of the territorial governments to use these dedicated taxes to subsidize industries which then compete in the U.S. market with domestic producers who are unable to obtain any comparable subsidy from their State governments. We do not believe that any increase in the Federal excise tax rate should necessarily be an occasion for a windfall to the territorial governments by virtue of the cover-over program. Finally, we would note that the policy concerns troubling us are equally applicable to the Virgin Islands and Puerto Rico, and we see no reason to distinguish between the two jurisdictions for this purpose.

H.R. 4596

Changes With Respect to the Tax Court

Current Law

Salaries and Benefits of Judges and Special Trial Judges

Section 7443(c) of the Code provides that Tax Court judges receive their salary at the same rate and in the same installments as judges of the United States District Courts. Under section 7447, a Tax Court judge who agrees to perform judicial duties if recalled by the chief judge of the Tax Court may elect to receive retired pay. A Tax Court judge forfeits all rights to retired pay, however, if he or she accepts civil office or employment under the United States Government (other than as a retired Tax Court judge) or performs legal or accounting services in the field of Federal taxation or renegotiation of Federal contracts. By contrast, District Court judges who resign and engage in the practice of law continue to receive their full retirement pay.

Section 7443(d) provides that Tax Court judges receive necessary traveling expenses and expenses actually incurred for subsistence while traveling on duty and away from their designated stations, subject to the same limitations that apply to the United States Court of International Trade.

The salaries of special trial judges of the Tax Court are established by section 225 of the Federal Salary Act of 1967 (2 U.S.C. 351-361), as adjusted by section 461 of Title 28, United States Code. On average, their salaries equal approximately 90 percent of those of Tax Court judges, but they are not required by law to be determined by reference to the salaries of the Tax Court judges. The rules for reimbursement of special trial judges for travel expenses and per diem allowances are provided in subchapter 1 of chapter 5 of Title 5, United States Code, under rules that are less generous than those applicable to Tax Court judges.

United States Marshals

United States marshals are the security force for the Federal judiciary, and are required to attend any sessions of United States District Courts, United States Court of Appeals, and the United States Court of International Trade, at the discretion of the respective courts. Although United States marshals sometimes attend Tax Court hearings when requested to do so, they are not required by statute to attend Tax Court hearings.

Additions to Tax

Section 6214(a) grants the Tax Court jurisdiction to "redetermine the correct amount of a deficiency." Because additions to tax for late payment of the amount shown on any tax return under section 6651(a)(2) are based upon the amount shown on the return rather than upon deficiency, the Tax Court has held that it does not have jurisdiction over such additions to tax. In Estate of Young v. Commissioner, 81 T.C. 879 (1983), the Internal Revenue Service determined a deficiency in estate tax, an addition to tax for late filing of the estate tax return, and an addition to tax for late payment of the amount shown as tax on the return. The Tax Court concluded that it had jurisdiction to decide the deficiency and the addition to tax for late filing, but not the addition to tax for late payment since it was not related to a deficiency.

Certification of Interlocutory Orders to the Courts of Appeals

District Court judges may certify interlocutory orders to the United States Courts of Appeals pursuant to 28 U.S.C. section 1292(b). Relying upon the applicable statutes, several courts have held that interlocutory orders certified by the Tax Court are not appealable under 28 U.S.C. section 1292(b), which by its terms is limited to orders of District Courts. Additionally, Rule 5 of the Federal Rules of Appellate Procedure, which sets forth the procedures for appeals under 28 U.S.C. section 1292(b), specifically does not apply to review of Tax Court decisions.

Description of H.R. 4596

Salaries and Benefits of Judges and Special Trial Judges

H.R. 4596 would provide that special trial judges would receive a salary at a rate equal to 90 percent of the rate for Tax Court judges, and in the same installments as such judges. Accordingly, special trial judges would be compensated at a rate equal to 90 percent of the salary of District Court judges. H.R. 4596 also would provide that special trial judges would receive the same expense allowance for travel and subsistence as Tax Court judges.

In addition, H.R. 4596 would amend section 7447(b) of the Code to provide that any Tax Court judge who meets certain age and service requirements may make an irrevocable election to receive 60 percent of retirement pay and would not forfeit such pay if he or she performed certain legal or accounting services or failed to perform judicial duties when recalled by the chief judge of the Tax Court.

United States Marshals

H.R. 4596 would require the United States marshal for any district in which the Tax Court is sitting, when requested by the Chief Judge of the Tax Court, to attend any session of the Tax Court in such district.

Additions To Tax

H.R. 4596 would amend section 6214 of the Code to give the Tax Court jurisdiction over any addition to tax. Thus, the Tax Court would have jurisdiction over an addition to tax for failure to pay the amount of tax shown on the return.

Certification of Interlocutory Orders to the Courts of Appeals

H.R. 4596 would provide that when any Tax Court judge states in an interlocutory order that a controlling question of law is involved with respect to which there is a substantial ground for difference of opinion and that an immediate appeal from that order may materially advance the ultimate termination of the litigation, the United States Court of Appeals may, in its discretion, permit an appeal to be taken from such order. Application must be made within ten days after the entry of such order. Neither the application nor the granting of an appeal shall stay the Tax Court proceedings unless a stay is ordered by a Tax Court judge or by the United States Court of Appeals that has jurisdiction of the appeal or by a judge of that court.

Discussion

Salaries and Benefits of Judges and Special Trial Judges

The Treasury Department supports the provisions of H.R. 4596 dealing with salaries and benefits for special trial judges. Setting the salaries of special trial judges as a percentage of the salaries of the Tax Court judges would accomplish two objectives. It would allow all judicial salaries of the Tax Court to be determined in the Internal Revenue Code by a single reference to the salaries of the judges of the United States District Courts, and it would ensure a fixed percentage differential between the salaries of the Tax Court judges and special trial judges.

The Treasury Department also agrees that special trial judges should be reimbursed for travel expenses at the same rate as Tax Court judges. Special trial judges travel extensively, often to hear regular Tax Court cases as well as the small tax case proceedings to which they are assigned. It is unfair to reimburse them for such travel at a lower rate than that applicable to Tax Court judges.

With respect to retired pay, the Treasury Department believes that Tax Court judges should be able to undertake other employment and continue to receive their retired pay just as United States District Court judges are permitted to do under current law. The position of Tax Court judges in the judicial system is similar to that of United States District Court judges--both are trial judges whose decisions are appealable to the United States Courts of Appeals. In our view, they should receive similar compensation. Indeed, as described above, Tax Court judges are paid a salary, pursuant to statute, at the same rate as District Court judges. We see no reason to provide Tax Court judges 60 percent of their full pay upon retirement when, under the same circumstances, District Court judges would receive 100 percent of their retired pay. 5/ Consequently, while we

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5/ We recognize that the number of retired Tax Court judges available to perform judicial duties constitutes a relatively high proportion of the Tax Court bench, and that the Tax Court faces a substantial backlog. We do not believe, however, that such circumstances, which are beyond the control of the judges, justify a decreased level of retirement pay.

recognize the provision of H.R. 4596 that would provide 60 percent of retirement pay to judges who accept other employment or refuse to accept judicial duties is an improvement over current law, we recommend that the provision be extended to provide retirement pay to Tax Court judges on the same basis as District Court judges.

<u>United States Marshals</u>

The Treasury Department believes there is a need for United States marshals to provide assistance to the Tax Court at its sessions. Although the United States Marshal Service generally agrees to provide such assistance, there have been occasional incidents in which the United States marshal of a particular district has questioned whether the rendering of such service was within the scope of his duties. The safety of Tax Court judges and the importance of smooth and orderly Tax Court hearings make it important that the United States marshals be authorized by statute to provide protection to the Tax Court. Although we thus agree with the intent of H.R. 4596, we prefer the approach taken in the Administration's comprehensive United States marshal proposal, introduced as H.R. 4001, which would in part grant the United States Marshal Service plenary responsibility for providing assistance to all Federal courts, including the Tax Court.

<u>Additions to Tax</u>

We believe that it is desirable for a taxpayer to be able to have an entire tax dispute resolved in one forum. Accordingly, the Treasury Department supports giving the Tax Court jurisdiction over additions to tax under section 6651(a)(2).

<u>Certification of Interlocutory Orders to the Courts of Appeals</u>

In most instances, Tax Court procedures correspond to procedures in the United States District Courts. There are situations in which permitting the appeal of Tax Court interlocutory orders could promote the prompt and efficient pretrial determination of the underlying litigation, thereby conserving the resources of the litigants and the Tax Court. Because we believe the purpose of the Interlocutory Appeals Act of 1958, which added section 1292(b) to Title 28 of the United States Code, was to avoid unnecessary judicial proceedings, and thereby increase efficiency, we support extension of the interlocutory appeals procedure to orders of the Tax Court.

H.R. 4597

Changes Relating to the Administration of the Excise Taxes on Alcohol, Tobacco, and Firearms

Current Law

Forfeiture of unregistered firearms

Weapons governed by the National Firearms Act are subject to seizure and formal forfeiture procedures, both judicial and administrative, if they are not registered. Such weapons include sawed-off shotguns and rifles, machine guns, mufflers and silencers, and destructive devices, such as bombs, grenades, mines, rockets, and large caliber weapons such as mortars, antitank guns, and bazookas. Property valued at more than $2,500 that has been seized for a violation of the internal revenue laws must be forfeited in an _in rem_ proceeding in a Federal district court located in the district in which the seizure is made. A formal complaint must be filed and a public notice of the pending action must be published in a newspaper with general circulation. If the property that is seized is valued at $2,500 or less, forfeiture proceedings are pursued administratively. Under the administrative procedures, the property must be appraised by three disinterested persons and notice of seizure must be published for three weeks in a newspaper. Any person interested in property so seized may file a claim and bond for costs in the amount of $2,500 in order to transfer the forfeiture proceeding to the appropriate United States District Court for judicial proceedings. If no such claim and bond for costs are filed, the property is forfeited administratively.

Property must be stored in the judicial district in which it is seized. If the Bureau of Alcohol, Tobacco, and Firearms (BATF) does not have storage facilities in that particular judicial district, then BATF must locate other storage facilities within the district for such items.

Place for registering firearms business and filing tax returns

On July 1, 1972, pursuant to Treasury Department Order No. 221, the administration and enforcement of the internal revenue laws relating to distilled spirits, wine, beer, tobacco and certain firearms was transferred from the Internal Revenue Service to BATF. Under section 5802 of the Code, importers, manufacturers, and dealers in firearms must register with BATF in each internal revenue district in which they carry on business. Under section 6091(b) of the Code, all tax returns must be filed in an internal revenue district or at an Internal Revenue Service Center serving an internal revenue district. No separate rules are provided for the excise taxes administered by BATF.

Description of H.R. 4597

Forfeiture of unregistered firearms

H.R. 4597 would eliminate formal forfeiture procedures, both judicial and administrative, involving unregistered National Firearms Act weapons. The owner or a person interested in the seized property would be permitted to submit a claim for the value of such property by establishing that the firearm was not involved or used in violation of law, or that any unlawful involvement or use had been without the owner's knowledge or consent.

The bill also would permit the storage of property seized for judicial forfeiture outside the judicial district in which it is seized. The place of storage would be determined by the Special Agent in charge of the particular district, taking into account what is convenient and appropriate.

Place for registering firearms business and filing tax returns

Finally, H.R. 4597 would require that importers, manufacturers, and dealers in firearms register with BATF in each State in which they carry on a business, rather than in each internal revenue district in which they carry on a business. H.R. 4597 also would permit the Treasury Department to provide by regulation for the filing of tax returns with BATF rather than with the Internal Revenue Service.

Discussion

The Treasury Department supports the provisions in H.R. 4597.

Forfeiture of unregistered firearms

Whether forfeiture proceedings are judicial or administrative, the process can be time consuming and costly because of the requirements for appraisal and publication of notice of seizure. Such an expenditure of time and money does not serve any useful purpose in the case of unregistered firearms, because the person from whom an unregistered firearm is seized cannot lawfully regain possession. The Supreme Court held in United States v. Freed, 401 U.S. 601 (1971), that unregistered firearms cannot be returned to the person from whom the firearms were seized because to do so would immediately place the person in violation of the law against possession of an unregistered firearm.

A procedure similar to that set forth in H.R. 4597 already requires the summary forfeiture of controlled substances such as drugs or narcotics that have no accepted medical use or have a high potential for abuse. 21 U.S.C. section 881(f). As with unregistered firearms, such controlled substances cannot be legally possessed by anyone, and thus formal forfeiture proceedings would be pointless. Accordingly, the Treasury Department supports the elimination of formal forfeiture procedures for unregistered firearms.

As to storage of property, the lack of storage facilities in certain judicial districts is a major problem for BATF. Many BATF field offices cover more than one judicial district. When BATF does not have a storage facility in the district in which the property was seized, investigative time is lost and additional costs are incurred because BATF must locate and utilize commercial storage facilities or other government storage facilities. Consequently, we support the provision in H.R. 4597 that would allow a centralized storage facility to be used to store property seized in different judicial districts within the jurisdiction of the field office.

Place for registering firearms business and filing tax returns

The revised filing requirements contained in H.R. 4597 merely reflect the transfer of the administration and enforcement of the internal revenue laws relating to distilled spirits, wine, beer, tobacco and certain firearms from the Internal Revenue Service to BATF. These changes would result in consolidation of administrative and enforcement functions within BATF and thus in greater efficiency. Consequently, we support this change.

Distilled Spirits, Wine and Beer

In addition to the specific provisions of H.R. 4597, the Subcommittee also requested testimony on (i) the tax treatment and labeling of non-alcoholic and alcohol-free beer and wine, and (ii) whether a wholesaler should be civilly or criminally liable for selling distilled spirits, wine or beer to any retailer, unless the retailer has furnished the wholesaler the identification number appearing on the current special tax covering the place where the business is conducted.

We understand that the BATF has agreed with the Subcommittee to testify regarding the tax treatment and labeling of non-alcoholic and alcohol-free beer and wine on May 19, 1986. Consequently, we will not at this time discuss this issue.

We will, however, discuss the special tax on certain retailers. Under section 5121 of the Code, a special occupational tax is imposed on retail dealers in distilled spirits, wine, and beer. The amount of the tax is generally $54 per year for dealers in distilled spirits and wine, and $24 per year for beer dealers.

The Treasury Department is aware of compliance problems regarding payment of the special occupational tax. In response to these problems, the Treasury Department submitted to the Congress a legislative recommendation that would impose a monetary penalty on wholesalers who sell distilled spirits, beer, or wine to retailers who have not furnished proof that the special tax has been paid. We continue to support that recommendation.

Since this legislative recommendation was made, however, we have met with industry representatives regarding their concerns with our approach. At that time, the wholesalers offered several alternative methods of improving compliance with the special occupational tax. We are now studying the industry's concerns and alternative solutions, and considering whether the proposed bill can be improved. We look forward to working further with the Subcommittee and the industry to determine the best approach to the problem.

Proposed Technical Changes

The Treasury Department also would like to note its support for certain additional technical changes regarding administration of the laws applicable to alcohol, tobacco, and firearms, that the BATF has identified and sent to the Ways and Means Committee. Although these changes are not included in H.R. 4597 and are thus beyond the scope of this hearing, the Treasury Department believes that they would clarify existing law in a number of technical areas where either confusion or the need for more regulatory authority has been identified by BATF.

H.R. 4603

Treatment of Costs of a Private Foundation in Removing Hazardous Substances as Qualifying Distributions

Current Law

Section 4942 of the Code in effect requires a private nonoperating foundation to make qualifying distributions at a specified minimum level by imposing an excise tax on the difference between qualifying distributions and such minimum level. Qualifying distributions include direct payments made to public charities or private operating foundations to accomplish charitable purposes. To avoid the section 4942 excise tax, a private nonoperating foundation must make qualifying distributions by the end of the following year, at least equal to five percent of the fair market value of its net investment assets for the year, less the tax imposed by section 4942. In general the section 4942 tax is equal to 15 percent of the excess of this minimum payout level (the distributable amount) over the amount of qualifying distributions as of the first day of the second (or any succeeding) taxable year.

Description of H.R. 4603

H.R. 4603 would reduce the minimum payout requirement of a private foundation under section 4942 by amounts paid, incurred or set aside by the foundation for removal or remedial action with respect to a hazardous substance released at a facility that was owned or operated by the foundation. This provision would apply to taxable years beginning after December 31, 1982.

Discussion

The Treasury Department opposes H.R. 4603 because it is inconsistent with the purpose of the minimum payout requirement. In addition, current law adequately protects the interests of private foundations with regard to costs incurred for the removal of hazardous substances. Section 4942 was enacted to require private foundations to distribute a minimum portion of their assets for charitable purposes. Enactment of H.R. 4603 would hinder this purpose by permitting noncharitable expenditures to reduce the amount required to be spent for charitable purposes. Moreover, under current law, payments made to discharge legal obligations generally are deductible in computing the fair market value of a foundation's net investment assets. Thus, payments required by law for removal or remedial action with respect to a hazardous substance currently reduce the amount that the foundation is required to distribute for charitable purposes. H.R. 4603 in effect would give foundations a double deduction for amounts expended for removal or remedial action with respect to a hazardous substance released at a facility owned or operated by the foundation.

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This concludes my prepared remarks. I would be happy to respond to any questions.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE May 12, 1986

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,037 million of 13-week bills and for $7,012 million of 26-week bills, both to be issued on May 15, 1986, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing August 14, 1986			26-week bills maturing November 13, 1986		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	6.05%	6.23%	98.471	6.09%	6.37%	96.921
High	6.07%	6.25%	98.466	6.11%	6.39%	96.911
Average	6.07%	6.25%	98.466	6.10%	6.38%	96.916

Tenders at the high discount rate for the 13-week bills were allotted 67%.
Tenders at the high discount rate for the 26-week bills were allotted 31%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 45,105	$ 42,105	$ 27,780	$ 27,780
New York	23,153,835	5,717,060	20,218,995	5,758,295
Philadelphia	29,690	29,690	19,045	19,045
Cleveland	53,660	50,690	28,490	28,490
Richmond	47,260	47,260	42,330	42,330
Atlanta	40,985	36,860	58,760	32,210
Chicago	1,709,790	375,290	1,584,185	423,125
St. Louis	72,795	52,795	55,295	35,295
Minneapolis	34,455	21,155	17,900	14,450
Kansas City	57,540	55,735	60,460	60,460
Dallas	46,255	36,255	24,160	15,710
San Francisco	1,557,915	209,175	1,570,885	205,555
Treasury	363,200	363,200	348,855	348,855
TOTALS	$27,212,485	$7,037,270	$24,057,140	$7,011,600
Type				
Competitive	$23,922,225	$3,747,010	$20,688,430	$3,642,890
Noncompetitive	1,179,435	1,179,435	861,525	861,525
Subtotal, Public	$25,101,660	$4,926,445	$21,549,955	$4,504,415
Federal Reserve	1,683,915	1,683,915	1,600,000	1,600,000
Foreign Official Institutions	426,910	426,910	907,185	907,185
TOTALS	$27,212,485	$7,037,270	$24,057,140	$7,011,600

An additional $20,090 thousand of 13-week bills and an additional $26,715 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-575

TREASURY NEWS
partment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE UPON DELIVERY EXPECTED AT
10:45 A.M., MAY 13, 1986

Statement by the Honorable James A. Baker, III
Secretary of the Treasury
before the
International Trade Subcommittee of the
Senate Finance Committee
and the
International Finance and Monetary
Policy Subcommittee of the
Senate Banking Committee

May 13, 1986

Mr. Chairman, I welcome this opportunity to discuss the Administration's approach in dealing with large U.S. trade deficits, particularly as they reflect problems relating to the exchange rate system and the debt situation in the developing countries. Before I begin, let me offer my congratulations to the Finance Committee for successfully completing work on a major bill of fundamental tax reform.

The Administration recognizes and shares congressional concerns about the impact of exchange rate volatility and LDC financial difficulties on the international competitive position of American industry, agriculture, and labor. We have been, and are, actively pursuing a comprehensive strategy to address this problem. I am pleased to be here today to describe our approach and to encourage your support for it.

Last September, the President presented a comprehensive trade policy action plan. Our approach includes four critical elements: strengthening the functioning of the international monetary system through closer economic cooperation; promoting stronger and more balanced growth among the major industrial nations; improving growth in developing nations with a heavy debt burden; and last, but not least, ensuring that trade is not only free but also fair and promoting open markets world-wide. It is our belief that this is the preferred path to reducing the U.S. trade deficit and will have long-range positive effects on the U.S. economy and world stability.

Today, my remarks will focus on the progress we have made in implementing the President's trade strategy and restoring this country's competitive position. In this context, I will offer some perspective on the agreements reached at the Tokyo Summit last week. I understand that Ambassador Yeutter will appear before you tomorrow to testify on one key aspect of our trade strategy, aggressive participation in a new round of trade negotiations.

Progress and Opportunities

We are making significant progress in establishing the fundamental conditions necessary to achieve and maintain a sound and growing world economy, more balanced trade positions, and greater exchange rate stability.

- o The Plaza Agreement last September has resulted in exchange rate relationships that better reflect underlying economic conditions. The Japanese yen and German mark have now appreciated more than 60 percent from their recent lows in February 1985. The dollar has more than fully offset its earlier appreciation against the yen; and it has reversed three-quarters of its appreciation against the mark.

- o The Plaza Agreement also contributed to movement toward stronger, more balanced growth among the major industrial countries, including policy commitments to that end. Efforts to fulfill those undertakings are ongoing. The favorable economic convergence which was the focus of the Plaza Agreement is being realized, with consequent narrowing of the "growth gap" between the U.S. and its major trading partners.

- o Inflation has been cut sharply and is expected to stay low, in part reflecting the effects of the sharp reduction in oil prices. This has facilitated a substantial reduction in interest rates and enhances prospects for further declines.

- o We now expect the deterioration in our trade position to halt this year, and we look forward to substantial improvement next year. Exchange rate changes take time to work their way through our economic system, as businesses and consumers gradually adjust their plans. Next year, as the impact of these changes is more fully felt, with assistance from the decline in oil prices, our trade and current account deficits should drop below $100 billion, or nearly one-third below our projections as recently as last autumn.

- o The U.S. has launched a major initiative to strengthen the international debt strategy. Our proposals for growth-oriented reforms in the debtor countries have gained wide support and have begun to be implemented.

o Preparations are well advanced for launching the new round of multilateral trade negotiations, with a Ministerial to be held this September. Our Summit partners agreed in Tokyo to the U.S. proposal that the new round should include services and trade related aspects of intellectual property rights and foreign direct investment.

Still, problems remain. The scars of a decade of economic turmoil are deep, and they cannot be easily or quickly erased. The distortions to our economies from the oil shocks, rapid inflation and the recessions of the 1970s and early 1980s have required us increasingly to address structural problems that demand time to correct. Unemployment remains high in many countries, and large domestic and external imbalances persist.

Uncertainties about the future behavior of exchange rates have also been prevalent, reflecting deficiencies in the international monetary system that gradually intensified over the years. We know also that the debt problems of the developing world, accumulated over a decade or more, cannot be resolved in a few short months.

And we know protectionist pressures remain strong. We recognize the need to address related problems -- in our monetary system, in our arrangements for international economic cooperation, in the developing countries -- if we are to contain those pressures and work toward more open and fair markets.

The progress that has been achieved in the general economic environment, however, provides a golden opportunity to resolve these remaining problems. Success inspires confidence that we can go further. At the Tokyo Summit, President Reagan and the heads of the other major Free World democracies manifested the political will and leadership to confront the tasks that remain.

Strengthening International Economic Policy Coordination

The Plaza Agreement and subsequent coordinated interest rate reductions evidenced the willingness and ability of the major industrial countries to cooperate more closely on their economic policies. At the same time, experience of the past year demonstrated that exchange rate changes alone could not be relied upon to achieve the full magnitude of adjustments required in external positions. It had become increasingly more apparent that closer coordination of economic policies will be required to achieve the stronger, more balanced growth and compatible policies necessary to reduce the large trade imbalances that remain and foster greater exchange rate stability. For this purpose, we went to Tokyo seeking to build upon the framework embodied in the Plaza Agreement and to establish an improved process for achieving closer coordination of economic policies on an ongoing basis. I believe we succeeded.

The international monetary arrangements that have been in place since the early 1970s contain a number of positive elements, particularly a necessary flexibility to respond to economic shocks. However, this flexibility went too far, allowing problems to cumulate and countries to pursue policies without adequately considering the international dimensions of their decisions. The agreement reached at the Tokyo Summit seeks to combine needed flexibility with a greater liklihood that remedial action will be taken to deal with problems before they reach disruptive proportions.

The arrangements that were adopted involve a significant strengthening of international economic policy coordination aimed at promoting non-inflationary growth, adoption of market-oriented incentives for employment and investment, opening the trade and investment system, and fostering greater exchange rate stability. Details of the new procedures will, of course, have to be worked out in subsequent discussions. However, I see the enhanced surveillance process working as follows:

<ins>First</ins>, the measures for use in assessing country goals and performance will be agreed upon by the countries participating in the enhanced surveillance process. As stated in the Tokyo communique, a broad range of indicators would be utilized in order to achieve the comprehensive policy coverage necessary to insure that the underlying problems, not just the symptoms, are addressed. These indicators would include growth rates, inflation rates, unemployment rates, fiscal deficits, current account and trade balances, interest rates, monetary growth rates, reserves, and exchange rates.

<ins>Second</ins>, each country will set forth its economic forecasts and objectives taking into account these indicators.

<ins>Third</ins>, the group would review, with the Managing Director of the International Monetary Fund, each country's forecasts to assess consistency, both internally and among countries. In this connection, exchange rates and current account and trade balances would be particularly important in evaluating the mutual consistency of individual country forecasts. Modifications would be considered as necessary to promote consistency.

<ins>Fourth</ins>, in the event of significant deviations in economic performance from an intended course, the group will use best efforts to reach understandings on appropriate remedial measures, focusing first and foremost on underlying policy fundamentals. Intervention in exchange markets could also occur when to do so would be helpful.

As you know, countries have been developing individual economic forecasts for years. Moreover, the IMF consults with individual countries on a regular basis regarding their economic policies and performance. What is new in the arrangements adopted in Tokyo is that the major industrial countries have agreed that their economic forecasts and objectives will be specified taking into account a broad range of indicators, and their internal consistency and external compatibility will be assessed. Moreover, if there are inconsistencies, efforts will be made to achieve necessary adjustments so that the forecasts and objectives of the key currency countries will mesh. Finally, if economic performance falls short of the intended course, it is explicitly agreed that countries will use their best efforts to reach understandings regarding appropriate corrective action.

The procedures for coordination of economic policy were further strengthened at the Summit. A new Group of Seven Finance Ministers, including Canada and Italy, was formed in recognition of the importance of their economies. At the same time, the Group of Five has agreed to enhance its multilateral surveillance activities.

In sum, Mr. Chairman, we have agreed on a more systematic approach to international economic policy coordination that incorporates a strengthened commitment to adjust economic policies. I am hopeful that the spirit of cooperation that made this agreement possible will carry over to its implementation. If so, we can look forward to greater exchange rate stability, enhanced prospects for growth, and more sustainable patterns of international trade.

Improving Growth in Debtor Nations

Successful economic policy coordination among the industrial nations complements our efforts to deal with LDC debt problems by strengthening the world economy, creating the conditions for lower interest rates, and helping to improve access to markets.

Recent improvements in the global economy are already making a significant contribution to developing nations' growth prospects and will substantially ease their debt service obligations. Stronger industrial country growth and lower inflation, for example, will add nearly $5 billion to developing nations' non-oil exports and reduce their import costs by approximately $4 billion this year. The sharp decline in interest rates since early 1985 will reduce their annual debt service payments by about $12 billion. The decline in oil prices will also save oil-importing developing nations an additional $14 billion annually.

At the same time, however, developing countries, particularly debtor nations, must position themselves to take advantage of these improvements by putting in place policies to assure stronger, sustained growth for their economies over the medium and longer term. As you know, the "Program for Sustained Growth" for the major debtor nations proposed by the U.S. in Seoul was premised on credible, growth-oriented economic reform by the debtor nations, supported by increased external financing.

In Tokyo, the Summit leaders welcomed the progress made in developing the cooperative debt strategy, in particular building on the United States' initiative. They emphasized that the role of the international financial institutions will continue to be central and welcomed moves for closer cooperation between the IMF and the World Bank, in particular. The debt initiative has also received strong support from the international financial institutions, national banking groups in all major countries, and the OECD Ministers, as well as the key IMF and World Bank Committees representing both debtor and creditor countries.

The adoption of growth-oriented macroeconomic and structural policies by the debtor nations is at the heart of the strengthened debt strategy and crucial to sustained growth over the longer term. Special emphasis needs to be placed on measures to increase savings and investment, improve economic efficiency, and encourage a return of flight capital. A more favorable climate for direct foreign investment can be an important element of such an approach, helping to reverse recent declines in net direct investment flows. Such inflows are non-debt creating, provide greater protection against changes in the cost of borrowing, and can help improve technology and managerial expertise.

Similarly, a rationalization and liberalization of debtors' trade regimes can contribute to improved efficiency and productivity for the economy as a whole. Together with other growth-oriented measures to assure more market-related exchange rates and interest rates, to reduce fiscal deficits, to improve the efficiency of capital markets, and to rationalize the public sector, such measures can help improve growth prospects, restore confidence in debtor economies, and encourage the return of flight capital.

Such policy changes will take time to put in place and can't be expected to occur overnight. The process of implementing these reforms will also be much less public than the series of announcements to date supporting the debt initiative. Implementation will take place through individual debtors' negotiations with the IMF, the World Bank and the commercial banks. We expect these negotiations to place greater emphasis on dealing with current debt problems through a medium-term, growth-oriented policy framework. This process is already underway. The IMF, for example, has existing or pending arrangements with 11 of the 15 major debtor nations, while the World Bank has structural or sector loan negotiations underway with 13 of these nations and has recently extended loans to

Ecuador, Argentina, and Colombia to support adjustment efforts in some of their key sectors.

As the Summit communique noted, sound adjustment programs will need to be supported by resumed commercial bank lending, flexibility in rescheduling debt, and appropriate access to export credits. Once debtor nations have designed economic reform programs to improve their growth prospects that have Fund and Bank support, it will be critical for the commercial banks to fulfill their pledges of financial support for these programs. The industrial nations must also cooperate regarding resumption of export credit cover to countries implementing appropriate adjustment policies.

We believe prompt enactment of legislation enabling U.S. participation in the Multilateral Investment Guarantee Agency would also make an important contribution to international efforts to improve the LDC investment climate and to facilitate new flows of foreign direct investment.

In addition to the strong global support for our initiative with respect to the major debtors, we are also very pleased with the recent action of both the IMF and the World Bank on the Trust Fund initiative to assist low-income developing nations, including Sub-Saharan Africa. This constitutes a major step forward in Fund/Bank cooperation and a positive context for current negotiations on IDA VIII. We look forward to its implementation so that a sound basis of growth can be established in these countries as well.

The Program for Sustained Growth is important because it touches on a wide range of U.S. interests, but paramount among these is its importance for U.S. trade. As you know, the debt crisis has had a direct impact on U.S. exports. U.S. exports to the 15 major debtor nations peaked at $40 billion in 1981. However, this reflected an international economic environment which was clearly not sustainable. Our exports to these countries fell sharply to $23 billion in 1983, as the debtor nations were unable to maintain previous import levels in the face of financial constraints and slower export growth.

The international debt strategy adopted in the wake of the debt crisis has helped to place the debtors' economies on a sounder footing and to permit a resumption of import growth at a more sustainable pace. U.S. exports to the major debtor nations have increased by 18%, or $4 billion, during the past two years and can be expected to improve further in response to both recent exchange rate changes and stronger growth in the debtor economies. The adoption of growth-oriented economic reforms, supported by increased financing from the international community, as envisaged by the debt initiative, will help to enhance both growth prospects and imports.

It will also be important, however, for the United States and other industrial nations to maintain open markets for LDC exports to permit them to earn the foreign exchange necessary to increase imports. The process of increasing growth and trade is an interactive one. We cannot expect to reap the benefits of stronger growth and increased trade abroad if we close our markets at home.

Promoting More Fair and Free Trade

Open markets are essential to our overall international strategy of economic adjustment and policy coordination. At the Tokyo Summit last week, the leaders of the Free World's major industrialized nations recommitted themselves to maintaining an open multilateral trading system, recognizing that:

- Open markets promote economic growth world-wide. We have only to review the Depression years to see the effects of closed markets.

- They provide debtor nations with markets for their exports that are essential if they are to service their debt and, in turn, serve as markets for U.S. goods and products; and

- Open markets facilitate our efforts to adjust large, unsustainable external imbalances among the industrial nations.

The Administration is committed to maintaining an open U.S. market and ensuring a free but fair international trading system. To implement our trade policy, we are supporting the new GATT round of trade negotiations to reduce barriers abroad. As mentioned, in the new round we will notably be seeking new GATT rules covering services, intellectual property protection, and international investment.

President Reagan and the others at the Tokyo Economic Summit pledged to work at the September GATT Ministerial meeting in Geneva to make decisive progress in launching the new round. We are also starting negotiations to remove barriers to trade and investment between the United States and Canada.

We are pursuing an aggressive program against unfair trade practices. President Reagan is the first president to self-initiate action under his retaliatory authority against such practices, including cases involving Japan, Brazil, Korea and Taiwan. The President has also announced that, unless we are able to resolve our dispute with the EC over its new restrictions affecting our farm exports to Spain and Portugal, we will respond in kind.

Our aggressive policy against unfair trading practices has already met with considerable success. We have settled disputes involving the EC's subsidies for canned fruit, Japan's footwear and leather import quotas, Taiwan's import monopoly for liquor and tobacco, and Korea's restrictions on foreign motion pictures.

In sum, I strongly believe that our policy of free but fair trade is working and is in our overall economic interest.

Legislation

At this point, Mr. Chairman, I would like to address the question of proposed international finance and trade legislation, such as S. 1860. I can well understand your frustration over our trade deficit. And I can sympathize with a desire to respond to constituent requests for action by passing legislation. However, certain modifications in our trade law will not eliminate the trade deficit and may actually make it worse.

The answer to our trading problems is a comprehensive international economic policy strategy that addresses international trade, monetary and debt issues in a coordinated fashion and involves the cooperation of other nations. We have developed such a strategy, as I have discussed here today, and we are implementing it.

The exchange rate and policy coordination sections of S. 1860 raise the right issues and point in the right direction, but they are now out of date in light of the agreement reached at the Tokyo Summit.

We are, of course, prepared to engage in thorough and meaningful discussion with the Congress on all pending legislation. And, as previously indicated, the Administration already supports legislation to:

- provide additional protection to the intellectual property rights of U.S. firms and individuals;
- alter our antitrust laws to help both our export and import sensitive industries; and
- provide a war chest to improve U.S. export opportunities by negotiating an end to tied aid credit abuses.

Legislation of this nature is not as glamorous as some of the bills that have been introduced, but it will provide needed support for our policies without undermining them.

We must avoid passage of protectionist trade legislation that would alienate our trading partners, encourage them to enact similar protectionist policies, and undermine the Administration's international economic policy. Closed markets and an atmosphere of confrontation would doom our efforts to solve our international economic problems in a responsible and constructive manner. The greatest threat today to economic well-being world-wide is the danger of protectionism and a trade war. We need your help to avoid these dangers. I urge you to give the Administration's policies a chance to work.

Conclusion

In conclusion, Mr. Chairman, I believe we have a viable strategy to address the trade and financial problems that confront us. We are working to implement it and have made significant progress, most recently at the Tokyo Summit. But we need your help to avoid measures that would undercut our efforts.

TREASURY NEWS
epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M. May 13, 1986

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $14,000 million, to be issued May 22, 1986. This offering will result in a paydown for the Treasury of about $300 million, as the maturing bills are outstanding in the amount of $14,304 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, May 19, 1986. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,000 million, representing an additional amount of bills dated February 20, 1986, and to mature August 21, 1986 (CUSIP No. 912794 LA 0), currently outstanding in the amount of $6,860 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,000 million, to be dated May 22, 1986, and to mature November 20, 1986 (CUSIP No. 912794 LL 6).

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing May 22, 1986. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold $1,083 million as agents for foreign and international monetary authorities, and $3,753 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series).

B-577

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE

May 13, 1986

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $9,252 million of 52-week bills to be issued May 15, 1986, and to mature May 14, 1987, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	6.16%	6.55%	93.772
High -	6.17%	6.56%	93.761
Average -	6.17%	6.56%	93.761

Tenders at the high discount rate were allotted 88%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 57,995	$ 17,875
New York	24,682,035	8,457,835
Philadelphia	6,275	6,275
Cleveland	15,805	15,805
Richmond	19,855	19,855
Atlanta	56,350	16,350
Chicago	1,809,125	100,805
St. Louis	52,190	32,190
Minneapolis	17,760	17,160
Kansas City	30,655	30,535
Dallas	19,285	9,285
San Francisco	2,448,210	374,610
Treasury	153,655	153,655
TOTALS	$29,369,195	$9,252,235
Type		
Competitive	$26,532,050	$6,415,090
Noncompetitive	518,145	518,145
Subtotal, Public	$27,050,195	$6,933,235
Federal Reserve	2,150,000	2,150,000
Foreign Official Institutions	169,000	169,000
TOTALS	$29,369,195	$9,252,235

R-578

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FOR IMMEDIATE RELEASE

Contact: Bob Levine
(202) 566-2041

May 14, 1986

U. S. TREASURY SIGNS BRIDGE LOAN TO ECUADOR

The U. S. Department of the Treasury and the Republic of Ecuador today signed a $150 million short-term bridge financing arrangement in support of Ecuador's economic programs and its continuing performance in adjusting its economy. The United States praises this ongoing adjustment performance, particularly in light of a projected balance of payments shortfall due to the drop in export revenues resulting from the recent decline in oil prices

The bridge loan will strengthen Ecuador's financial position. It will also permit continuation of orderly trade and financial transactions as Ecuador finalizes negotations for a new financing facility from commercial banks and additional loans from international financial institutions.

B-579

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FOR IMMEDIATE RELEASE
May 14, 1986

CONTACT: CHARLES POWERS
(202) 566-8773

UNITED STATES AND PEOPLE'S REPUBLIC OF CHINA SIGN PROTOCOL
TO INCOME TAX TREATY

The Treasury Department today announced the signing of a Protocol to the proposed income tax treaty between the United States and the People's Republic of China. The Protocol was signed on May 10,1986 in Beijing by Secretary of the Treasury James A. Baker, III and Finance Minister Wang Bingqian. It modifies the "Agreement Between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with respect to Taxes on Income", which includes an accompanying Protocol and Exchange of Notes, signed by President Reagan on April 30, 1984. It becomes an integral part of the Agreement and will be transmitted to the Senate for its advice and consent to ratification of the Agreement, as modified by the Protocol.

The new Protocol contains only one article. It amends paragraph 7 of the original Protocol to provide rules to prevent "treaty shopping", i.e., the use of the Agreement by residents of third countries to obtain treaty tax benefits by channelling their investments in one of the treaty countries through the other country. The Protocol is substantially identical to the corresponding article in the proposed U.S.-Denmark income tax treaty, which was considered by the Senate Foreign Relations Committee at the same time as the proposed Agreement with China.

As an integral part of the Agreement, the new Protocol would enter into force at the same time, that is on the thirtieth day after notification that the legal procedures have been completed in both countries, and its provisions would take effect for income derived during taxable periods of the recipient beginning on or after the following January 1.

A limited number of copies of the Protocol are available from the Public Affairs Office, room 2315, Treasury Department, Washington, D.C. 20220, telephone (202) 566-2041.

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B-580

TREASURY NEWS
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FOR RELEASE AT 4:00 P.M. May 14, 1986

TREASURY TO AUCTION $9,750 MILLION OF 2-YEAR NOTES

The Department of the Treasury will auction $9,750 million of 2-year notes to refund $8,548 million of 2-year notes maturing May 31, 1986, and to raise about $1,200 million new cash. The $8,548 million of maturing 2-year notes are those held by the public, including $900 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $9,750 million is being offered to the public, and any amounts tendered by Federal Reserve Banks as agents for foreign and international monetary authorities will be added to that amount. Tenders for such accounts will be accepted at the average price of accepted competitive tenders.

In addition to the public holdings, Government accounts and Federal Reserve Banks, for their own accounts, hold $644 million of the maturing securities that may be refunded by issuing additional amounts of the new notes at the average price of accepted competitive tenders.

Details about the new security are given in the attached highlights of the offering and in the official offering circular.

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Attachment

B-581

HIGHLIGHTS OF TREASURY OFFERING TO THE PUBLIC OF 2-YEAR NOTES TO BE ISSUED JUNE 2, 1986

May 14, 1986

<u>Amount Offered:</u>

To the public	$9,750 million

<u>Description of Security:</u>

Term and type of security	2-year notes
Series and CUSIP designation	Z-1988 (CUSIP No. 912827 TR 3)
Maturity Date	May 31, 1988
Call date	No provision
Interest Rate	To be determined based on the average of accepted bids
Investment yield	To be determined at auction
Premium or discount	To be determined after auction
Interest payment dates	November 30 and May 31
Minimum denomination available ..	$5,000

<u>Terms of Sale:</u>

Method of sale	Yield auction
Competitive tenders	Must be expressed as an annual yield, with two decimals, e.g., 7.10%
Noncompetitive tenders	Accepted in full at the average price up to $1,000,000
Accrued interest payable by investor	None
Payment by non-institutional investors	Full payment to be submitted with tender
Payment through Treasury Tax and Loan (TT&L) Note Accounts ...	Acceptable for TT&L Note Option Depositaries
Deposit guarantee by designated institutions	Acceptable

<u>Key Dates:</u>

Receipt of tenders	Wednesday, May 21, 1986, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions)	
a) cash or Federal funds	Monday, June 2, 1986
b) readily-collectible check ..	Thursday, May 29, 1986

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
May 15, 1986

CONTACT: Art Siddon
566-5252

TREASURY ANNOUNCES PUBLICATION OF REGULATIONS AND FEATURES OF ITS NEW BOOK-ENTRY SYSTEM

The Department of the Treasury will publish final regulations tomorrow on its new, automated TREASURY DIRECT Book-entry Securities System. Book-entry securities are represented by accounting entries in the records of the Treasury or a financial institution; no engraved securities are issued. TREASURY DIRECT will permit investors in book-entry Treasury bills, notes and bonds to have their securities maintained directly by the Treasury. Currently, the Treasury offers book-entry accounts only for Treasury bill investors. Treasury plans to begin offering notes and bonds through TREASURY DIRECT this July. Treasury bills may be maintained in the new system beginning next year.

The new system will contain features that are not presently available. Four features that should be of particular interest to investors are: (1) interest and principal payments by electronic direct deposit, (2) the capability of the Federal Reserve Banks and Branches to service accounts directly, (3) a single account under which investors can hold various issues of bills, notes, and bonds, and (4) automatic reinvestment of Treasury bills on an extended or one-time basis.

The TREASURY DIRECT system will provide electronic payments that are automatically credited on the due date to investors' designated checking or savings accounts. Electronic direct deposit eliminates the risk of theft, forgery and mailing delays associated with check payments. Additionally, the system will enable Federal Reserve Banks and Branches to process most transactions. Currently, all transactions to accounts maintained by the Treasury must be forwarded to the Treasury Department. Investors using the new system will no longer have to keep track of multiple accounts or security descriptions. A single account number will record all of an investor's holdings and transactions in bills, notes and bonds. Finally, Treasury bill investors will be able to automatically extend the reinvestment of their bill accounts for up to two years.

B-582

Information concerning an investor's Treasury security account will be accessible through the Federal Reserve system nationwide. All Federal Reserve Banks and Branches can respond to investors' inquiries. Investors will receive a statement of account following any transaction, such as an additional investment, a transfer of securities, or a change of address.

Investors requiring additional information may contact their nearest Federal Reserve Bank or Branch, or the Department of the Treasury, Bureau of the Public Debt.

QUESTIONS AND ANSWERS

1. What is book-entry?

   The term "book-entry" indicates that the securities are maintained as computerized accounting records. Currently, only Treasury bills are maintained exclusively in book-entry form; however, with the implementation of the new TREASURY DIRECT Book-entry Securities System, all new issues of Treasury notes and bonds will also be maintained exclusively in book-entry form.

2. What advantage is there in a single account number?

   A single account number will simplify investors' bookkeeping records. Instead of having an account number for each security owned, as with the previous system, investors will only have one account number to refer to. Additionally, a single statement of account and a statement of interest earned will record all the pertinent information concerning the account.

3. Will all TREASURY DIRECT payments be made by Direct Deposit?

   Yes, except for:

   -payments where there is not sufficient time to notify the investor's designated institution before a payment has to be made, and

   -payments to foreign addresses.

4. What information is needed to establish Direct Deposit payments?

   Very little. All that is required is the name of a financial institution, the name(s) on and the number of the account designated at the financial institution to receive payments, and the institution's 9 digit American Bankers Association Routing Transit Number which can be found at the bottom of a check or deposit slip. Investors should verify the accuracy of this information before submitting payment instructions.

5. What benefit is there in extended reinvestment?

   Extended reinvestment will make it easier for bill investors who will no longer have to wait to receive a reinvestment (rollover) card, assure that the card is properly completed, and mailed in time for Treasury's receipt and processing.

6. Can Treasury bond or note investors request extended reinvestment?

   No, only Treasury bill investors can request extended reinvestment because bills are offered for the shortest terms and on a regular schedule.

7. Will any charges or fees be imposed on investors on account of securities held in TREASURY DIRECT?

   While no provision for charging fees has been included in the regulations, if legislation currently under consideration should be enacted, it could lead to investor fees being charged for securities in TREASURY DIRECT.

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FOR RELEASE
MAY 16, 1986

STATEMENT BY THE HONORABLE DAVID C. MULFORD
ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS
U.S. TREASURY DEPARTMENT

BEFORE THE
BANKERS' ASSOCIATION FOR FOREIGN TRADE
ANNUAL MEETING
PHOENIX, ARIZONA

MAY 16, 1986

Strengthening the Global Economy

I welcome this opportunity to discuss the international debt situation, which continues to pose a serious challenge for the global economy. Fortunately, our efforts to manage and resolve the debt crisis are improving, thanks in large part to the Program for Sustained Growth launched by Secretary Baker last fall in Korea. We still read and hear lots of doom and gloom in the media, in the Congress, and among some of the debtor nations, but to those of us on the firing line, important changes are visible.

First, it is becoming increasingly accepted by all parties that the debt crisis can only be resolved by improving growth prospects in the debtor nations. This means improving their ability to accumulate foreign exchange at a faster pace than they accumulate debt. The key point here is that sustained, lower-inflation growth can only be accomplished through fundamental economic reforms in the debtor countries' economies. Unless credible reforms are put in place, these countries will not be able to command the necessary capital for their development. Acceptance of these facts represents an important and basic recognition of reality from which a new beginning can be made.

Second, and very fortunate from a timing standpoint, improvements presently taking place in the global economic environment will have an enormous impact on the ability of debtor nations to service their debt and finance imports needed for growth.

-- Industrial country growth will be approximately one percent higher than projected at the end of 1985, and inflation will be about two percent lower. We estimate that in 1986 this will add nearly $5 billion to developing nations' non-oil exports and reduce their non-oil import costs by approximately $4 billion.

-- The sharp decline in interest rates -- nearly 3 percentage points since early 1985 -- will reduce annual debt service payments for all LDCs by about $12 billion, freeing up these resources for productive use elsewhere in the debtors' economies. For the major debtors alone, the savings will be nearly $8 billion, or 20 percent of their annual interest payments on outstanding debt. If we compare current 6-month LIBOR rates to the average for 1984, and focus on debt owed to the commercial banks, the savings are even more dramatic -- a decline of nearly 5 percentage points and a 45% savings in annual interest payments to commercial banks.

These developments will provide significant relief for debtor economies which is only now beginning to be more broadly recognized internationally.

There are other foreign exchange savings as well. Declining oil prices will save oil-importing developing nations some $14 billion annually. While it is true that several major oil-exporting debtor nations will suffer from falling oil export revenues, they will benefit from lower interest rates and stronger world growth.

In fact, we are seeing the most favorable economic environment since the early 1970s, and we should bear in mind that these broad economic changes could be more important to a resolution of the debt problem than the provision of marginal amounts of financing by the banks or the much-touted World Bank general capital increase.

Admittedly, positive changes in the global economic environment must be supplemented by economic reforms in the debtor nations themselves to have a lasting effect. Without such reforms, no amount of international lending or external economic improvements can assure sustained growth for the longer term.

I often hear criticism that the creditor nations are not called upon to do anything under the Baker plan. This usually refers to the provision of more aid or a general capital increase for the World Bank. This criticism, in my view, entirely misses the point. The major industrial countries have a broader responsibility, which in a sense serves as the foundation for the debt initiative -- namely, the provision of a sound world economic environment. Viewed in this light, the contribution since last fall has been substantial.

I want to dwell on this for a moment, because I have just returned from the Tokyo Summit, and it is possible now to bring a greater sense of perspective to the important question of international economic policy coordination. Last September's Plaza agreement and the Program for Sustained Growth in October were mutually supportive initiatives to improve the prospects for growth and stability in the global economy. It is widely agreed that the results of the Plaza agreement have been impressive. Major exchange rate adjustments have taken place which will substantially improve the U.S. trade deficit, and there has been better coordination of policy actions among the Group of Five industrial nations, particularly with regard to interest rates.

The recent Summit agreement constitutes another important step forward in strengthening the system of international economic policy coordination among the key industrial nations. A new Group of Seven Finance Ministers, including Canada and Italy, was formed in recognition of the importance of their economies. The Group of Five will continue its multilateral surveillance activities, but important improvements in the process for international economic policy coordination have been agreed. This process will now involve the following steps:

First, countries will develop individual country economic forecasts.

Second, these forecasts will then be reviewed for internal consistency and external compatibility, using a range of economic indicators. These indicators would include growth rates, inflation rates, unemployment rates, fiscal deficits, current account and trade balances, interest rates, monetary growth rates, reserves, and exchange rates. Exchange rates and current account and trade balances would be particularly useful in assessing the mutual compatibility of country forecasts.

Third, modifications in forecasts and underlying policies would be considered as necessary to promote consistency. Whenever there are significant deviations from an intended course, best efforts will be made to reach an understanding on appropriate remedial measures, focusing first and foremost on underlying policy fundamentals. Intervention in exchange markets could also occur when to do so would be helpful.

The IMF, through Managing Director de Larosiere, will play an important role in this process. We intend to implement this agreement with the same degree of commitment and cooperation that made reaching this agreement possible. With such implementation, we believe the prospects are significantly enhanced for greater exchange rate stability, more balanced growth, and more sustainable patterns of international trade.

The Debt Initiative

The Tokyo Summit also endorsed the U.S. debt initiative and recognized that its priorities are right. In particular, the Summit communique emphasized the importance of effective structural adjustment policies within the debtor nations, coupled with measures to mobilize domestic savings, encourage the repatriation of capital, improve the environment for foreign investment, and promote more open trading policies.

Providing a more favorable climate for foreign direct investment is particularly important to help reverse recent declines in net direct investment flows. This is the exclusive responsibility of the debtor nations themselves. If they choose to ignore the growing competition for attracting capital, they will face further declines in investment flows. The U.S. stock of investment in Mexico, for example, was down 7% in 1984 compared with the average U.S. investment level for the years 1980-84.

Similarly, a rationalization and liberalization of debtors' trade regimes can contribute to improved efficiency and productivity for the economy as a whole. Policy improvements in the areas of both direct investment and trade should be part of broader efforts by the debtor nations to improve the prospects for growth. Neither, alone, can do the whole job.

These aren't impractical objectives, despite the political sensitivity of some of these reforms. It is also important to emphasize that we are not advocating austerity measures here but policies with real potential to make an immediate and lasting contribution to growth. There already has been, I believe, some significant change in attitudes within some of the debtor nations. Brazil and Argentina, for example, have undertaken substantial domestic economic reform programs to reduce inflation. A number of countries, including Chile, Mexico, and Argentina, are moving to privatize public enterprises, while Ecuador and Colombia have taken steps to significantly increase the market-orientation of their economies.

Taken as a whole, I am optimistic that many of the Latin debtors -- with a few exceptions -- are working to improve the efficiency of their economies at a time when growth prospects are improving. The IMF and the World Bank are assisting in this process. The IMF has existing or pending arrangements with 11 of the 15 major debtor nations, while the World Bank has structural or sector loan negotiations underway with 13 of these nations and has recently extended loans to Ecuador, Argentina, and Colombia to support adjustment efforts in some of their key sectors.

In addition, several of the major debtors have discussions underway with the World Bank on the development of medium-term adjustment programs, focusing on efforts to increase growth and export capabilities, mobilize domestic savings, encourage increased investment, and liberalize trade. These medium-term programs will provide the framework for future World Bank sector or structural adjustment loans and IMF programs or arrangements.

The Role of the Commercial Banks

Once debtor governments have committed to undertake viable economic reform programs which have World Bank and IMF support, commercial banks should be ready to implement their earlier pledges of support in short order. I recognize that the commercial banks are cautious about seeing the precise conditions for IMF and World Bank lending before committing to increase their own lending. This is understandable, and will undoubtedly mean that pledges by the commercial banks will come later in the process than was true in the 1982-1985 period. However, once reforms are agreed upon, commercial banks must be ready to lend without delay.

Yet I am concerned that not enough has been done by commercial banks to assure that when the time comes, they will in fact be ready to lend. Have the modalities for additional lending within current lending syndicates been agreed? Have the differences between the larger and smaller banks been resolved? I doubt it. And I would caution again, as I did when I spoke to a large group of banks in London in February, that continued efforts by banks to obtain government guarantees or to secure for themselves the preferred creditor status of the multilateral development banks, will not be supported by the Administration. The Administration is firmly on record as opposing government or World Bank guarantees for new commercial bank lending.

Coordination among commercial banks -- domestically and internationally -- is a vital part of this exercise. Smaller banks must be able to count on the willingness of the major banks heading bank advisory groups to keep them informed at an early stage of country and other developments affecting bank lending. Similarly, the large U.S. banks need some assurance that regional and foreign banks will continue to participate in reschedulings and new money packages. Resolving these problems is fundamental to continued concerted lending.

In Washington, we frequently hear that smaller banks "want out", despite the pledges of support for the debt initiative from U.S. banks with 98 percent of U.S. commercial bank exposure to the major debtor nations. We have accepted these pledges of support and the subsequent endorsement from BAFT membership as representing the serious intentions of U.S. and foreign banks, and we are grateful for them. Nevertheless, there seems to be an inconsistency between previous pledges and the alleged desire of smaller banks to cut and run.

We do not intend to twist the arms of U.S. banks. They will lend if they perceive it to be in their interest to do so. Taken as a whole, the banks know that without growth in the debtor nations -- and an improved ability to earn foreign exchange -- they cannot expect to be repaid, nor, to put it bluntly, can they expect to continue favorable earnings on assets of declining quality. The banks also know that growth must be financed in large part from private capital resources. The banking community, therefore, should concern itself with helping both the debtor nations and the international financial institutions to develop the necessary reforms and procedures for implementing the debt strategy. Traditionally, banks have worked with troubled clients, because they have believed it to be in their own self-interest. The present international debt situation is no different. Indeed, there is more at stake for the participating banks in all the creditor nations, because they share the same international and interdependent financial system.

I would urge you to continue to consider innovative means to keep banks with less exposure involved and at the same time simplify the lending/negotiating process. That is a major challenge.

When senior financial officials of debtor countries have to travel throughout the United States to sell their program to virtually every potential lender right down to those with a few tens of thousands of dollars of exposure, one must seriously question the wisdom of syndicate members, both large and small. Those officials should be home developing and implementing the policies to improve their economies. The syndicates should centralize their efforts more effectively and improve the cohesion of their groups by making all members feel they have a stake in the progress of the debtor nations. I would add to that the need to plan ahead so that the valuable time you have now to prepare for the major negotiations which are nearly at hand will not have been wasted.

Debt/Equity Swaps

I would like to comment on debt/equity swaps.

Coming as I do from an investment banking background, I am intrigued by recent developments in the area of debt/equity swaps and the securitization of commercial bank loans. Debt equity swaps, in particular, can help to reduce outstanding debt obligations, thereby also reducing the annual debt service burden. They can also provide an attractive means of encouraging the return of flight capital.

Chile has recently adopted modifications in its foreign exchange regulations which permit nationals and foreigners to make debt/equity conversions. At least $300 million in such conversions have already occurred since last August, including foreign equity positions in financial institutions in Chile. We understand there are hopes that considerable further sums will be converted this year.

Part of the attraction in Chile, of course, is its open, market-oriented investment regime, which is likely to attract foreign direct investment in Chile, quite apart from debt/equity swaps.

I would encourage other debtor nations to follow Chile's example and in liberalizing their direct investment regime to permit financial institutions to establish financial subsidiaries that would be active in the host country's domestic markets. I understand that some commercial banks might be interested in moving in this direction.

In your other discussions here, you may want to review the possibility for other innovative mechanisms to securitize debt. I have long believed it must be possible to establish a consortia-type development bank in certain debtor countries, owned partly by the commercial banks, partly by the host government concerned, and perhaps partly owned by the public, which could use existing debt to purchase the shares of domestic corporations, privatized parastatals, as well as existing private company shares. I believe this to be worth exploring.

I don't want to overstate the potential benefits nor minimize the complexities we are dealing with. I assume that as debt is shifted to equity, or as loans are swapped or sold off, the syndicate or exposure bases for new lending would also shift or change. But I can't believe this is an insoluble problem.

There are a fair number of regulatory and accounting rules, guidelines and standards that would be involved. My understanding is that within the existing framework, there already may be a degree of flexibility to deal with the kinds of innovations that I would like to encourage. Situations will vary country by country and bank by bank; the existing markets are thin; spreads between bids and offers are wide; and some creative possibilities for improvement are only in a nascent stage of development. Given the long tradition of BAFT's, technical expertise perhaps some of your own committees might have suggestions to put forward in this regard.

Finally, in discussing these issues, let me stress the continued need for the CEOs and boards of directors of your institutions to take a direct interest and longer term view of the potential benefits of the Program for Sustained Growth, both to your banks and your domestic clients, as well as to the borrowers. Banks and exporters are interdependent. So, as I have emphasized earlier, is the banking community as a whole.

To the extent that the Program for Sustained Growth succeeds, all the participants -- including the banks and the regions they serve -- will be better off.

You know your markets, your clients and peers -- larger and smaller -- better than we do in Washington. Now is the time to exercise your ingenuity, to have the information and syndicates in place and be ready to act. We must have your vigorous leadership and active cooperation if the Program is to succeed.

TREASURY NEWS

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STATEMENT OF
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ACTING DEPUTY TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on the following bills: H.R. 3139, which would exempt certain emergency medical transportation from the excise tax on air transportation; H.R. 3301, which would exempt from taxation corporations or trusts that acquire and manage real property for certain tax-exempt organizations; H.R. 4056, which would deny the benefits of the foreign earned income exclusion to individuals who are in a foreign country in violation of an Executive Order; H.R. 4077, which would provide that the interest on an obligation issued to provide property for use by certain electric utilities is not exempt from tax if such a utility fails to adhere to "take or pay agreements" entered into in connection with the proposed construction of certain nuclear electric generating facilities; H.R. 4379, which would provide that nonrecognition of gain on the sale of a principal residence would be available even if one of the spouses who occupied the residence died before occupying a new residence; and H.R. 4595, which would provide generally that certain amounts received by a qualified cooperative housing corporation in connection with its refinancing of indebtedness would not be subject to Federal income tax.

I will discuss each bill in turn.

B-584

H.R. 3139

Excise Tax Exemption for Emergency Medical Transportation

Current Law

Section 4261 of the Code imposes an excise tax equal to eight percent of the amount paid for air transportation of any person where the transportation begins and ends in the United States. 1/ This tax, which is generally paid by the passenger, is scheduled to expire on December 31, 1987. Revenues from the excise tax are deposited into the Airport and Airway Trust Fund, which is used to fund Federal aviation activities, such as the construction of certain airport facilities, and the provision of air traffic control and air navigation services.

Section 4261(e) exempts from the air passenger excise tax any transportation by helicopter for the following purposes:

(1) transporting individuals, equipment, or supplies in the exploration for, or the development or removal of, hard minerals, or the exploration for oil or gas, or

(2) planting, cultivating, cutting, transporting or caring for trees.

This excise tax exemption for certain helicopter uses applies, however, only if the helicopter does not take off from or land at a facility eligible for assistance under the Airport and Airway Development Act of 1970, and does not take advantage of services provided pursuant to the Airport and Airway Improvement Act of 1982 during the flight. In addition, the air passenger excise tax does not apply to transportation by any aircraft, including a helicopter, having a maximum certified take-off weight of 6,000 pounds or less, except when such aircraft is operated on an established line.

Section 4271 generally imposes an excise tax equal to five percent of the amount paid for air transportation of property within the United States, if the amounts are paid to a person engaged in the business of transporting property for hire. Like the air passenger excise tax, the air cargo excise tax is scheduled to expire on December 31, 1987, and revenues from the tax are remitted to the Airport and Airway Trust Fund.

1/ The eight percent air transportation passenger excise tax also applies to transportation that begins and ends within any portion of Canada or Mexico that is within 225 miles of the continental United States, unless the Secretary of the Treasury, as specified in section 4262(e), determines that the tax should not apply.

Description of H.R. 3139

H.R. 3139 would provide an exemption from both the air passenger and air cargo excise taxes for certain emergency medical transportation. The exemption would apply to any air transportation by helicopter if four requirements were met: the helicopter did not take off or land at a facility eligible for assistance under the Airport and Airway Development Act of 1970; the helicopter did not otherwise use services provided pursuant to the Airport and Airway Improvement Act of 1982 during the emergency medical transportation; the helicopter was used primarily to provide emergency medical services; and the helicopter was owned or leased by a nonprofit health care facility and was operated exclusively under the control of such facility.

These exemptions would apply to transportation beginning after January 1, 1985.

Discussion

The air passenger and air cargo excise taxes are used exclusively to develop and maintain Federal airport and airway facilities through the Airport and Airway Trust Fund. The exemptions provided in present law for mining, drilling, and logging operations reflect the policy that transportation that derives only an insignificant, if any, benefit from Federal facilities should not bear the excise tax.

In the case of excise taxes that are dedicated to trust funds, and thus represent surrogate user fees, the Treasury Department believes, in general, that it is appropriate to limit incidence of the excise taxes to activities that properly are related to the trust fund. 2/ Consistent with that policy, the proposed exemption for emergency medical service helicopters under H.R. 3139 is crafted narrowly to cover only those operations that derive insignificant benefits, if any, from the Federally assisted facilities that are funded by the air cargo and air passenger excise taxes. Accordingly, the Treasury Department supports H.R. 3139. 3/

2/ We note, for example, that the excise tax on gasoline, which is used to fund the Highway Trust Fund, is refunded to the ultimate purchasers of gasoline when such gasoline is for off-highway qualified business uses. This exception is granted primarily because such uses do not benefit from the Highway Trust Fund.

3/ We estimate that enactment of H.R 3139 would result in only a negligible revenue loss during the five-year budget period.

H.R. 3301

Tax Exemption for Corporations or Trusts that Acquire and Manage Real Property for Certain other Exempt Organizations

Current Law

The Internal Revenue Code provides an exemption from Federal income tax for a variety of nonprofit entities ("exempt organizations"), including so-called "title-holding companies," which are exempted under section 501(c)(2). In general terms, a title-holding company is a corporation organized for the exclusive purpose of holding title to property, collecting the income from such property, and turning over the entire net income to another exempt organization. Traditionally, exempt organizations have used title holding companies in cases where several factors -- such as limitation of liability, accounting simplification, and clarification of title -- may warrant the segregation of an organization's property and investments in separate entities.

Section 501(c)(2) provides that an exempt title-holding company must turn over the income collected to "an organization." This language raises the question whether an exempt title-holding company may have more than one parent. 4/ Another unresolved issue under section 501(c)(2) is whether a title-holding company that turns over all of its income to an exempt organization qualifies for exemption under section 501(c)(2) when it is organized and operated by a for-profit company, such as an investment adviser or a brokerage company.

While exempt organizations, including title-holding companies, generally are not subject to Federal income tax, section 511 imposes a tax on income earned by an exempt organization from the conduct of an unrelated trade or business. Unrelated business income ("UBI") generally is taxed in a manner comparable to the income of commercial businesses. Section 512 generally excludes passive income, such as rental income derived from real property, from the definition of UBI.

4/ The Office of the Chief Counsel of the Internal Revenue Service has taken the position in a General Counsel Memorandum (G.C.M. 37351, December 20, 1977) that an organization will not qualify for exemption under section 501(c)(2) unless it distributes all of its income to one or more related exempt organizations. In two earlier revenue rulings, the Internal Revenue Service recognized entities as exempt under section 501(c)(2), even though they apparently had multiple, unrelated exempt organization parents. *See* Rev. Rul. 68-490, 1968-2 C.B. 241; Rev. Rul 68-371, 1968-2 C.B. 204.

Although "passive" income ordinarily is not subject to the UBI tax, this exception does not apply to debt-financed property. The debt-financed property rules originally were enacted in response to abusive sale-leaseback transactions between exempt organizations and the taxable owners of active businesses, and are designed primarily to prevent the exploitation of an exempt organization's tax exemption by taxable persons. Where applicable, these rules prevent the "leveraging" of an exempt organization's tax exemption by treating as UBI a share of the income derived from debt-financed property in proportion to the ratio of debt on the property to its adjusted basis. An exception to the debt-financed property rules provides that, in certain cases, income derived from debt-financed real property investments by educational organizations and pension, profit-sharing, or stock bonus plans that are qualified trusts under section 401 does not constitute UBI. This exception, however, is subject to several restrictions and limitations in section 514(c)(9)(B) that are designed to preclude the types of abusive transactions that originally gave rise to the debt-financed property rules.

Description of H.R. 3301

H.R. 3301 would add to the Code a new section 501(c)(24), 5/ which would exempt from tax a corporation or trust organized exclusively for the purposes of acquiring and holding title to property, collecting income from the property, and paying the income (less expenses) to one or more qualifying exempt organizations. Qualifying organizations would consist of (i) qualified pension, profit-sharing, or stock bonus plans that meet the requirements of section 401(a); (ii) governmental pension plans as defined in section 414(d); (iii) the United States, any State or locality, or any Federal, State or local agency; and (iv) charitable organizations described in section 501(c)(3). Under the bill, exempt status under section 501(c)(24) would be limited to organizations that have 35 or fewer shareholders or beneficiaries and only one class of investment interest, that permit a majority in interest of the tax-exempt investors to replace the investment adviser, and that provide the investors with the opportunity, subject to certain restrictions, to convert their interests into cash.

The bill also would extend to organizations exempt under proposed section 501(c)(24) the exception to the debt-financed property rules that currently applies to certain real estate investments made by qualified pension trusts and certain educational organizations. The bill would be effective for taxable years beginning after December 31, 1984. 6/

5/ Although H.R. 3301 by its terms would add section 501(c)(24) to the Code, we note that the recently enacted Comprehensive Omnibus Budget Reconciliation Act already has added section 501(c)(24) to the Code.

6/ For convenience, organizations that would be exempt from tax under proposed section 501(c)(24) are referred to below as "collective real estate investment corporations."

Discussion

In general, the Treasury Department does not oppose H.R. 3301 in its present form. We would, however, suggest certain technical modifications to the bill.

Collective Investments

In principle, the Treasury Department does not object to allowing certain exempt organizations to make collective investments in real estate through the use of a corporation or trust, where those investments represent undivided interests in the underlying assets. Functionally, such investments are not distinguishable from ownership of the underlying real property by the investors as tenants in common, which generally can be accomplished without creation of a taxable entity. In the past, our primary concerns with the use of a corporation or trust have been that, in practice, the for-profit investment adviser, rather than the exempt investors, could control the basic investment decisions of the entity, and that dissatisfied investors would have no alternative to continuation of the investment in the entity. In such instances, the investment adviser might reap the primary benefits of the arrangement.

H.R. 3301 has several safeguards that should prevent such results. First, an entity would qualify as a collective real estate investment corporation only if a majority in interest of its shareholders or beneficiaries had the right to dismiss the entity's investment adviser. The only limitation on this right would be a requirement of reasonable notice to the adviser. We would assume that a reasonable notice period for this purpose generally would be approximately 30 days.

Second, a collective real estate investment corporation would qualify for exemption only if each shareholder or beneficiary has the right to dispose of its interest. This right could take either (or both) of two forms -- the right to sell or exchange the shareholder's or beneficiary's interest to another exempt organization, or the right to require the collective real estate investment corporation to redeem the interest upon 90 days' notice.

We believe that these safeguards, which would both guarantee the majority in interest the right to control the entity and guarantee any investor the right to liquidate its interest, should ensure that the entity is operated exclusively for the benefit of the exempt investors. We have some concern, however, that the 35 shareholder limitation may be too high, and may thus render less valuable the right to dismiss the investment adviser. We believe that a lower ceiling might facilitate exercise of the investors' right to dismiss the investment adviser, and should perhaps be considered by the Subcommittee. Furthermore, a lower ceiling on the number of investors would be more consistent with the traditional purposes of title-holding companies.

Finally, although the bill's heading specifically refers to the acquisition and management of real property, proposed section 501(c)(24)(A)(iii) requires only that the entity be organized for the exclusive purpose of "acquiring property and holding title to, and collecting income from, such property." We recommend that the proposed statutory language be amended to clarify that the investments of the entity must be limited to real property.

Debt-Financed Property Rules

H.R. 3301 also would extend to collective real estate investment corporations the provision of current law that generally exempts certain real estate investments of qualified pension trusts and educational organizations from the debt-financed property rules. By extending the exception to such corporations, the bill indirectly would extend the exception to all organizations eligible to own beneficial interests in such corporations.

On several prior occasions, the Treasury Department has testified that the debt-financed property rules should not be narrowed. On August 9, 1983, for example, the Treasury Department testified before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee in opposition to the expansion of the exception to include qualified educational organizations. Similarly, on September 26, 1983, we testified before that Subcommittee in opposition to expanding the exception to include collective real estate investment corporations.

Several developments subsequent to our prior testimony have caused us to alter our position regarding expansion of the exception to the debt-financed property rules. First, the conditions set forth in section 514(c)(9)(B), which restrict the ability of eligible organizations to qualify for the exception, were expanded as part of the Tax Reform Act of 1984. As a result, the potential for abuse through an acquisition of debt-financed property has been reduced.

Second, the Congress, in 1984, broadened the exception to the debt-financed property rules to include educational organizations. We opposed such an expansion of the exception. Given the extension of the exception to educational organizations, however, we see no principled reason the exception should not now apply equally to the other exempt organizations described in section 501(c)(3). Our acquiescence in this narrowing of the debt-financed property rules is based on our judgment that, in their present form, the rules make an untenable distinction between educational organizations and other section 501(c)(3) organizations.

We would like to make several additional comments regarding this aspect of the bill. First, the bill extends the exception in section 514(c)(9) only to collective real estate investment corporations. If the exception is to be extended to such entities, however, there is no reason that it should exclude exempt organizations that could invest in a collective real estate investment corporation. It would be anomalous for section 501(c)(9) to treat a section 501(c)(3) organization less favorably than a collective real estate investment corporation wholly owned by the same organization. Accordingly, we would extend the exception to all organizations eligible under the bill to invest in a collective real estate investment corporation.

Second, although H.R. 3301 would include collective real estate investment corporations within the definition of "qualified organization" entitled to exemption from the debt-financed property rules, it is not entirely clear how the restrictions contained in section 514(c)(9)(B) should apply. We believe that collective real estate investment corporations should be treated as pass-through entities for purposes of section 514(c)(9)(D), and recommend that the bill or legislative history reflect that intention.

Finally, we note that the Subcommittee on Oversight is considering the possibility of comprehensive hearings later this year on the UBI tax. We are hopeful that, if such hearings occur, we will have the opportunity to consider in greater detail the policy implications of debt-financed acquisitions of income-producing property by exempt organizations. Our testimony today should not be construed as indicative of what our testimony will be in the context of a comprehensive review of the UBI rules.

Effective Date

As noted, H.R. 3301 would be effective for taxable years beginning after December 31, 1984. We recommend that this effective date be made prospective.

Revenue Estimate

Assuming a continuation of the current law rules applicable to investments in real estate, we estimate that H.R. 3301 would would lose $64 million in revenue during the fiscal 1987-1991 budget period. Under the House-passed version of H.R. 3838, however, the revenue cost of H.R. 3301 would be $176 million. Finally, under H.R. 3838 as approved by the Senate Finance Committee, the provisions described in H.R. 3301 would lose $243 million over five years. All of these revenue estimates, consistent with our suggestion above, assume that H.R. 3301 would be effective for taxable years beginning after December 31, 1986.

H.R. 4056

Denial of Benefits of Section 911 of the Code to Individuals in a Foreign Country in Violation of an Executive Order

Current Law

The United States taxes its citizens on a worldwide basis, wherever they reside. Under section 911 of the Code, however, a United States citizen who has his or her tax home in a foreign country and who either is present overseas for 11 of 12 consecutive months or is a bona fide resident of a foreign country for an entire taxable year may elect to exclude from gross income up to $80,000 of income from personal services performed in a foreign country. Under current law, this exclusion is scheduled to increase to $85,000 in 1988, $90,000 in 1989, and $95,000 in 1990. In addition, qualifying individuals may exclude certain additional housing expenses incurred in a foreign country.

H.R. 3838, as passed by the House of Representatives, would permanently reduce the maximum exclusion to $75,000 for taxable years beginning after 1985. In addition, the foreign earned income exclusion would become subject to the minimum tax. As ordered reported by the Senate Finance Committee, however, H.R. 3838 would reduce the maximum exclusion to $70,000 a year, but remove it from the minimum tax base.

The objective of the exclusion under section 911 is to encourage United States exports by reducing the cost of employing Americans abroad. United States businesses operating abroad frequently prefer to employ Americans, who may be more familiar with the business than local labor. These businesses argue that Americans also may be more familiar than foreigners with American products, and may therefore be more likely to purchase them on behalf of their employers, thus aiding United States exports.

Absent the exclusion, these businesses argue, it would be more difficult to employ Americans abroad. Foreign employees working in the same country are often subject only to the host country tax. In countries with lower tax burdens than the United States, Americans would incur a higher tax cost in the absence of special relief. The foreign earned income exclusion provides a substantial exemption of foreign earnings from United States tax, making United States labor more competitive with foreign labor in low tax countries.

In Executive Orders 12543 and 12544 of January 7 and 8, 1986, the President, under the authority of the International Emergency Economic Powers Act and other statutes, ordered specified sanctions against Libya to be implemented in accordance with regulations issued by the Treasury Department. In particular, the President ordered that United States persons generally are prohibited from performing any contract in support of an industrial, commercial, or governmental project in Libya. Among several other provisions, the President prohibited any transaction by a United States person relating to activities by any such person within Libya, other than certain specified transactions, including travel for journalistic activities by persons regularly employed in such capacity by a newsgathering organization.

Description of H.R. 4056

H.R. 4056 would deny the foreign earned income exclusion to Americans present in a foreign country in violation of an Executive Order, effective for periods beginning after January 31, 1986. Although neither Executive Orders 12543 and 12544 nor the underlying Treasury regulations prohibit presence in Libya *per se*, H.R. 4056 would have the effect of denying the foreign earned income exclusion to Americans working in Libya after the effective date. Limited exceptions would apply with respect to journalists and to spouses and dependents of Libyan nationals who, in certain cases, are not in Libya in violation of the law.

Discussion

The Treasury Department generally opposes using the income tax as an instrument of foreign policy. We do not believe that the denial of tax benefits is an appropriate form of opposition to a foreign government's non-tax policies. H.R. 4056, however, addresses a very exceptional case. The activity giving rise to the tax benefits -- employment in a particular country -- is prohibited by statute, as implemented by Executive Order of the President and underlying regulations, and criminal sanctions apply if violations of the Executive Order occur. The criminal penalties for violation of the prohibition can be a fine of $50,000 and imprisonment for 10 years.

The Treasury Department believes that, in the exceptional situation addressed in this case, the Congress could rationally choose to deny the tax benefit of the foreign earned income exclusion to persons earning income in Libya in violation of the Executive Order. We would not regard such action as precedent for denying tax benefits, such as the foreign tax credit, in other circumstances where direct statutory penalties would be appropriate.

We also note that the State Department does not oppose this bill.

H.R. 4077

Denial of Tax-Exemption for Bonds to Provide Property Used by Certain Electric Utilities

Current Law

Section 103, with certain exceptions, excludes from gross income interest on obligations of a State or its political subdivisions. Interest on bonds issued to finance publicly owned electric generating facilities qualify for this exclusion, unless the bonds are classified as industrial development bonds or consumer loan bonds.

A bond issued by a State or local government to finance a publicly owned electric generating facility is an industrial development bond ("IDB") if one nonexempt person (or two or more nonexempt persons, each of which pays annually a guaranteed minimum payment exceeding three percent of the average annual debt service) agrees (i) to take, or to take or pay for, more than 25 percent of the total output of the facility, and (ii) to pay more than 25 percent of the total debt service on the bonds.

A bond issued by a State or local government is a consumer loan bond if more than five percent of the bond proceeds are reasonably expected to be used directly or indirectly to make or finance loans to nonexempt persons. A contract to sell the output of a bond-financed electric generating facility to an nonexempt person may constitute a loan for this purpose if the contract significantly shifts the burdens and benefits of ownership of the bond-financed facility to the nonexempt person.

If a bond is an IDB or a consumer loan bond, the bond may nevertheless qualify for tax exemption if the bond proceeds are used to provide an exempt facility. Under present law, facilities for the local furnishing of electric energy qualify as exempt facilities. (H.R. 3838, as passed by the House of Representatives, would repeal this exception.)

Description of H.R. 4077

H.R. 4077 would amend section 103 to deny the tax exemption for interest on a bond, under certain circumstances, if any portion of the bond proceeds is to be used directly or indirectly to provide property for use by any one of 88 electric utilities that entered into an agreement in 1974 with a certain corporation to "take or pay" for specified amounts of electricity to be generated by either of two nuclear electric generating facilities that were not constructed. In particular, interest on such bonds would not be excludable from gross income during any period that payments under the take or pay agreements are in arrears. For purposes of determining the amount of payments that are in arrears, the bill treats the agreements as binding and construes them as if electricity were generated (and available for purchase) from the facilities involved. The bill would apply to obligations issued after the date of enactment.

While the bill is framed in terms of general applicability, it is our understanding that the only utilities that would be affected by the provision are those that contracted with the Washington Public Power Supply System ("WPSS") for the purchase of power from the planned (but uncompleted) nuclear generating units four and five of that system.

Discussion

The Treasury Department strongly opposes H.R. 4077.

The 88 electric utilities referred to by the bill contracted with WPSS to purchase electric power from two nuclear electric generating facilities to be constructed. Under the terms of the contracts, the utilities agreed to pay their share of the construction costs (including debt service on bonds issued by WPSS), even if the facilities were never completed. After WPSS issued bonds to finance construction and pledged the contracts to the bondholders as security, cost overruns and reduced electric demand adversely affected the anticipated economic viability of the facilities, and construction of the facilities was suspended. Subsequently, actions were brought by ratepayers and some of the 88 utilities to declare the contracts null and void on the ground that the utilities, most of which were State public utilities, did not have authority to enter into them. The State of Washington Supreme Court decided that the contracts were invalid, and barred the State's public and municipal utilities from making any payments under the contracts. After the State court's action, the bonds issued by WPSS went into default.

The purpose of the bill seems to be either to force the 88 utilities to make payments under the contracts, which would apparently contravene the decision of the Washington Supreme Court and might subject the directors of the utility to personal liability under shareholder or ratepayer suits, or to penalize them for not doing so by restricting their ability to borrow on a tax-exempt basis. We believe that it is entirely inappropriate under these circumstances to attempt to accomplish either of these purposes through the Internal Revenue Code.

Under the bill, the utilities involved in this case would be denied the availability of tax exempt financing either because they exercised their legal rights by successfully bringing suit to stop payments or, for those utilities that did not support the actions to declare the contracts invalid and continued to make payments under their contracts, because they were barred from doing so under State law. Under such circumstances, it is clearly inappropriate to withhold tax benefits as proposed by the bill. Finally, we note that the bill also would adversely affect the ability of other public utilities to finance their facilities with tax-exempt bonds if they have contracted to sell a significant amount of power to any of the 88 utilities, because such facilities apparently would be considered used by one of the 88 utilities for purposes of the bill.

H.R. 4379

Nonrecognition of Gain on Sale of Old Residence Where One Spouse Dies Before Occupying New Residence

Current Law

In general, section 1034 of the Code allows a taxpayer to defer the recognition of gain on the sale of his or her principal residence if the taxpayer invests the proceeds from such sale in a new principal residence within two years. Section 1034(g) addresses the particular situation where a taxpayer and the taxpayer's spouse each contribute different proportions of the cost of the new residence as compared to the old residence. For example, if the taxpayer paid the entire $50,000 cost of the old residence, but only one-half of the $75,000 cost of the new residence, section 1034(g) of the Code allows the taxpayer and the taxpayer's spouse to elect to treat the taxpayer as providing the entire cost of purchasing the new residence so that no gain must be recognized. The taxpayer and the taxpayer's spouse must both consent to the application of this provision and agree to calculate their basis in the new residence to preserve the gain that was inherent in the sale of the old residence.

Description of H.R. 4379

H.R. 4379 would amend section 1034(g) to allow nonrecognition of gain on the sale by a married couple of an old principal residence where one spouse who occupied the old residence dies after the date of the sale of the old residence, but before the deceased spouse occupies the new residence. This result would be achieved by removing the requirements that the deceased spouse both consent to the application of 1034(g) and occupy the new residence as the principal residence. The bill would apply to the sale of old residences after December 31, 1984.

Discussion

Treasury Department supports H.R. 4379, with suggestions for minor technical changes.

Section 1034, as currently in effect, does not by its terms contemplate the possibility that one spouse may die in the period between the sale of the old residence and the occupation of the new residence. It would be consistent with the policy of section 1034 to allow the application of section 1034(g) in such a situation, because the gain from the sale of the old residence would be preserved in the surviving spouse's basis in the new residence.

While the Treasury Department supports H.R. 4379, we believe that certain minor changes should be made to clarify its meaning. Specifically, we would: (1) replace the term "the taxpayer" with the term "the taxpayer or his spouse," and (2) clarify that the surviving spouse must occupy the new residence as the principal residence within the prescribed period and must agree to calculate his or her basis in the new residence so as to preserve the gain before this provision would be applicable.

H.R. 4595

Treatment of Certain Amounts Received by Qualified Cooperative Housing Corporations in Connection with the Refinancing of Certain Indebtedness

Current Law

Under section 216 of the Code, a tenant-stockholder of a cooperative housing corporation ("cooperative") may deduct amounts paid or accrued to the cooperative to the extent such amounts represent the tenant-stockholder's proportionate share of (1) real estate taxes allowable as a deduction to the cooperative that are paid or incurred by the cooperative with respect to the cooperative's land or buildings, and (2) the interest allowable as a deduction to the cooperative that is paid or incurred by the corporation on its indebtedness contracted in the acquisition, construction, or improvement of the cooperative's buildings or in the acquisition of the cooperative's land.

A corporation generally may qualify as a cooperative housing corporation only if (1) it has only one class of stock, (2) each of its stockholders is entitled, solely by reason of ownership of stock, to occupy a dwelling unit owned or leased by the corporation, (3) none of its stockholders is entitled to receive any distribution not out of earnings and profits of the corporation, except on a complete or partial liquidation, and (4) 80 percent of more of its gross income for the taxable year is derived from tenant-stockholders.

Under section 118(a), gross income of a corporation does not include any contribution to the capital of the corporation. The Congress, in enacting this provision in 1954, intended it to apply in cases in which, "because the contributor expects to derive indirect benefits, the contribution cannot be called a gift; yet the anticipated future benefits may also be so intangible as to not warrant treating the contribution as a payment for future services." S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 18-19 (1954); H. Rep. No. 1337, 83d Cong., 2d Sess., pp. 17-18 (1954).

The issue whether a payment to a corporation by a nonshareholder constitutes a contribution to capital under section 118(a) or gross income under section 61 is an inherently factual determination. In The May Department Stores Company, 33 T.C.M. 1128 (1974), aff'd per curiam, 519 F.2d 1154, 75-2 U.S.T.C. par. 9628 (8th Cir. 1975), for example, the Tax Court held that the taxpayer received a nontaxable contribution to capital where developers of a shopping center transferred to the taxpayer a parcel of land to induce the taxpayer to construct a department store on the land. The developers were motivated by their expectation that construction of the department store would increase the value of their real estate interests if the store attracted customers to the shopping center. Under those circumstances, the court reasoned that the benefits sought by the developer were "indirect" and "intangible" and constituted a nontaxable contribution to capital. On the other hand, in Teleservice Company of Wyoming Valley v. Commissioner, 254 F.2d 105, 58-1 U.S.T.C. par. 9383, (3d Cir. 1958), aff'g 27 T.C. 722 (1957), the court held that customer contributions to a community television antenna system for the construction of facilities represented taxable income to the taxpayer because those contributions in substance constituted "part of the payment for services rendered or to be rendered."

Under section 277, deductions attributable to providing services or goods to members of a social club or other membership organization are allowed only to the extent of income derived during the taxable year from members. To the extent deductions attributable to membership activities exceed such income for a taxable year, the excess is carried forward to the succeeding taxable year and is again subject to the same limitation. Section 277 applies to cooperative housing corporations. 7/

Under section 163(a), a deduction generally is allowed for all interest paid or accrued within the taxable year on indebtedness of the taxpayer. Section 446(b) provides, however, that if the method of accounting used by the taxpayer does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, clearly reflects income.

Background

The Treasury Department is aware of several taxpayer controversies involving cooperative housing corporations, currently pending before the Internal Revenue Service, that would be affected by the terms of H.R. 4595. In particular, certain cooperative housing corporations, prior to January 1, 1984, refinanced their existing mortgage loans in transactions that resulted in an agency of the Federal Government providing a guarantee of a new first mortgage loan held by a city housing corporation, and the creation of an unguaranteed second mortgage loan held by the city housing corporation.

7/ See S. Rep. No. 938, 94th Cong., 2d Sess., pp. 397-398 (1976); Shore Drive Apartments, Inc. v. U.S., 76-2 U.S.T.C. par. 9808 (M.D. Fla. 1976).

In the course of each of these refinancing transactions, the Federal government agency required the city housing corporation to pay certain costs as a condition of guaranteeing the loan. These payments included the costs of closing the refinancing and establishing a capital reserve fund for the benefit of the cooperative. The reserve fund was to be used for the benefit of the cooperative for purposes approved by the Federal Government agency, such as capital expenditures to repair the building or to replace appliances. The fund was invested in income-producing instruments, and the interest income could be used for operating expenses of the cooperative. Any remaining balance of the fund will be paid to the cooperative upon final payment of the first and second mortgages.

Finally, the terms of the second mortgage loan provided for a below-market interest rate, a moratorium on principal and interest payments for two years, and a limited obligation to make subsequent payments of principal and interest (with no accrual of interest on deferred payments) until complete repayment of the 40-year first mortgage loan.

In certain of the cases described generally above, Technical Advice Memoranda stating the position of the Internal Revenue Service have been issued, and conferences have been held between the Service and the taxpayers regarding these positions. Because of our acute sensitivity to maintaining confidential taxpayer information, we have summarized above only those facts that are both properly available to the public under section 6103 and important to understanding the implications of H.R. 4595.

Description of H.R. 4595

Section 1(a) of the bill provides that, in the case of a qualified refinancing of a mortgage loan of a qualified cooperative housing corporation, the payment or reimbursement by a city housing development corporation of amounts for (1) closing costs incurred with respect to the refinancing, and (2) the creation of a reserve for the cooperative, shall not be included in the gross income of the cooperative. Section 1(b) of the bill provides that income attributable to a reserve described in section 1(a) of the bill shall be treated as derived from members for purposes of sections 216 and 277. Section 1(c) of the bill provides that any amount claimed by a qualified cooperative housing corporation as a deduction for interest on a second mortgage loan made by a city housing development corporation in connection with a qualified refinancing shall be treated as if such amount were paid during such taxable year. The provisions of section 1 of the bill are effective only for taxable years beginning before January 1, 1986.

For purposes of section 1 of the bill, a "qualified cooperative housing corporation" means any corporation that (1) is subject to a limited-profit housing companies law that limits the resale price for a tenant-stockholder's stock in a cooperative housing corporation to his or her stock basis and share of amortization of any mortgage on the cooperative's building, and (2) would be treated as a cooperative housing corporation under section 216 after application of sections 1(a) and 1(b) of the bill. Under section 1(e) of the bill, a "qualified refinancing" generally means a refinancing that occurred before January 1, 1984, and in which a first mortgage loan held by a city housing development corporation was refinanced with a first mortgage loan insured by an agency of the Federal Government and a second mortgage loan held by the city housing development corporation.

Section 2 of the bill provides that, for taxable years beginning after December 31, 1985, payments from a qualified refinancing-related reserve described in section 1 of the bill out of amounts excluded from gross income shall not give rise to deductions from income and, in the case of payments made to acquire property, shall not be included in the basis of such property.

Discussion

As described above, H.R. 4595 specifically affects several ongoing controversies between the Internal Revenue Service and taxpayers. This is illustrated by the fact that section 1 of the bill applies only to taxable years beginning before 1986, with respect to refinancings that occurred before 1984. By their terms, therefore, the principal provisions of H.R. 4595 apply only retroactively. 8/

The Treasury Department generally opposes retroactive legislation that will affect live controversies between the Internal Revenue Service and taxpayers. We believe that the Congress generally should not interfere in such cases. Accordingly, because H.R. 4595 involves existing taxpayer disputes with the Internal Revenue Service, the Treasury Department must oppose the bill.

Although we oppose the bill on its face, several substantive tax law concerns also are raised by H.R. 4595. In particular, the provisions of the bill raise three discrete sets of underlying substantive issues. The first question is whether payments by the city housing development corporation, a nonshareholder, to or on behalf of the cooperative constitute gross income to the cooperative or should be treated as a contribution to capital excluded from the cooperative's gross income under section 118(a). Second, for purposes of the rules regarding "membership income" of cooperative housing corporations, it must be determined whether income derived from the investment of reserve funds should be treated as membership

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8/ Section 2 of the bill, which provides rules applicable to payments made out of the reserve, would affect future taxable years, but only with respect to reserves created before 1984.

or nonmembership income. Third, it must be determined under what circumstances it is appropriate for the Commissioner to exercise his discretion under section 446(b) to disregard a taxpayer's method of accounting as not clearly reflecting income.

<u>Treatment of Payments as Contributions to Capital</u>

As described above, a contribution to the capital of a corporation is not included in the corporation's gross income under section 118(a). Under the case law, the treatment of a payment to or on behalf of a corporation as a contribution to capital is appropriate only where the facts and circumstances indicate that the payment was not made by the payor for the purpose of obtaining benefits other than benefits that are "indirect" and "intangible." In the case of the refinancing transactions described in H.R. 4595, the facts indicate that the person making payments to or on behalf of the cooperatives received direct and tangible benefits, namely the proceeds of new first mortgage loans guaranteed by an agency of the Federal Government. Thus, under section 118(a), the Internal Revenue Service has taken the position that the payments made to the cooperative in connection with these refinancing transactions did not constitute contributions to capital excludable from gross income. Accordingly, the payments would be taxable to the corporation.

On the other hand, because the benefits derived by the payor as a result of these transactions were not provided by the cooperative receiving the benefits of the payments (<u>i.e.</u>, the payments did not constitute consideration for a service), the cooperative has argued that it may exclude such payments under the traditional application of section 118(a).

The issue whether the payments made to the cooperatives were income or contributions to capital is factual, requiring application of the general principles of section 118(a) to the circumstances of a specific case. We believe it is particularly appropriate for such mattters to be resolved by the Internal Revenue Service and the taxpayer, through the courts if necessary. The Congress should not interfere in such a determination. If the Congress undertakes to resolve this factual dispute between taxpayers and the Internal Revenue Service, it may be drawn into many other such controversies.

<u>Treatment of Reserve-Fund Income as Derived from Tenant-Stockholders</u>

The special rules for tenant-stockholders of cooperative housing corporations are intended to place tenant-stockholders in essentially the same tax position as if they had directly purchased interests in their dwelling units. In the case of a cooperative that does not receive any income from sources other than rent payments from tenant-stockholders, this goal would be realized without complication.

Cooperatives, however, often receive income from other sources, including business transactions with persons other than tenant-stockholders as well as from investment activities. The proper taxation of cooperative corporations requires that these transactions be adequately considered. In particular, it is necessary to ensure that income derived from investment activities and from the operation by a cooperative of a trade or business with outsiders is taxed in a fashion comparable to income earned by a corporation that does not also furnish housing to its stockholders. If these classes of income were not subject to the normal corporate tax rules, tenant-stockholders of cooperative housing corporations would not merely obtain the same tax benefits obtained by direct homeowners, but would be treated more favorably than homeowners similarly earning income through corporate business or investment activities.

As stated above, section 277 provides that deductions attributable to providing services to tenant-stockholders, such as depreciation and operating expenses, are allowed only to the extent of income derived from members, such as rental payments, and are not allowed to reduce income from non-member sources. If investment income earned by a cooperative from investing in a capital reserve fund were treated as derived from tenant-stockholders for purposes of section 277, a cooperative earning such income would be able to pay, with before-tax dollars, expenses that a direct homeowner must pay with after-tax dollars, such as insurance, maintenance, and principal payments on a mortgage loan. Thus, allowing a cooperative's investment income to be treated as membership income would be roughly equivalent to exempting a cooperative homeowner's investment income from tax when the income is used to pay housing expenses. The purpose of section 277 is to prevent membership organizations such as housing cooperatives from obtaining such an unintended benefit.

Accordingly, investment income from qualified refinancing-related reserve funds should not be treated as derived from tenant-stockholders for purposes of section 277. Section 1(b)(2) of H.R. 4595, however, would provide the opposite result. 9/

A slightly different issue is raised by section 1(b)(1) of the bill, which would treat the investment income from the reserve fund as derived from tenant-stockholders for purposes of section 216. The effect of this provision would be to permit tenant-stockholders of an affected cooperative to deduct their contributions to the cooperative's mortgage interest and real estate taxes even if the cooperative derived more than 20 percent of its income from non-member sources (taking into account the reserve-fund income).

9/ We note that many cooperatives, including housing cooperatives, urge a broader definition of membership income, and would thus argue that the investment income from the reserve fund should be considered membership income.

In general, corporate investment income should not be treated as derived from tenant-stockholders for purposes of the 20-percent rule of section 216. If corporate investment income were not subject to the 20-percent limit, any amount of such investment income would potentially be used by cooperatives to provide economic benefits to the tenant-stockholders (generally in the form of reduced rent), even though the tenant-stockholders normally do not report taxable dividends in such circumstances. Under normal corporate tax rules, which apply to direct homeowners who are stockholders in corporations earning investment income, corporate after-tax income cannot be used to provide benefits to stockholders without creating taxable dividend income. It would be inappropriate to expand the ability of cooperative housing corporations to earn investment income without clearly subjecting the tenant-stockholders to dividend taxation.

<u>Treatment of Accrued but Unpaid Interest as not Clearly Reflecting Income</u>

As stated above, in the refinancing transactions described in H.R. 4595, second mortgage loans were created with terms that (1) provided below-market interest rates, (2) provided a moratorium on all principal and interest payments for two years, and (3) provided that the obligation to make any principal and interest payments would be substantially limited until after the first mortgage loans were fully paid, 40 years after the first interest accruals. Section 1(c) of the bill would provide that any amount claimed by a qualified cooperative housing corporation as a deduction for interest for any taxable year beginning before January 1, 1986, with respect to such second mortgage loans would be treated as paid in the year claimed.

In light of the substantial period of time during which the cooperatives in question will not be unconditionally obligated to pay interest that accrued during the years in question, the small present value of the deferred amounts, and the possibility that the amounts may in fact never be paid, the Internal Revenue Service has concluded, under the authority of section 446(b), that allowing the deduction of such interest in the year accrued would not clearly reflect income. The taxpayer, in contrast, has claimed that such deductions are properly allowable under section 163. The question whether the Commissioner has properly exercised his discretion under section 446(b), like the other issues presented by these transactions, should be resolved between the parties. Again, we urge the Congress not to make such determinations.

* * *

This concludes my prepared remarks. I would be pleased to respond to any questions.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE May 19, 1986

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 7,001 million of 13-week bills and for $ 7,025 million of 26-week bills, both to be issued on May 22, 1986, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing August 21, 1986			26-week bills maturing November 20, 1986		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	6.17%	6.36%	98.440	6.26%	6.55%	96.835
High	6.23%	6.42%	98.425	6.28%	6.58%	96.825
Average	6.22%	6.41%	98.428	6.28%	6.58%	96.825

Tenders at the high discount rate for the 13-week bills were allotted 60%.
Tenders at the high discount rate for the 26-week bills were allotted 80%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 40,380	$ 40,380	$ 30,055	$ 26,855
New York	17,837,875	5,628,875	19,890,595	6,119,395
Philadelphia	24,800	24,800	19,000	19,000
Cleveland	56,390	56,390	23,490	23,490
Richmond	52,455	52,055	29,460	27,460
Atlanta	32,600	32,600	49,145	44,145
Chicago	1,382,225	397,225	1,178,575	221,695
St. Louis	65,610	45,610	60,555	40,555
Minneapolis	19,380	19,380	17,285	16,285
Kansas City	66,595	66,595	37,565	37,565
Dallas	46,735	41,735	22,730	16,730
San Francisco	2,172,975	245,975	1,263,585	131,385
Treasury	348,880	348,880	300,450	300,450
TOTALS	$22,146,900	$7,000,500	$22,922,490	$7,025,010
Type				
Competitive	$18,786,160	$3,639,760	$19,584,825	$3,687,345
Noncompetitive	1,129,555	1,129,555	734,440	734,440
Subtotal, Public	$19,915,715	$4,769,315	$20,319,265	$4,421,785
Federal Reserve	1,904,010	1,904,010	1,875,000	1,875,000
Foreign Official Institutions	327,175	327,175	728,225	728,225
TOTALS	$22,146,900	$7,000,500	$22,922,490	$7,025,010

An additional $37,025 thousand of 13-week bills and an additional $63,975 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-585

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE UPON DELIVERY EXPECTED AT
9:30 A.M., MAY 20, 1986

Statement by the Honorable James A. Baker, III
Secretary of the Treasury
before the
Committee on Foreign Relations
United States Senate

May 20, 1986

Mr. Chairman, members of the Committee:

I am pleased to have the opportunity to brief you this morning on the principal economic developments at the Tokyo Summit and to bring you up to date on progress in implementing our international debt strategy. I would also like to urge your support for the important piece of legislation before the Congress authorizing U.S. participation in the Multilateral Investment Guarantee Agency.

The Setting: Progress and Opportunities

Allow me, before turning to these specific subjects, to describe the significant progress being made in establishing the fundamental conditions necessary to achieve and maintain a sound and growing world economy, more balanced trade positions, and greater exchange rate stability.

- o The Plaza Agreement last September has resulted in exchange rate relationships that better reflect underlying economic conditions. The Japanese yen and German mark have now appreciated more than 55 percent from their recent lows in February 1985. The dollar has more than fully offset its earlier appreciation against the yen; and it has reversed nearly three-quarters of its appreciation against the mark.

- o The Plaza Agreement also contributed to movement toward stronger, more balanced growth among the major industrial countries, including policy commitments to that end. Efforts to fulfill those undertakings are ongoing. The favorable economic convergence which was the focus of the Plaza Agreement is being realized, with consequent narrowing of the "growth gap" between the U.S. and its major trading partners.

- o Inflation has been cut sharply and is expected to stay low, in part reflecting the effects of the sharp reduction in oil prices. This has facilitated a substantial reduction in interest rates and enhances prospects for further declines.

- o We now expect the deterioration in our trade position to halt this year, and we look forward to substantial improvement next year. Exchange rate changes take time to work their way through our economic system, as businesses and consumers gradually adjust their plans. Next year, as the impact of these changes is more fully felt, with assistance from the decline in oil prices, our trade and current account deficits should drop below $100 billion, or nearly one-third below our projections as recently as last autumn.

- o Preparations are well advanced for launching the new round of multilateral trade negotiations, with a Ministerial to be held this September. Our Summit partners agreed in Tokyo to the U.S. proposal that the new round should include services and trade related aspects of intellectual property rights and foreign direct investment.

- o And, as I will detail later, our proposals for improving growth in the debtor countries have gained wide support and are now being implemented.

Still, there is no doubt that problems remain and that we have to do more to address them.

The scars of a decade of economic turmoil are deep, and they cannot be easily or quickly erased. The distortions to our economies from the oil shocks, rapid inflation and the recessions of the 1970s and early 1980s have required us increasingly to address structural problems that demand time to correct. Unemployment remains high in many countries, and large domestic and external imbalances persist.

Uncertainties about the future behavior of exchange rates have also been prevalent, reflecting deficiencies in the international monetary system that gradually intensified over the years. We know also that the debt problems of the developing world, accumulated over a decade or more, cannot be resolved in a few short months. And we know protectionist pressures remain strong. We recognize the need to address related problems -- in our monetary system, in our arrangements for international economic cooperation, in the developing countries -- if we are to contain those pressures and work toward more open and fair markets.

The progress that has been achieved in the general economic environment, however, provides a golden opportunity to resolve these remaining problems. Success inspires confidence that we can go further. At the Tokyo Summit, President Reagan and the heads of the other major Free World democracies manifested the political will and leadership to confront the tasks that remain.

Strengthening International Economic Coordination at The Tokyo Economic Summit

The Plaza Agreement and subsequent coordinated interest rate reductions evidenced the willingness and ability of the major industrial countries to cooperate more closely on their economic policies. At the same time, experience of the past year demonstrated that exchange rate changes alone could not be relied upon to achieve the full magnitude of adjustments required in external positions. It had become increasingly apparent that closer coordination of economic policies will be required to achieve the stronger, more balanced growth and compatible policies necessary to reduce the large trade imbalances that remain and foster greater exchange rate stability.

For this purpose, we went to Tokyo seeking to build upon the framework embodied in the Plaza Agreement and to establish an improved process for achieving closer coordination of economic policies on an ongoing basis. I believe we succeeded.

The international monetary arrangements that have been in place since the early 1970s contain a number of positive elements, particularly a necessary flexibility to respond to economic shocks. However, this flexibility went too far, allowing problems to cumulate and countries to pursue policies without adequately considering the international dimensions of their decisions. The agreement reached at the Tokyo Summit seeks to combine needed flexibility with a greater likelihood that remedial action will be taken to deal with problems before they reach disruptive proportions.

The arrangements that were adopted involve a significant strengthening of international economic policy coordination aimed at promoting non-inflationary growth, adoption of market-oriented incentives for employment and investment, opening the trade and investment system, and fostering greater exchange rate stability. Details of the new procedures will, of course, have to be worked out in subsequent discussions. However, I see the enhanced surveillance process working as follows:

> First, the measures for use in assessing country goals and performance will be agreed upon by the countries participating in the enhanced surveillance process. As stated in the Tokyo communique, a broad range of indicators would be utilized in order to achieve the comprehensive policy coverage necessary to insure that the underlying problems, not just the symptoms, are addressed. These

indicators would include growth rates, inflation rates, unemployment rates, fiscal deficits, current account and trade balances, interest rates, monetary growth rates, reserves, and exchange rates.

Second, each country will set forth its economic forecasts and objectives taking into account these indicators.

Third, the group would review, with the Managing Director of the International Monetary Fund, each country's forecasts to assess consistency, both internally and among countries. In this connection, exchange rates and current account and trade balances would be particularly important in evaluating the mutual consistency of individual country forecasts. Modifications would be considered as necessary to promote consistency.

Fourth, in the event of significant deviations in economic performance from an intended course, the group will use best efforts to reach understandings on appropriate remedial measures, focusing first and foremost on underlying policy fundamentals. Intervention in exchange markets could also occur when to do so would be helpful.

As you know, countries have been developing individual economic forecasts for years. Moreover, the IMF consults with individual countries on a regular basis regarding their economic policies and performance. What is new in the arrangements adopted in Tokyo is that the major industrial countries have agreed that their economic forecasts and objectives will be specified taking into account a broad range of indicators, and their internal consistency and external compatibility will be assessed. Moreover, if there are inconsistencies, efforts will be made to achieve necessary adjustments so that the forecasts and objectives of the key currency countries will mesh. Finally, if economic performance falls short of an intended course, it is explicitly agreed that countries will use their best efforts to reach understandings regarding appropriate corrective action.

The procedures for coordination of economic policy were further strengthened at the Summit. A new Group of Seven Finance Ministers, including Canada and Italy, was formed in recognition of the importance of their economies. At the same time, the Group of Five has agreed to enhance its multilateral surveillance activities.

In sum, Mr. Chairman, we have agreed on a more systematic approach to international economic policy coordination that incorporates a strengthened commitment to adjust economic policies. I am hopeful that the spirit of cooperation that made this agreement possible will carry over to its implementation. If so, we can look forward to greater exchange rate stability, enhanced prospects for growth, and more sustainable patterns of international trade.

International Trade at the Tokyo Economic Summit

Action toward closer international coordination of economic policies and greater exchange rate stability complements our efforts to promote a fair and open international trading system.

President Reagan and the others at the Tokyo Economic Summit reaffirmed their commitment to fighting protectionism and strengthening the international trading system. They further pledged to work at the September GATT Ministerial meeting to make decisive progress in launching the new round of multilateral trade negotiations. We expect this meeting will initiate these important negotiations.

As mentioned earlier, in the new round we will notably be seeking new GATT rules covering services, intellectual property protection, and international investment, as well as improved market access abroad. Agricultural issues are a priority for the U.S., and agriculture will also be included in the new round of trade negotiations.

The Tokyo Summit also featured a precedent-setting discussion of agricultural issues by the Heads of State and Government. The Summit gave special emphasis to concerns about the global structural surplus in some agricultural commodities that results in part from the subsidies and protection provided in all the Summit countries. Moreover, the Summit leaders agreed that policies should be redirected and the structure of agricultural production adjusted in the light of world demand. They also expressed their determination to support the work of the OECD in this area.

Open markets are essential to our overall international strategy of economic adjustment and policy coordination. In recommitting themselves to maintaining an open multilateral trading system, the leaders of the Free World's major industrialized nations recognized in Tokyo that:

- o Open markets promote economic growth world-wide. We have only to review the Depression years to see the effects of closed markets.

- o Open markets provide debtor nations with markets for their exports that are essential if they are to service their debt and, in turn, serve as markets for U.S. goods and products; and

- o Open markets facilitate our efforts to adjust large, unsustainable external imbalances among the industrial nations.

The Administration is committed to maintaining an open U.S. market and ensuring a free but fair international trading system. We must avoid passage of protectionist trade legislation that would alienate our trading partners, encourage them to enact similar protectionist policies, and undermine the Administration's international economic policy. Closed markets and an atmosphere of confrontation would doom our efforts to solve our international economic problems in a responsible and constructive manner. The greatest threat today to economic well-being world-wide is the danger of protectionism and a trade war. We need your help to avoid these dangers. I urge you to give the Administration's policies a chance to work.

International Debt Strategy

The resolution of international debt problems is important to the U.S. economy as a whole, as well as to our international trade and financial system. We also have strong political and humanitarian interests in improving economic growth and political stability in the debtor nations.

When I briefed this Committee last October on our proposals for strengthening the international debt strategy, I warned that there are no easy solutions to the debt problem, and that the road ahead would be difficult and challenging. Seven months later, that statement remains valid. But I can also assure you that the directions in which we turned last fall are still correct and that we are making progress in implementing our initiative.

Recent improvements in the global economy are already making a significant contribution to developing nations' growth prospects and will substantially ease their debt service obligations. Stronger industrial country growth and lower inflation, for example, will add nearly $5 billion to developing nations' non-oil exports and reduce their import costs by approximately $4 billion this year. The sharp decline in interest rates since early 1985 will reduce their annual debt service payments by about $12 billion. The decline in oil prices will also save oil-importing developing nations an additional $14 billion annually.

At the same time, however, developing countries, particularly debtor nations, must position themselves to take advantage of these improvements by putting in place policies to assure stronger, sustained growth for their economies over the medium and longer term. As you know, the "Program for Sustained Growth" for the major debtor nations proposed by the U.S. in Seoul was premised on credible, growth-oriented economic reform by the debtor nations, supported by increased external financing.

In Tokyo, the Summit leaders welcomed the progress made in developing the cooperative debt strategy, in particular building on the United States' initiative. They emphasized that the role of the international financial institutions will continue to be central and welcomed moves for closer cooperation between the IMF and the World Bank, in particular. The debt initiative has also received strong support from the international financial institutions, national banking groups in all major countries, and the OECD Ministers, as well as the key IMF and World Bank Committees representing both debtor and creditor countries.

The adoption of growth-oriented macroeconomic and structural policies by the debtor nations is at the heart of the strengthened debt strategy and crucial to sustained growth over the longer term. Special emphasis needs to be placed on measures to increase savings and investment, improve economic efficiency, and encourage a return of flight capital. A more favorable climate for direct foreign investment can be an important element of such an approach, helping to reverse recent declines in net direct investment flows. Such inflows are non-debt creating, provide greater protection against changes in the cost of borrowing, and can help improve technology and managerial expertise.

Similarly, a rationalization and liberalization of debtors' trade regimes can contribute to improved efficiency and productivity for the economy as a whole. Together with other growth-oriented measures to assure more market-related exchange rates and interest rates, to reduce fiscal deficits, to improve the efficiency of capital markets, and to rationalize the public sector, such measures can help improve growth prospects, restore confidence in debtor economies, and encourage the return of flight capital.

Such policy changes will take time to put in place and can't be expected to occur overnight. The process of implementing these reforms will also be much less public than the series of announcements to date supporting the debt initiative. Implementation will take place through individual debtors' negotiations with the IMF, the World Bank and the commercial banks. We expect these negotiations to place greater emphasis on dealing with current debt problems through a medium-term, growth-oriented policy framework. This process is already underway. The IMF, for example, has existing or pending arrangements with 11 of the 15 major debtor nations.

The World Bank is also moving ahead to strengthen procedures and policies to implement its expanded role in the debt strategy. It is currently assisting major debtors in the development of medium-term adjustment programs. It also plans to implement procedures which will streamline operations and provide for a more comprehensive review of lending priorities for individual countries. Finally, Bank staff are working with private creditors in considering ways to better mobilize additional support for debtors' adjustment programs.

The World Bank currently has structural or sector loan negotiations underway with 13 of the heavily indebted, middle income debtors. New structural or sectoral adjustment loans have already been signed with some of these countries, including

Ecuador and Argentina, both of which are also discussing follow-on standby programs with the IMF. Other countries are at different stages in implementing comprehensive growth-oriented economic programs.

As the Summit communique noted, sound adjustment programs will need to be supported by resumed commercial bank lending, flexibility in rescheduling debt, and appropriate access to export credits. Once debtor nations have designed economic reform programs to improve their growth prospects that have Fund and Bank support, it will be critical for the commercial banks to fulfill their pledges of financial support for these programs. The industrial nations must also cooperate regarding resumption of export credit cover to countries implementing appropriate adjustment policies.

In addition to the strong global support for our initiative with respect to the major debtors, we are also very pleased with the recent actions of the IMF and the World Bank on the Trust Fund initiative to assist low-income developing nations, primarily those in Sub-Saharan Africa. Creation of these new arrangements constitutes a major step forward in helping these countries address their fundamental economic problems. The new arrangements will also stimulate closer Fund/Bank cooperation and provide a positive context for current negotiations on IDA VIII. We look forward to their implementation so that a sound basis of growth can be established in these countries as well.

The Program for Sustained Growth is important because it touches on a wide range of U.S. interests, but paramount among these is its importance for U.S. trade. As you know, the debt crisis has had a direct impact on U.S. exports. U.S. exports to the 15 major debtor nations peaked at $40 billion in 1981. However, this reflected an international economic environment that was clearly not sustainable. Our exports to these countries fell sharply to $23 billion in 1983, as the debtor nations were unable to maintain previous import levels in the face of financial constraints and slower export growth.

The international debt strategy adopted in the wake of the debt crisis has helped to place the debtors' economies on a sounder footing and to permit a resumption of import growth at a more sustainable pace. U.S. exports to the major debtor nations have increased by 18%, or $4 billion, during the past two years and can be expected to improve further. The adoption of growth-oriented economic reforms, supported by increased financing from the international community, as envisaged by the debt initiative, will help to enhance both growth prospects and imports.

It will also be important, however, for the United States and other industrial nations to maintain open markets for LDC exports to permit them to earn the foreign exchange necessary to increase imports. The process of increasing growth and trade is an interactive one. We cannot expect to reap the benefits of stronger growth and increased trade abroad if we close our markets at home.

Multilateral Investment Guarantee Agency (MIGA)

We believe prompt enactment of legislation enabling U.S. participation in the Multilateral Investment Guarantee Agency would make an important contribution to the implementation of our international debt strategy.

The MIGA is designed to encourage the flow of investment to and among developing countries by issuing guarantees against political risk, encouraging sound investment policies in member countries, and carrying out a wide range of promotional activities. The United States has long been an advocate of a greater role for foreign direct investment in the development process. Foreign direct investment both enhances the private sector's role in development and, as I earlier suggested, encourages the flow of non-debt capital to LDCs.

The MIGA will stimulate these flows and in addition, because of its multilateral nature, will be well positioned to promote investment policy reforms in developing countries. The United States has a direct stake in the investment policy reform process; since this country is the largest direct investor in other countries, it is in our best interests to see that appropriate investment protection standards are more widely accepted.

The Administration thus strongly supports U.S. membership in the Multilateral Investment Guarantee Agency and has requested Congress to authorize and provide full funding for membership in fiscal year 1987. The $222 million U.S. subscription to the MIGA involves only a $22 million budget outlay to be paid in cash. While another $22 million of budget authority has also been requested, it is not expected to result in any outlays and will be in the form of non-negotiable, non-interest-bearing promissory notes. The remaining $178 million is for callable capital under program limitations. The potential return on this small investment is, however, substantial. As the MIGA stimulates private investment flows to LDCs, this additional capital can, over time, substitute for scarce official flows from both governments and the multilateral development institutions.

The MIGA supports our development policies, reinforces our international debt strategy and will result in additional flows of direct investment to LDCs. In addition to the strong support of the Administration, MIGA has also attracted broad endorsement from the private sector. Both the Chamber of Commerce and the American Bar Association have issued statements in support of U.S. membership.

We should not allow delay in acting on the MIGA legislation to weaken the impetus behind MIGA. Many countries are moving expeditiously to take the necessary steps to join the agency. The United States, which has been a strong advocate of the MIGA and has taken an active role in ensuring that the agency created will be a sound and credible one, should now also take the steps necessary to join this important institution.

I strongly encourage prompt enactment of the legislation (S.2169) now before the Congress.

This legislation also contains authorization to merge the Ordinary Capital and Inter-Regional Capital accounts of the Inter-American Development Bank (IDB), which will allow more efficient use of Bank capital. In other words, the IDB will be able to lend on the basis of a smaller increment of capital subscriptions from members than if the two accounts were to remain separate. U.S. agreement to the proposal requires legislative action, and I urge your early and favorable consideration.

Multilateral Development Bank Replenishments

Mr. Chairman, currently we are negotiating replenishments with all of Multilateral Development Bank (MDB) groups. We have been consulting with members of Congress regularly to ensure that your views are taken into account. In conducting these negotiations we have -- per the President's budget request -- assumed that up to $1.4 billion in budget authority would be available in the out-years to fund these replenishments. The $1.4 billion amount maintains the budget authority level for the MDBs of previous years and reflects considerable inter-agency discussion, taking into account the impact of Gramm-Rudman-Hollings. The actual amount of each replenishment will be a function of how far an MDB goes in accepting the policy reforms we are seeking, e.g., improved loan quality, emphasis on privatization, and enhanced compatibility between MDB country strategies and individual loans.

We were very successful in achieving our objectives in the Asian Development Fund and agreed to a $3.6 billion replenishment over four years. The U.S. share remains at 16.23 percent, which means a contribution of $146 million per year. We are achieving a significant consensus among IDA Donors on U.S. policy objectives. Provided there is agreement to U.S. suggestions on policy reforms, the Administration is willing to support an IDA replenishment in the $10.5-$12 billion range.

Regarding the Inter-American Development Bank, we are in the midst of protracted and intense negotiations, including a meeting this week in Buenos Aires. It is still uncertain whether we will secure the reforms we seek, and as a result the role the IDB will play in the debt initiative has not been resolved. Discussions are just beginning in the African Development Bank, which we hope to complete by the time of their Annual Meeting next year. We do not see the need for a World Bank General Capital Increase at this time. The World Bank has ample capacity to increase lending commitments by some $2-2.5 billion above the FY 1985 amount, and to concentrate that lending more heavily on the large debtors with credible reform programs.

I want to emphasize the Administration's commitment and full support for the MDBs. They play an important role in U.S. foreign and international economic policy. Now, we are asking them to take a more active part in supporting growth-oriented policy reform in the developing countries -- to play a central role in implementing the "Program for Sustained Growth."

I recognize fully that even in the best of circumstances supporting foreign assistance is never popular. Now, at a time of severe budget constraint, it will be even more difficult. However, of all the existing institutions, the MDBs are the most cost-effective from a U.S. budgetary perspective. One dollar of budget authority for the World Bank, for example, translates into $60 of lending authority.

Mr. Chairman, we can't duplicate that kind of leveraging on a bilateral basis. For instance, through 1984 the MDB hard loan windows have made total loan commitments of $133.1 billion at a cost to the United States of only $2.4 billion. The soft, concessional loan windows have made $50.6 billion in loan commitments at a cost to U.S. taxpayers of $14.8 billion.

The MDBs are also very effective at providing financial resources to countries of importance to us. For example, in FY 1984 total lending from the MDBs was $22.9 billion. Of this amount, $15.6 billion went to countries receiving U.S. foreign assistance and another $4.6 billion went to countries which are of strategic importance to us -- such as Mexico, Argentina, Brazil and Korea -- but which did not receive any bilateral assistance. In other words, nearly 88 percent of MDB lending went to countries of significant importance to the United States.

We need the MDBs as part of our international economic strategy. I strongly believe that if we do not support the MDBs now, we may have to resort to more costly measures later.

Conclusion

Mr. Chairman, the problems still with us in the international economic arena are substantial and difficult. But we now have the most favorable general economic environment in many years for making further large strides towards resolving them. The United States is leading the way in devising solutions in the best interest of both our own country and the community of nations. We believe the comprehensive, growth-oriented approach we have urged is the preferred path, and we are making real progress in implementing our strategy. I hope for your support in our efforts.

TREASURY NEWS

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May 20, 1986

O. DONALDSON CHAPOTON

Deputy Assistant Secretary (Tax Policy)

Secretary of the Treasury James A. Baker, III today announced the appointment of O. Donaldson Chapoton as Deputy Assistant Secretary (Tax Policy).

As Deputy Assistant Secretary (Tax Policy), Mr. Chapoton will serve as the chief deputy to the Assistant Secretary for Tax Policy, J. Roger Mentz, and oversee the activities of the Office of Tax Legislative Counsel and the Office of the International Tax Counsel.

Prior to joining the Treasury Department, Mr. Chapoton was a Senior Partner with the law firm of Baker & Botts in Houston specializing in the areas of corporate reorganizations, acquisitions and liquidations, oil and gas and partnership tax law, and tax aspects of foreign investment in the United States. From 1961-63, Mr. Chapoton served in the Judge Advocate General's Corps, U.S. Army. He also served as a law clerk to John R. Brown, Fifth Circuit Court of Appeals, Houston, Texas, after receiving his LL.B. from the University of Texas School of Law in 1960.

Mr. Chapoton is a member of the Texas Bar Association and the American Bar Association as well as the tax sections of both of those associations. He has lectured extensively on a wide variety of tax matters.

Mr. Chapoton, a native of Houston, Texas, is married to the former Mary Jo Kelley. They have two children, a daughter Kelley, age 10 and a son Hunt, age 7.

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TREASURY NEWS
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STATEMENT OF THE HONORABLE FRANCIS A. KEATING II
ASSISTANT SECRETARY OF THE TREASURY
(ENFORCEMENT)

HEARING ON H.R. 4700

SUBCOMMITTEE ON INTERNATIONAL ECONOMIC POLICY
HOUSE FOREIGN AFFAIRS COMMITTEE

May 20, 1986

Economic Sanctions Against the Government of Libya

Mr. Chairman and Members of the Committee:

I am pleased to be with you today to discuss the status of the economic sanctions imposed against the Government of Libya, with particular reference to the Treasury licenses issued to the U.S. oil companies.

My statement today will outline the role of the Department of the Treasury in administering the sanctions. By implementing the President's decision to impose sanctions on Libya, the Treasury is carrying out a long-standing role under statutes delegating to the President broad authority to impose trade and financial sanctions during a national emergency declared in response to an international situation that constitutes a threat to the national security, foreign policy or economy of the United States.

Since January 7, the Treasury Department has been administering the Libyan sanctions pursuant to President Reagan's authority under the International Emergency Economic Powers Act (IEEPA). Treasury's role has been to constantly monitor and where necessary modify and fine-tune the embargo through regulations and licenses. Treasury's role can be placed in historical perspective by describing briefly our implementation of economic sanctions not only under IEEPA but under the Trading With the Enemy Act as well. I will attempt to do this in my statement today. Before I do so, however, I would like to describe the role of my immediate office in the process.

Treasury Agencies and Offices

As Assistant Secretary of the Treasury for Enforcement, I bear responsibility for Treasury resources, programs, policies and activities in law enforcement. This includes the Bureau of Alcohol, Tobacco and Firearms, the Federal Law Enforcement Training Center, the Office of Foreign Assets Control (commonly known as "FAC"), the United States Customs Service, and the United States Secret Service. Of these entities, it is the

Office of Foreign Assets Control, under my supervision, that has responsibility for administration of the Libyan Sanctions Regulations. With regard to enforcement of the regulations, that office is supported by the U.S. Customs Service, which has broad overall enforcement responsibilities regarding imports and exports from the United States.

The Office of Foreign Assets Control

The Office of Foreign Assets Control (FAC) is a subordinate element of my immediate office. It is headed by a Director, Mr. Dennis O'Connell, who is an attorney and who served as Chief Counsel and Director of the office during the Iran crisis. The office dates from 1950 when President Truman imposed an assets freeze and trade embargo against the People's Republic of China and North Korea during the Korean War. It is a successor to the Treasury office that administered the broad trading with the enemy and alien property program during World War II. The countries currently under full embargo controls, including an assets freeze, under FAC administration are Cuba, North Korea, Vietnam and Kampuchea, in addition to Libya. FAC also administers a trade embargo against Nicaragua imposed by the President on May 1 last year. Finally, the Office also administers prohibitions imposed last fall on lending to South African Government agencies and on imports of the South African gold coin, the krugerrand.

The U.S. Customs Service

The Customs Service's primary role in this embargo is to identify and prevent exportation or importation of goods which are prohibited by the Libyan sanctions. Thus, for example, Customs will detect, interdict and detain, for possible seizure and forfeiture and imposition of penalties, any products of Libyan origin which someone may attempt to import into the United States. Similarly, Customs will be alert to interdict United States exports, such as spare parts, which may be intended to reach Libya either directly or through third country routing.

The Libyan Sanctions

The economic sanctions against Libya, including controls on transactions involving Libya and a freeze on Libyan government assets, were imposed by two successive Executive Orders, issued on January 7 and 8.

The first, Executive Order No. 12543 of January 7, 1986, prohibited trade transactions, service contracts and travel transactions. Specifically, it prohibited the following:

(a) the importation into the United States of any goods or services of Libyan origin, other than publications and materials imported for news publication or news broadcast journalism;

(b) the exportation to Libya of any goods, technology, or services from the United States except publications and donations of articles intended to relieve human suffering, such as food, clothing, medicine and medical supplies intended strictly for medical purposes;

(c) any transactions by a United States person relating to transportation to or from Libya; the provision of transportation to or from the United States by any Libyan person on any vessel or aircraft of Libyan registration; or the sale in the United States by any person holding authority under the Federal Aviation Act of any transportation by air which includes any stops in Libya;

(d) the purchase by any United States person of goods for export from Libya to any country;

(e) the performance by any United States person of any contract in support of an industrial or other commercial or governmental project in Libya;

(f) the grant or extension of credits or loans by any United States person to the Government of Libya, its instrumentalities, and controlled entities;

(g) any transaction by a United States person relating to travel by any United States citizen or permanent resident alien to Libya, or to activities by any such person within Libya, other than transactions necessary to effect such person's departure from Libya, or travel for journalism by persons regularly employed in such capacity by newsgathering organizations; and

(h) any transactions by any United States person which evades or avoids, or has the purpose of evading or avoiding, any of the prohibitions described above.

On January 8, 1986, Executive Order No. 12544 was issued prohibiting any transfer of property and interests in property of the Government of Libya, its agencies, instrumentalities and controlled entities (including the Central Bank of Libya) that are in the United States, that come within the United States after the date of the Executive Order, or that are or come within the possession or control of U.S. persons, including overseas branches of U.S. persons. This order had the effect of freezing Libyan government assets in the United States.

On January 10, 1986, the Treasury Department's Office of Foreign Assets Cotrol issued the Libyan Sanctions Regulations, implementing the terms of Executive Order 12543 which imposed trade and financial sanctions on Libya. The regulations were amended on January 16, 1986, adding new provisions implementing Executive Order No. 12544, which froze Libyan government assets.

The freeze on Libyan assets took effect immediately on

January 8, 1986. Also, certain provisions of the January 7 sanctions took effect immediately on January 7, namely, the prohibition on the extension of loans or credits to Libya and the restrictions on transactions relating to travel. However, other provisions of the January 7 sanctions, including the prohibition on engaging in any contract in support of an industrial project in Libya had a deferred effective date, namely, February 1. Between January 7 and February 1 a number of U.S. companies, including five oil companies, contacted the Treasury Department and requested authorization to conduct an orderly winddown of their Libyan operations extending after February 1.

After a number of meetings with the companies, careful review of information submitted by them, and careful interagency review within the Government, it was determined that affording the companies a limited time after February 1 in which to close out their Libyan involvement was most consistent with our objectives of maximizing economic pressure on Libya without causing excessive and unnecessary harm to U.S. business. On February 7, the State and Treasury Departments announced that the following principles would govern in implementation of the provision of the Executive Orders for the divestiture of assets of U.S. companies in Libya:

(A) As a general rule, all activities pursuant to contracts an other arrangements between U.S. nationals and Libya were to be terminated immediately.

(B) U.S. nationals owning assets in Libya would be free to remove such property, where possible, or to sell it to Libya, to Libyan nationals or, if the property is not for use in Libya, to anyone else.

(C) in exceptional cases, where abandonment of contracts or concessions would result in a substantial economic windfall to Libya, limited extensions would be granted to companies to prevent windfalls, on strict conditions.

To carry out these principles, the Treasury Department on February 7, 1986, issued licenses to five American oil companies to conduct an orderly termination of their Libyan operations. The companies are Conoco, Amerada Hess, Occidental, Marathon, and W.R. Grace. This process of the oil companies phasing out of their Libyan business has been going forward and must be completed by the end of June. The administration policy of permitting the companies to remain in Libya up to this point has avoided the catastrophic losses to the American companies and the windfall to Qadhafi that a precipitous cutoff of U.S. operations would have entailed.

Since the February licenses were issued, the U.S. companies have not been permitted to operate the oil fields but only to sell their share of the oil "at the flange" in Libyan ports. Without their involvement, Libya could still have marketed the oil and retained the oil companies' share of the profits. Hasty U.S. action might have delivered the oil companies' assets into the hands of Qadhafi as "abandoned" properties without his having to take the politically and legally risky step of expropriation.

The licenses contain the following provisions. They:

a) authorize the sales of Libyan oil "at the flange" at Libyan ports, provided the oil companies do not directly or indirectly ship or distribute the crude oil;

b) direct the companies to terminate their involvement in the operations of their oil-related business in Libya, and dissolve any companies owned or controlled by them that operate their concessions. The companies are also directed to ensure that any successor operating companies will be Libya;

c) direct the companies to remove from Libya or sell any property or assets that are located in Libya as soon as practical. The Treasury Department must be notified in writing both prior to any such sales and at the completion of any sales;

d) require that the net proceeds of the licensed operations be placed in an escrow-type account and may be released only pursuant to a Treasury license;

e) require that the companies undertake no new contracts or agreements which would entail additional expenditures or otherwise expand their Libyan activities;

f) prohibit the exportation of U.S.-origin equipment, technical data, or services to Libya by the companies; and

g) require every 30 days a report to the Treasury Department detailing all transactions the companies engaged in pursuant to the licenses.

The licenses have no specific termination dates as issued; however, it was understood that they would probably be effective for several months. Following the Tokyo Economic Summit, the President announced that the oil companies would be required to terminate their operations in Libya by June 30, 1986. We have met with the companies to inform them of this decision and to discuss the necessary revisions of the licenses. No amendments to the licenses have yet been issued. Proposed amendments requiring cessation of operations by June 30 are in the interagency clearance process. Essentially the amendments will require that the companies:

(1) suspend all operations in Libya by June 30, including the distribution of equity oil;

(2) cease all involvement in their oil-related business in

Libya including any involvement in any companies owned or controlled by them that operate their concessions;

(3) make no payments to Libya after June 30.

The exact wording of the licenses is still under discussion. However, we expect to issue amendments to the oil company licenses within the next week.

That concludes my prepared testimony. I would be happy to answer your questions.

TREASURY NEWS

partment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M. May 20, 1986

TREASURY TO AUCTION $7,750 MILLION
OF 5-YEAR 2-MONTH NOTES

The Department of the Treasury will auction $7,750 million of 5-year 2-month notes to raise new cash. Additional amounts of the notes may be issued to Federal Reserve Banks as agents for foreign and international monetary authorities at the average price of accepted competitive tenders.

Details about the new security are given in the attached highlights of the offering and in the official offering circular.

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Attachment

B-589

HIGHLIGHTS OF TREASURY
OFFERING TO THE PUBLIC
OF 5-YEAR 2-MONTH NOTES
TO BE ISSUED JUNE 3, 1986

May 20, 1986

Amount Offered:

To the public	$7,750 million

Description of Security:

Term and type of security	5-year 2-month notes
Series and CUSIP designation	K-1991 (CUSIP No. 912827 TS 1)
Maturity Date	August 15, 1991
Call date	No provision
Interest Rate	To be determined based on the average of accepted bids
Investment yield	To be determined at auction
Premium or discount	To be determined after auction
Interest payment dates	February 15 and August 15 (first payment on February 15, 1987)
Minimum denomination available ..	$1,000

Terms of Sale:

Method of sale	Yield auction
Competitive tenders	Must be expressed as an annual yield, with two decimals, e.g., 7.10%
Noncompetitive tenders	Accepted in full at the average price up to $1,000,000
Accrued interest payable by investor	None
Payment by non-institutional investors	Full payment to be submitted with tender
Payment through Treasury Tax and Loan (TT&L) Note Accounts ...	Acceptable for TT&L Note Option Depositaries
Deposit guarantee by designated institutions	Acceptable

Key Dates:

Receipt of tenders	Wednesday, May 28, 1986, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions)	
a) cash or Federal funds	Tuesday, June 3, 1986
b) readily-collectible check ..	Friday, May 30, 1986

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M. May 20, 1986

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $14,400 million, to be issued May 29, 1986. This offering will provide about $125 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $14,271 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Tuesday, May 27, 1986. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,200 million, representing an additional amount of bills dated February 27, 1986, and to mature August 28, 1986 (CUSIP No. 912794 LB 8), currently outstanding in the amount of $6,829 million, the additional and original bills to be freely interchangeable.

183-day bills (to maturity date) for approximately $7,200 million, representing an additional amount of bills dated November 29, 1985, and to mature November 28, 1986 (CUSIP No. 912794 KT 0), currently outstanding in the amount of $9,064 million, the additional and original bills to be freely interchangeable.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing May 29, 1986. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold $2,078 million as agents for foreign and international monetary authorities, and $3,364 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series).

B-590

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

federal financing bank NEWS
WASHINGTON, D.C. 20220
Press 566 2041
FFB 566 2468

FOR IMMEDIATE RELEASE

FEDERAL FINANCING BANK ACTIVITY

Francis X. Cavanaugh, Secretary, Federal Financing Bank (FFB), announced the following activity for the month of March 1986.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $153.5 billion on March 31, 1986, posting an increase of less than $0.1 billion from the level on February 28, 1986. This net change was the result of increases in holdings of agency-guaranteed debt of $0.3 billion and in holdings of agency assets of $0.1 billion while holdings of agency debt issues declined by $0.4 billion. FFB made 385 disbursements during March.

Attached to this release are tables presenting FFB March loan activity, commitments entered during March and FFB holdings as of March 31, 1986.

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B-591

FEDERAL FINANCING BANK

MARCH 1986 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
AGENCY DEBT					
TENNESSEE VALLEY AUTHORITY					
Advance #582	3/4	$ 242,000,000.00	3/10/86	7.315%	
Advance #583	3/6	284,000,000.00	3/13/86	7.195%	
Advance #584	3/10	259,000,000.00	3/18/86	6.935%	
Advance #585	3/13	285,000,000.00	3/21/86	6.955%	
Advance #586	3/18	223,000,000.00	3/24/86	6.885%	
Advance #587	3/21	20,000,000.00	3/25/86	6.765%	
Advance #588	3/21	248,000,000.00	3/27/86	6.765%	
Advance #589	3/24	189,000,000.00	3/31/86	6.725%	
Advance #590	3/27	79,000,000.00	4/1/86	6.735%	
Advance #591	3/27	173,000,000.00	4/3/86	6.735%	
Advance #592	3/31	347,000,000.00	4/7/86	6.655%	
EXPORT-IMPORT BANK					
Note #68	3/3	3,000,000.00	3/1/96	8.255%	8.172% qtr.
NATIONAL CREDIT UNION ADMINISTRATION					
Central Liquidity Facility					
+Note #388	3/3	5,000,000.00	4/2/86	7.365%	
+Note #389	3/10	9,550,000.00	6/10/86	6.945%	
+Note #390	3/17	19,715,000.00	6/17/86	6.875%	
UNITED STATES RAILWAY ASSOCIATION					
*Note #33	3/31	81,142,814.85	6/30/86	6.655%	
AGENCY ASSETS					
FARMERS HOME ADMINISTRATION					
Certificates of Beneficial Ownership					
	3/1	100,000,000.00	3/1/01	8.375%	8.550% ann.
	3/16	35,000,000.00	3/16/01	8.055%	8.217% ann.
	3/25	55,000,000.00	3/25/96	7.825%	7.978% ann.
RURAL ELECTRIFICATION ADMINISTRATION					
Certificates of Beneficial Ownership					
	3/31	100,500,000.00	4/1/86	6.655%	
	3/31	346,900,000.00	3/31/16	7.755%	
GOVERNMENT - GUARANTEED LOANS					
DEPARTMENT OF DEFENSE					
Foreign Military Sales					
Botswana 4	3/3	292,577.83	7/25/92	7.905%	
Greece 15	3/3	211,950.00	6/15/12	8.365%	
Morocco 9	3/3	9,495.49	3/31/94	8.205%	
Peru 9	3/3	189,234.90	9/15/95	8.215%	
Thailand 12	3/3	1,250,536.00	3/20/96	8.199%	
Egypt 6	3/5	1,418,299.01	4/15/14	8.225%	
Philippines 9	3/5	17,200.00	5/15/91	7.655%	
Thailand 12	3/5	4,220,812.00	3/20/96	8.005%	

+rollover
*maturity extension

FEDERAL FINANCING BANK

MARCH 1986 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual	INTEREST RATE (other than semi-annual)
Foreign Military Sales (Cont'd)					
Tunisia 7	3/5	$ 72,086.00	9/15/96	7.930%	
Greece 15	3/6	1,214,258.91	6/15/12	8.385%	
Cameroon 7	3/6	589,333.84	3/26/91	7.340%	
Turkey 18	3/6	455,775.00	3/12/14	8.315%	
Egypt 7	3/7	7,366,801.38	7/31/14	8.355%	
Turkey 17	3/7	137,109.53	11/30/13	8.405%	
Egypt 7	3/10	939,348.45	7/31/14	8.295%	
Morocco 13	3/11	69,063.23	5/31/96	7.615%	
Greece 14	3/11	3,421,600.00	4/30/11	8.215%	
Greece 15	3/11	1,422,815.38	6/15/12	8.075%	
Egypt 7	3/11	363,385.87	7/31/14	8.145%	
Morocco 11	3/12	69,407.25	9/8/95	7.315%	
Niger 2	3/12	89,306.54	10/15/10	7.325%	
Turkey 18	3/12	1,652,218.54	3/12/14	7.925%	
Greece 15	3/13	34,921.80	6/15/12	7.995%	
Peru 10	3/17	35,034.58	4/10/96	7.805%	
Turkey 17	3/17	295,385.77	11/30/13	8.125%	
Indonesia 10	3/19	3,577,837.82	3/20/93	7.853%	
Egypt 7	3/20	1,339,330.42	7/31/14	8.145%	
Jordan 11	3/20	7,799,660.04	11/15/92	7.678%	
Thailand 12	3/20	2,835,112.00	3/20/96	7.892%	
Egypt 7	3/21	1,946,592.17	7/31/14	8.095%	
Colombia 7	3/25	1,770,711.30	9/5/91	7.286%	
Egypt 6	3/25	203,726.12	4/15/14	8.035%	
Turkey 13	3/25	2,288.46	3/24/12	8.065%	
Cameroon 7	3/26	253,974.48	3/26/91	7.055%	
Greece 15	3/26	386,749.21	6/15/12	7.995%	
Israel 12	3/27	100,000,000.00	8/5/11	7.776%	
Egypt 7	3/27	2,248,595.04	7/31/14	7.965%	
Morocco 11	3/28	67,017.45	9/8/95	7.215%	
Morocco 12	3/28	20,625.00	9/21/95	7.545%	
Philippines 10	3/31	20,589.47	7/15/92	7.445%	
DEPARTMENT OF HOUSING & URBAN DEVELOPMENT					
Community Development					
+Indianapolis, IN	3/3	11,857,000.00	3/1/87	7.555%	7.697% ann.
Boston, MA	3/3	2,514,938.40	3/1/91	8.035%	8.196% ann.
Springfield, MA	3/5	620,000.00	8/1/86	7.215%	
Mayaguez, PR	3/6	3,073.18	8/1/86	7.255%	
Pasadena, CA	3/10	178,246.17	7/15/86	6.995%	
Garden Grove, CA	3/14	1,157,159.80	8/1/86	7.025%	
Biloxi, MI	3/18	282,300.00	5/1/87	7.185%	7.314% ann.
Garden Grove, CA	3/18	1,600,721.00	8/1/86	6.985%	
Sacramento, CA	3/18	727,542.00	2/17/87	7.145%	7.261% ann.
Sacramento, CA	3/18	188,000.00	3/1/88	7.335%	7.470% ann.
Santa Ana, CA	3/18	1,979,921.36	8/15/86	7.015%	
Mayaguez, PR	3/19	162,876.20	8/1/87	7.255%	7.387% ann.
Baltimore, MD	3/24	170,000.00	1/2/04	8.020%	8.181% ann.
Biloxi, MI	3/31	386,460.00	5/1/87	6.945%	7.066% ann.
Council Bluffs, IA	3/31	210,355.00	6/2/86	6.655%	
Lincoln, NE	3/31	171,000.00	11/3/86	6.775%	6.808% ann.
Long Beach, CA	3/31	800,000.00	8/1/86	6.685%	
DEPARTMENT OF THE NAVY					
Ship Lease Financing					
Lummus 1	3/6	116,787,637.44	4/15/86	7.195%	
Lummus Container	3/6	2,200,413.00	4/15/86	7.195%	

+rollover

FEDERAL FINANCING BANK

MARCH 1986 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
Defense Production Act					
Gila River Indian Community	3/26	$ 163,748.79	10/1/92	7.486%	7.417% qtr.
RURAL ELECTRIFICATION ADMINISTRATION					
Saluda River Electric #271	3/3	1,279,000.00	1/2/18	8.402%	8.316% qtr.
*South Mississippi Electric #90	3/3	709,000.00	12/31/12	8.349%	8.264% qtr.
*United Power #139	3/3	3,650,000.00	1/3/17	8.404%	8.318% qtr.
*Saluda River Electric #186	3/3	2,565,000.00	1/3/17	8.404%	8.318% qtr.
*Saluda River Electric #186	3/3	4,907,000.00	1/3/17	8.405%	8.319% qtr.
Kamo Electric #209	3/3	4,200,000.00	1/3/17	8.404%	8.318% qtr.
*Soyland Power #105	3/5	9,554,000.00	12/31/14	8.219%	8.136% qtr.
*Sunflower Electric #174	3/5	42,300,000.00	1/3/17	8.222%	8.139% qtr.
Sitka Telephone #213	3/5	670,000.00	12/31/20	8.229%	8.146% qtr.
Allegheny Electric #255	3/5	933,000.00	12/12/20	8.229%	8.146% qtr.
*Tri-State G&T #79	3/6	1,109,000.00	12/31/13	8.425%	8.338% qtr.
*Tri-State G&T #79	3/6	3,599,000.00	12/31/13	8.425%	8.338% qtr.
*Tri-State G&T #79	3/6	888,000.00	12/31/13	8.425%	8.338% qtr.
*Tri-State G&T #79	3/6	997,000.00	12/31/13	8.425%	8.338% qtr.
*Tri-State G&T #79	3/6	336,000.00	12/31/13	8.425%	8.338% qtr.
*Oglethorpe Power #74	3/6	12,990,000.00	12/31/14	8.424%	8.337% qtr.
*Oglethorpe Power #150	3/6	259,148,000.00	12/31/14	8.424%	8.337% qtr.
*Oglethorpe Power #150	3/6	16,204,000.00	12/31/14	8.424%	8.337% qtr.
Seminole Electric #141	3/6	14,426,000.00	3/31/88	7.675%	7.603% qtr.
Western Illinois Power #160	3/10	514,000.00	12/31/20	8.309%	8.224% qtr.
*Colorado Ute Electric #71	3/10	2,920,000.00	3/10/88	7.415%	7.348% qtr.
*Deseret G&T #170	3/10	1,378,000.00	12/31/15	8.317%	8.232% qtr.
*Deseret G&T #170	3/10	1,417,000.00	12/31/15	8.317%	8.232% qtr.
*Deseret G&T #170	3/10	695,000.00	12/31/14	8.321%	8.236% qtr.
*Deseret G&T #170	3/10	294,000.00	12/31/19	8.310%	8.225% qtr.
*Deseret G&T #211	3/10	21,565,000.00	12/31/19	8.310%	8.225% qtr.
*Deseret G&T #211	3/10	4,915,000.00	12/31/19	8.310%	8.225% qtr.
*Deseret G&T #211	3/10	1,232,000.00	12/31/19	8.310%	8.225% qtr.
*Deseret G&T #211	3/10	31,781,000.00	1/3/17	8.313%	8.228% qtr.
*Deseret G&T #211	3/10	5,089,000.00	1/3/17	8.313%	8.228% qtr.
*Deseret G&T #211	3/10	4,671,000.00	1/3/17	8.316%	8.231% qtr.
*Deseret G&T #211	3/10	13,752,000.00	1/3/17	8.316%	8.231% qtr.
*Deseret G&T #211	3/10	7,210,000.00	1/3/17	8.313%	8.228% qtr.
*Deseret G&T #211	3/10	32,490,000.00	1/3/17	8.316%	8.231% qtr.
*Deseret G&T #211	3/10	4,449,000.00	1/3/17	8.313%	8.228% qtr.
*Deseret G&T #211	3/10	22,243,000.00	1/3/17	8.313%	8.228% qtr.
*Deseret G&T #211	3/10	21,332,000.00	1/3/17	8.316%	8.231% qtr.
*Tex-La Electric #202	3/12	780,000.00	1/3/17	8.087%	8.007% qtr.
*Dairyland Power #54	3/12	2,100,000.00	12/31/14	8.087%	8.007% qtr.
Tex-La Electric #208	3/12	842,000.00	12/31/20	8.087%	8.007% qtr.
*Wabash Valley Power #104	3/12	7,021,000.00	3/12/88	7.275%	7.210% qtr.
*Wabash Valley Power #206	3/12	524,000.00	3/12/88	7.275%	7.210% qtr.
*Cajun Electric #197	3/12	40,000,000.00	3/13/89	7.345%	7.279% qtr.
*Wolverine Power #100	3/12	839,000.00	12/31/12	8.039%	7.960% qtr.
*Wolverine Power #101	3/12	1,073,000.00	12/31/12	8.039%	7.960% qtr.
*Wolverine Power #101	3/12	40,000.00	12/31/12	8.039%	7.960% qtr.
*Wabash Valley Power #104	3/12	5,530,000.00	12/31/14	8.087%	8.007% qtr.
*Wolverine Power #182	3/12	3,420,000.00	1/3/17	8.087%	8.007% qtr.
*Wolverine Power #183	3/12	4,362,000.00	1/3/17	8.087%	8.007% qtr.
*Brazos Electric #144	3/12	4,165,000.00	1/3/17	8.087%	8.007% qtr.
*Gulf Telephone #50	3/12	544,000.00	12/31/14	8.088%	8.008% qtr.
*Gulf Telephone #50	3/12	230,000.00	12/31/14	8.088%	8.008% qtr.
*South Mississippi Electric #90	3/13	1,297,000.00	12/31/12	7.977%	7.899% qtr.
*Cont. Tele. of Kentucky #115	3/13	3,000,000.00	12/31/14	8.055%	7.975% qtr.
*Western Illinois Power #99	3/14	2,245,000.00	1/3/17	8.111%	8.030% qtr.
Central Electric #248	3/17	1,513,000.00	12/31/20	8.097%	8.017% qtr.
*Tri-State G&T #177	3/17	279,000.00	1/3/17	8.098%	8.018% qtr.
*New Hampshire Electric #192	3/17	1,380,000.00	1/3/17	8.098%	8.018% qtr.

*maturity extension

FEDERAL FINANCING BANK

MARCH 1986 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
RURAL ELECTRIFICATION ADMINISTRATION (Cont'd)					
West Virginia Telephone #17	3/17	$ 32,000.00	3/17/88	7.315%	7.249% qtr.
*Colorado Ute Electric #203	3/17	1,030,000.00	3/17/88	7.315%	7.249% qtr.
*N.E. Missouri Electric #217	3/17	2,009,000.00	1/3/17	8.098%	8.018% qtr.
*East Kentucky Power #188	3/17	9,307,000.00	1/3/17	8.098%	8.018% qtr.
*Cajun Electric #76	3/18	50,000,000.00	12/31/14	8.143%	8.062% qtr.
*East Kentucky Power #140	3/18	1,897,000.00	12/31/20	8.130%	8.049% qtr.
*East Kentucky Power #291	3/18	751,000.00	12/31/15	8.139%	8.058% qtr.
*Dairyland Power #54	3/19	2,011,000.00	3/20/89	7.415%	7.348% qtr.
*Wabash Valley Power #206	3/19	837,000.00	3/19/88	7.365%	7.298% qtr.
Oglethorpe Power #246	3/20	70,087,000.00	12/31/20	8.146%	8.065% qtr.
*Plains Electric #158	3/20	402,000.00	1/3/17	8.149%	8.068% qtr.
*Plains Electric #158	3/20	10,000,000.00	1/3/17	8.147%	8.066% qtr.
*Plains Electric #158	3/20	106,000.00	12/31/19	8.147%	8.066% qtr.
*Plains Electric #158	3/20	23,000.00	1/3/17	8.087%	8.007% qtr.
*Plains Electric #300	3/20	63,072,062.99	1/3/17	8.087%	8.007% qtr.
*Plains Electric #300	3/20	5,615,149.62	1/3/17	8.087%	8.007% qtr.
*Plains Electric #300	3/20	6,887,370.07	1/3/17	8.087%	8.007% qtr.
*Plains Electric #300	3/20	505,763.78	1/3/17	8.087%	8.007% qtr.
*Plains Electric #300	3/20	3,981,669.28	1/3/17	8.087%	8.007% qtr.
*Plains Electric #300	3/20	620,000.00	1/3/17	8.087%	8.007% qtr.
*Plains Electric #300	3/20	727,136.00	1/3/17	8.087%	8.007% qtr.
*Dairyland Power #161	3/21	849,000.00	3/21/88	7.295%	7.230% qtr.
*Cajun Electric #316	3/21	50,000,000.00	12/31/20	8.083%	8.003% qtr.
*North Carolina Electric #185	3/24	13,916,000.00	12/31/15	8.141%	8.060% qtr.
*North Carolina Electric #185	3/24	4,679,000.00	12/31/15	8.141%	8.060% qtr.
*North Carolina Electric #185	3/24	6,160,000.00	12/31/15	8.141%	8.060% qtr.
*North Carolina Electric #185	3/24	10,824,000.00	12/31/15	8.141%	8.060% qtr.
*North Carolina Electric #185	3/24	19,610,000.00	12/31/15	8.141%	8.060% qtr.
*North Carolina Electric #185	3/24	7,051,000.00	1/3/17	8.140%	8.059% qtr.
*North Carolina Electric #185	3/24	13,097,000.00	1/3/17	8.140%	8.059% qtr.
*North Carolina Electric #185	3/24	26,305,000.00	1/3/17	8.140%	8.059% qtr.
*North Carolina Electric #185	3/24	7,000,000.00	1/3/17	8.140%	8.059% qtr.
*North Carolina Electric #185	3/24	4,755,000.00	1/3/17	8.140%	8.059% qtr.
*North Carolina Electric #185	3/24	7,517,000.00	1/2/18	8.138%	8.057% qtr.
*North Carolina Electric #185	3/24	10,371,000.00	1/2/18	8.138%	8.057% qtr.
*North Carolina Electric #185	3/24	17,248,000.00	1/2/18	8.138%	8.057% qtr.
*North Carolina Electric #185	3/24	34,471,000.00	1/2/18	8.138%	8.057% qtr.
*North Carolina Electric #189	3/24	8,725,000.00	12/31/14	8.136%	8.055% qtr.
*North Carolina Electric #268	3/24	7,207,000.00	1/2/18	8.134%	8.053% qtr.
*North Carolina Electric #268	3/24	10,520,000.00	1/2/18	8.134%	8.053% qtr.
*North Carolina Electric #268	3/24	33,677,000.00	1/2/18	8.134%	8.053% qtr.
*North Carolina Electric #268	3/24	7,462,000.00	1/2/18	8.134%	8.053% qtr.
*North Carolina Electric #268	3/24	9,188,000.00	1/2/18	8.134%	8.053% qtr.
*North Carolina Electric #268	3/24	34,996,000.00	1/2/18	8.134%	8.053% qtr.
*North Carolina Electric #268	3/24	5,461,000.00	1/2/18	8.134%	8.053% qtr.
*North Carolina Electric #268	3/24	12,308,000.00	1/2/18	8.134%	8.053% qtr.
*North Carolina Electric #268	3/24	26,001,000.00	1/2/18	8.134%	8.053% qtr.
*North Carolina Electric #268	3/24	11,932,000.00	1/2/18	8.134%	8.053% qtr.
*North Carolina Electric #268	3/24	10,753,000.00	1/2/18	8.134%	8.053% qtr.
*North Carolina Electric #268	3/24	8,079,000.00	1/2/18	8.134%	8.053% qtr.
*North Carolina Electric #268	3/24	28,191,000.00	1/2/18	8.134%	8.053% qtr.
*North Carolina Electric #268	3/24	7,521,000.00	1/2/18	8.134%	8.053% qtr.
*North Carolina Electric #268	3/24	4,590,000.00	1/2/18	8.134%	8.053% qtr.
*Colorado Ute Electric #168	3/24	290,794.00	3/24/88	7.315%	7.249% qtr.
*Western Farmers Electric #64	3/24	480,000.00	1/3/17	8.138%	8.057% qtr.
*Western Farmers Electric #133	3/24	120,000.00	1/3/17	8.138%	8.057% qtr.
*Western Farmers Electric #220	3/24	12,000,000.00	1/3/17	8.138%	8.057% qtr.
*East Kentucky Power #140	3/24	530,000.00	1/3/17	8.138%	8.057% qtr.
*Old Dominion Electric #267	3/24	2,289,000.00	12/31/13	8.109%	8.028% qtr.
*North Carolina Electric #268	3/24	17,210,000.00	1/2/18	8.134%	8.053% qtr.
*Sugar Land Telephone #210	3/24	5,857,000.00	12/31/20	8.134%	8.053% qtr.
*North Carolina Electric #185	3/25	7,630,000.00	12/31/15	8.041%	7.962% qtr.

*maturity extension

FEDERAL FINANCING BANK

MARCH 1986 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
RURAL ELECTRIFICATION ADMINISTRATION (Cont'd)					
*North Carolina Electric #185	3/25	$ 4,561,000.00	12/31/15	8.041%	7.962% qtr.
*North Carolina Electric #185	3/25	2,850,000.00	12/31/15	8.041%	7.962% qtr.
*North Carolina Electric #185	3/25	2,788,000.00	12/31/15	8.041%	7.962% qtr.
*North Carolina Electric #185	3/25	20,247,000.00	1/3/17	8.040%	7.961% qtr.
*North Carolina Electric #185	3/25	5,380,000.00	1/3/17	8.040%	7.961% qtr.
*North Carolina Electric #185	3/25	8,729,000.00	1/3/17	8.040%	7.961% qtr.
*North Carolina Electric #185	3/25	25,153,000.00	1/3/17	8.040%	7.961% qtr.
*North Carolina Electric #185	3/25	7,049,000.00	1/3/17	8.039%	7.960% qtr.
*North Carolina Electric #185	3/25	9,312,000.00	1/3/17	8.039%	7.960% qtr.
*North Carolina Electric #185	3/25	1,516,000.00	1/3/17	8.039%	7.960% qtr.
*North Carolina Electric #286	3/25	29,714,000.00	1/2/18	8.036%	7.957% qtr.
*Colorado Ute Electric #78	3/26	2,989,000.00	3/31/88	7.251%	7.186% qtr.
*Colorado Ute Electric #96	3/26	474,000.00	3/26/88	7.245%	7.181% qtr.
*Colorado Ute Electric #203	3/26	2,714,000.00	3/26/88	7.245%	7.181% qtr.
*North Carolina Electric #268	3/27	2,877,000.00	1/2/18	7.960%	7.882% qtr.
Deseret G&T #170	3/28	571,000.00	12/31/20	7.767%	7.693% qtr.
Deseret G&T #211	3/28	2,556,000.00	12/31/20	7.767%	7.693% qtr.
Kamo Electric #266	3/31	4,162,000.00	12/31/15	7.764%	7.690% qtr.
South Texas Electric #200	3/31	302,000.00	12/31/20	7.767%	7.693% qtr.
Western Illinois Power #294	3/31	16,186,000.00	1/2/18	7.763%	7.689% qtr.
Soyland Power #293	3/31	26,216,000.00	1/2/18	7.763%	7.689% qtr.
New Hampshire Electric #270	3/31	3,530,000.00	1/2/18	7.767%	7.693% qtr.
Central Electric #248	3/31	667,000.00	1/2/18	7.767%	7.693% qtr.
*S. Mississippi Electric #3	3/31	2,701,416.64	12/31/10	7.701%	7.628% qtr.
*S. Mississippi Electric #3	3/31	2,475,000.00	12/31/10	7.701%	7.628% qtr.
*S. Mississippi Electric #3	3/31	3,419,166.63	12/31/10	7.701%	7.628% qtr.
*S. Mississippi Electric #3	3/31	1,851,666.70	12/31/10	7.701%	7.628% qtr.
*S. Mississippi Electric #3	3/31	114,583.31	12/31/10	7.701%	7.628% qtr.
*East Kentucky Power #73	3/31	8,534,743.95	12/31/15	7.764%	7.690% qtr.
*East Kentucky Power #73	3/31	292,753.60	12/31/15	7.764%	7.690% qtr.
*East Kentucky Power #73	3/31	487,922.70	12/31/15	7.764%	6.690% qtr.
*Colorado Ute Electric #78	3/31	4,157,875.03	3/31/88	7.159%	7.096% qtr.
*Colorado Ute Electric #78	3/31	2,570,575.03	3/31/88	7.160%	7.097% qtr.
*Colorado Ute Electric #78	3/31	814,000.03	3/31/88	7.159%	7.096% qtr.
*Colorado Ute Electric #78	3/31	717,799.97	3/31/88	7.159%	7.096% qtr.
*Tri-State G&T #89	3/31	8,666,625.00	3/31/88	7.162%	7.099% qtr.
*Tri-State G&T #89	3/31	7,698,255.00	3/31/88	7.162%	7.099% qtr.
*Tri-State G&T #89	3/31	9,041,940.00	3/31/88	7.162%	7.099% qtr.
*Southern Illinois Power #38	3/31	300,000.00	3/31/88	7.161%	7.098% qtr.
*Allegheny Electric #93	3/31	3,141,000.00	12/31/13	7.715%	7.642% qtr.
*Big Rivers Electric #58	3/31	521,000.00	12/31/14	7.765%	7.691% qtr.
*Big Rivers Electric #58	3/31	20,000.00	12/31/14	7.765%	7.691% qtr.
*Big Rivers Electric #58	3/31	738,000.00	12/31/14	7.765%	7.691% qtr.
*Big Rivers Electric #58	3/31	764,000.00	1/3/17	7.765%	7.691% qtr.
*Big Rivers Electric #65	3/31	138,000.00	12/31/14	7.765%	7.691% qtr.
*Big Rivers Electric #91	3/31	2,846,000.00	12/31/14	7.765%	7.691% qtr.
*Big Rivers Electric #91	3/31	4,883,000.00	12/31/14	7.765%	7.691% qtr.
*Big Rivers Electric #91	3/31	2,415,000.00	12/31/14	7.765%	7.691% qtr.
*Big Rivers Electric #91	3/31	46,000.00	1/3/17	7.765%	7.691% qtr.
*Big Rivers Electric #91	3/31	1,191,000.00	1/3/17	7.765%	7.691% qtr.
*Big Rivers Electric #91	3/31	1,483,000.00	1/3/17	7.765%	7.691% qtr.
*Big Rivers Electric #136	3/31	67,000.00	12/31/14	7.765%	7.691% qtr.
*Big Rivers Electric #136	3/31	560,000.00	12/31/14	7.765%	7.691% qtr.
*Big Rivers Electric #136	3/31	193,000.00	12/31/14	7.765%	7.691% qtr.
*Big Rivers Electric #136	3/31	20,000.00	1/3/17	7.765%	7.691% qtr.
*Big Rivers Electric #136	3/31	457,000.00	1/3/17	7.765%	7.691% qtr.
*Big Rivers Electric #136	3/31	16,000.00	1/3/17	7.765%	7.691% qtr.
*Big Rivers Electric #136	3/31	509,000.00	1/3/17	7.766%	7.692% qtr.
*Big Rivers Electric #143	3/31	91,000.00	1/3/17	7.765%	7.691% qtr.
*Big Rivers Electric #143	3/31	129,000.00	1/3/17	7.765%	7.691% qtr.
*Big Rivers Electric #143	3/31	367,000.00	1/3/17	7.765%	7.691% qtr.
*Big Rivers Electric #143	3/31	167,000.00	1/3/17	7.766%	7.692% qtr.
*Big Rivers Electric #179	3/31	24,500,000.00	1/3/17	7.766%	7.692% qtr.

*maturity extension

FEDERAL FINANCING BANK

MARCH 1986 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
RURAL ELECTRIFICATION ADMINISTRATION (Cont'd)					
*Big Rivers Electric #179	3/31	5,555,000.00	1/3/17	7.766%	7.692% qtr.
*North Carolina Electric #185	3/31	396,460,000.00	12/31/15	7.765%	7.691% qtr.
*North Carolina Electric #185	3/31	7,566,000.00	12/31/15	7.765%	7.691% qtr.
*North Carolina Electric #185	3/31	2,925,000.00	1/3/17	7.765%	7.691% qtr.
*North Carolina Electric #185	3/31	7,084,000.00	1/3/17	7.765%	7.691% qtr.
*North Carolina Electric #185	3/31	14,285,000.00	1/3/17	7.766%	7.692% qtr.
*North Carolina Electric #185	3/31	8,865,000.00	1/3/17	7.766%	7.692% qtr.
*North Carolina Electric #185	3/31	26,472,000.00	1/3/17	7.766%	7.692% qtr.
*Cajun Electric #263	3/31	55,000,000.00	1/3/17	7.748%	7.674% qtr.
*Brazos Electric #108	3/31	249,000.00	1/3/17	7.766%	7.692% qtr.
*Brazos Electric #230	3/31	8,154,000.00	1/3/17	7.766%	7.692% qtr.
*Vermont Electric #193	3/31	4,880,000.00	1/3/17	7.766%	7.692% qtr.
*Glacier Highway Electric #262	3/31	494,000.00	1/3/17	7.766%	7.692% qtr.
*Tel. Ut. of E. Oregon #256	3/31	1,686,000.00	1/3/17	7.766%	7.692% qtr.
*Old Dominion Electric #267	3/31	1,247,474.72	12/31/13	7.737%	7.664% qtr.
*Old Dominion Electric #267	3/31	828,131.28	12/31/13	7.737%	7.664% qtr.
*Old Dominion Electric #267	3/31	5,262,424.24	12/31/13	7.737%	7.664% qtr.
*Sunflower Electric #63	3/31	432,000.00	12/31/13	7.764%	7.690% qtr.
*Kansas Electric #216	3/31	4,573,000.00	1/3/17	7.766%	7.692% qtr.
*Kansas Electric #216	3/31	1,502,000.00	1/3/17	7.766%	7.692% qtr.
*Corn Belt Power #138	3/31	200,000.00	1/3/17	7.766%	7.692% qtr.
*Saluda River Electric #271	3/31	11,507,000.00	1/2/18	7.764%	7.690% qtr.
*Tex-La Electric #208	3/31	5,056,000.00	12/31/20	7.767%	7.693% qtr.
SMALL BUSINESS ADMINISTRATION					
State & Local Development Company Debentures					
Lorain 503 Development Corp.	3/5	45,000.00	3/1/01	8.112%	
Wilmington Indus. Dev. Corp.	3/5	51,000.00	3/1/01	8.112%	
B.D.C. of Nebraska, Inc.	3/5	54,000.00	3/1/01	8.112%	
Hamilton County Dev. Co., Inc.	3/5	76,000.00	3/1/01	8.112%	
St. Louis County L.D. Co.	3/5	83,000.00	3/1/01	8.112%	
Iowa Business Growth Co.	3/5	101,000.00	3/1/01	8.112%	
Empire State C.D. Corp.	3/5	147,000.00	3/1/01	8.112%	
S.C. Kansas Dev. Dis., Inc.	3/5	173,000.00	3/1/01	8.112%	
Capital Ec. Dev. Corp.	3/5	184,000.00	3/1/01	8.112%	
St. Louis County L.D. Co.	3/5	208,000.00	3/1/01	8.112%	
Indiana Statewide C.D. Corp.	3/5	210,000.00	3/1/01	8.112%	
San Diego County L.D. Corp.	3/5	211,000.00	3/1/01	8.112%	
Hamilton County Dev. Co., Inc.	3/5	291,000.00	3/1/01	8.112%	
Indiana Statewide C.D. Corp.	3/5	415,000.00	3/1/01	8.112%	
Washington Community Dev. Corp.	3/5	500,000.00	3/1/01	8.112%	
Long Island Dev. Corp.	3/5	500,000.00	3/1/01	8.112%	
Nine County Dev., Inc.	3/5	25,000.00	3/1/06	8.216%	
Dev. Corp. of Middle Georgia	3/5	43,000.00	3/1/06	8.216%	
N. Virginia L.D. Co., Inc.	3/5	44,000.00	3/1/06	8.216%	
Rural Enterprises, Inc.	3/5	45,000.00	3/1/06	8.216%	
Nevada State Dev. Corp.	3/5	48,000.00	3/1/06	8.216%	
Wilmington Indus. Dev., Inc.	3/5	52,000.00	3/1/06	8.216%	
Hamilton County Dev. Co., Inc.	3/5	71,000.00	3/1/06	8.216%	
Topeka/Shawnee County Dev. Corp	3/5	74,000.00	3/1/06	8.216%	
Nevada State Dev. Corp.	3/5	86,000.00	3/1/06	8.216%	
St. Louis Local Dev. Co.	3/5	88,000.00	3/1/06	8.216%	
Catawba Regional Dev. Corp.	3/5	89,000.00	3/1/06	8.216%	
Hamilton County Dev. Co., Inc.	3/5	100,000.00	3/1/06	8.216%	
Corp. for Bus. Asst. in NJ	3/5	101,000.00	3/1/06	8.216%	
Indiana Statewide C.D. Corp.	3/5	105,000.00	3/1/06	8.216%	
Nevada State Dev. Corp.	3/5	107,000.00	3/1/06	8.216%	
Ark-Tex Reg. Dev. Co., Inc.	3/5	108,000.00	3/1/06	8.216%	
Verd-Ark-Ca Dev. Corp.	3/5	113,000.00	3/1/06	8.216%	
Birmingham City Wide L.D. Co.	3/5	114,000.00	3/1/06	8.216%	
Evergreen Community Dev. Assoc.	3/5	116,000.00	3/1/06	8.216%	
Metropolitan Growth & Dev. Co.	3/5	120,000.00	3/1/06	8.216%	

*maturity extension

FEDERAL FINANCING BANK

MARCH 1986 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
State & Local Development Company Debentures (Cont'd)					
Dallas Sm. Bus. Corp., Inc.	3/5	$ 130,000.00	3/1/06	8.216%	
E.C.I.A. Bus. Growth, Inc.	3/5	130,000.00	3/1/06	8.216%	
South Shore Ec. Dev. Corp.	3/5	132,000.00	3/1/06	8.216%	
Region E. Development Corp.	3/5	139,000.00	3/1/06	8.216%	
Dallas Sm. Business Corp., Inc.	3/5	157,000.00	3/1/06	8.216%	
Empire State C.D. Corp.	3/5	158,000.00	3/1/06	8.216%	
The Mid-Atlantic C.D. Co.	3/5	160,000.00	3/1/06	8.216%	
Massachusetts C.D. Corp.	3/5	166,000.00	3/1/06	8.216%	
S.W. Pennsylvania E.D. Dist.	3/5	172,000.00	3/1/06	8.216%	
Caprock L.D. Co.,	3/5	180,000.00	3/1/06	8.216%	
Commonwealth S.B.D. Corp.	3/5	185,000.00	3/1/06	8.216%	
S.W. Pennsylvania E.D. Dist.	3/5	200,000.00	3/1/06	8.216%	
Birmingham City Wide L.D. Co.	3/5	226,000.00	3/1/06	8.216%	
N. Texas C.D. Corp.	3/5	227,000.00	3/1/06	8.216%	
S.W. Pennsylvania E.D. Dist.	3/5	229,000.00	3/1/06	8.216%	
Granite State Ec. Dev. Corp.	3/5	239,000.00	3/1/06	8.216%	
N. Virginia L.D. Co., Inc.	3/5	249,000.00	3/1/06	8.216%	
Long Island Dev. Corp.	3/5	252,000.00	3/1/06	8.216%	
W. C. Arkansas P&D Dist., Inc.	3/5	267,000.00	3/1/06	8.216%	
Monroe County Indus. Dev. Corp.	3/5	270,000.00	3/1/06	8.216%	
Pocono N.E. Enterprise Dev Corp	3/5	273,000.00	3/1/06	8.216%	
Lake County Ec. Dev. Corp.	3/5	282,000.00	3/1/06	8.216%	
Long Island Dev. Corp.	3/5	365,000.00	3/1/06	8.216%	
Empire State C.D. Corp.	3/5	367,000.00	3/1/06	8.216%	
Urban Business Dev. Corp.	3/5	388,000.00	3/1/06	8.216%	
Columbus Countywide Dev. Corp.	3/5	461,000.00	3/1/06	8.216%	
Wisconsin Bus. Dev. Fin. Corp.	3/5	500,000.00	3/1/06	8.216%	
Indiana Statewide C.D. Corp.	3/5	500,000.00	3/1/06	8.216%	
Arizona Enterprise Dev. Corp.	3/5	500,000.00	3/1/06	8.216%	
River East Progress, Inc.	3/5	43,000.00	3/1/11	8.271%	
MSP 503 Dev. Corp.	3/5	58,000.00	3/1/11	8.271%	
Capital Region Bus. Corp.	3/5	74,000.00	3/1/11	8.271%	
Panhandle Area Council, Inc.	3/5	92,000.00	3/1/11	8.271%	
Central California C.D. Corp.	3/5	109,000.00	3/1/11	8.271%	
Warren Redev. & Planning Corp.	3/5	113,000.00	3/1/11	8.271%	
Montgomery County B.D. Corp.	3/5	114,000.00	3/1/11	8.271%	
La Habra L.D. Co., Inc.	3/5	130,000.00	3/1/11	8.271%	
San Diego County L.D. Corp.	3/5	138,000.00	3/1/11	8.271%	
Worcester Bus. Dev. Corp.	3/5	147,000.00	3/1/11	8.271%	
Alabama Community Dev. Corp.	3/5	153,000.00	3/1/11	8.271%	
Wilmington Indus. Dev. Corp.	3/5	159,000.00	3/1/11	8.271%	
St. Louis Local Dev. Co.	3/5	160,000.00	3/1/11	8.271%	
St. Louis Local Dev. Co.	3/5	170,000.00	3/1/11	8.271%	
Granite State Ec. Dev. Corp.	3/5	257,000.00	3/1/11	8.271%	
Phoenix Local Dev. Corp.	3/5	264,000.00	3/1/11	8.271%	
St. Louis Local Dev. Co.	3/5	315,000.00	3/1/11	8.271%	
Southern Nevada C.D. Co.	3/5	340,000.00	3/1/11	8.271%	
South Shore Ec. Dev. Corp.	3/5	367,000.00	3/1/11	8.271%	
St. Louis County L.D. Co.	3/5	368,000.00	3/1/11	8.271%	
Wilmington Indus. Dev., Inc.	3/5	479,000.00	3/1/11	8.271%	
Androscoggin Valley C. of Gs.	3/5	493,000.00	3/1/11	8.271%	
N. Virginia L.D. Co., Inc.	3/5	500,000.00	3/1/11	8.271%	
Small Business Investment Company Debentures					
Marcon Capital Corporation	3/19	150,000.00	3/1/93	7.795%	
Bancorp Hawaii SBIC, Inc.	3/19	500,000.00	3/1/96	7.895%	
Bancorp Venture Capital, Inc.	3/19	2,250,000.00	3/1/96	7.895%	
Domestic Capital Corporation	3/19	1,000,000.00	3/1/96	7.895%	
Intermountain Ventures, Ltd.	3/19	1,250,000.00	3/1/96	7.895%	
Jupiter Partners	3/19	1,000,000.00	3/1/96	7.895%	
RIHT Capital Corporation	3/19	1,000,000.00	3/1/96	7.895%	

FEDERAL FINANCING BANK

MARCH 1986 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
Small Business Investment Company Debentures (Cont'd)					
Retzloff Capital Corporation	3/19	$ 2,000,000.00	3/1/96	7.895%	
Ritter Partners	3/19	1,000,000.00	3/1/96	7.895%	
Unicorn Ventures, Ltd.	3/19	500,000.00	3/1/96	7.895%	
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
+Note A-86-06	3/31	634,012,613.97	6/30/86	6.655%	

+rollover

FEDERAL FINANCING BANK
MARCH 1986 Commitments

BORROWER	GUARANTOR	AMOUNT	COMMITMENT EXPIRES	MATURITY
Baltimore, MD	HUD	$ 805,000.00	1/2/88	1/2/04
Fulton, GA	HUD	600,000.00	1/5/87	1/5/87
Greeley, CO	HUD	700,000.00	11/1/86	11/1/86
Indianapolis, IN	HUD	14,424,571.00	3/1/87	3/1/87
Lincoln, NE	HUD	1,000,000.00	10/1/87	10/1/87
Long Beach, CA	HUD	5,000,000.00	8/1/87	8/1/87
Mayaguez, PR	HUD	2,785,000.00	8/1/87	8/1/87
Newport News, VA	HUD	3,848,115.00	2/15/87	2/15/87
Philadelphia, PA	HUD	707,110.00	10/1/87	10/1/03
Ponce, PR	HUD	6,820,000.00	10/1/87	10/1/87
Provo, UT	HUD	942,583.00	8/1/86	8/1/86
Tacoma, WA	HUD	173,990.00	10/15/87	10/15/03
Winston-Salem, NC	HUD	2,198,000.00	8/1/87	8/1/87

FEDERAL FINANCING BANK HOLDINGS
(in millions)

Program	March 31, 1986	February 28, 1986	Net Change 3/1/86-3/31/86	Net Change—FY 1986 10/1/85-3/31/86
Agency Debt				
Export-Import Bank	$ 15,250.1	$ 15,670.3	$ -420.2	$ -159.0
NCUA-Central Liquidity Facility	223.0	225.8	-2.9	0.8
Tennessee Valley Authority	14,649.0	14,673.0	-24.0	268.0
U.S. Postal Service	1,690.0	1,690.0	-0-	-0-
U.S. Railway Association	73.8	73.8	-0-	-0-
Agency Assets				
Farmers Home Administration	63,464.0	63,774.0	-310.0	-705.0
DHHS-Health Maintenance Org.	105.9	105.9	-0-	-3.3
DHHS-Medical Facilities	122.1	122.1	-0-	-0.7
Overseas Private Investment Corp.	3.4	3.4	-0-	-2.7
Rural Electrification Admin.-CBO	4,171.7	3,724.3	447.4	447.4
Small Business Administration	29.4	30.0	-0.6	-3.5
Government-Guaranteed Lending				
DOD-Foreign Military Sales	18,584.3	18,542.4	41.9	495.7
DEd.-Student Loan Marketing Assn.	5,000.0	5,000.0	-0-	-0-
DHUD-Community Dev. Block Grant	297.1	288.7	8.4	7.7
DHUD-New Communities	32.2	32.2	-0-	-1.3
DHUD-Public Housing Notes	2,111.4	2,111.4	-0-	-34.7
General Services Administration	405.3	405.3	-0-	-3.1
DOI-Guam Power Authority	34.7	35.1	-0.5	-0.5
DOI-Virgin Islands	27.8	27.8	-0-	-0.4
NASA-Space Communications Co.	887.6	887.6	-0-	-0-
DON-Ship Lease Financing	1,588.6	1,469.6	119.0	275.5
DON-Defense Production Act	7.5	7.3	0.2	1.6
Oregon Veteran's Housing	-0-	60.0	-60.0	-60.0
Rural Electrification Admin.	20,958.8	20,739.0	219.8	-716.8
SBA-Small Business Investment Cos.	1,051.0	1,059.8	-8.8	27.1
SBA-State/Local Development Cos.	703.6	688.5	15.2	108.0
TVA-Seven States Energy Corp.	1,742.3	1,728.5	13.9	90.9
DOT-Section 511	63.7	65.6	-1.9	-89.9
DOT-WMATA	177.0	177.0	-0-	-0-
TOTALS*	$ 153,455.3	$ 153,418.4	$ 36.8	$ -58.0

*figures may not total due to rounding

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE May 21, 1986

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $9,811 million of $35,599 million of tenders received from the public for the 2-year notes, Series Z-1988, auctioned today. The notes will be issued June 2, 1986, and mature May 31, 1988.

The interest rate on the notes will be 7-1/8%. The range of accepted competitive bids, and the corresponding prices at the 7-1/8% interest rate are as follows:

	Yield	Price
Low	7.20%	99.863
High	7.20%	99.863
Average	7.20%	99.863

Tenders at the high yield were allotted 81%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 110,335	$ 27,335
New York	32,024,415	9,156,505
Philadelphia	27,785	27,785
Cleveland	80,520	45,520
Richmond	94,795	48,795
Atlanta	54,205	35,205
Chicago	1,477,565	152,565
St. Louis	105,310	99,310
Minneapolis	51,510	41,510
Kansas City	129,655	122,655
Dallas	17,855	17,855
San Francisco	1,418,970	29,970
Treasury	6,160	6,160
Totals	$35,599,080	$9,811,170

The $9,811 million of accepted tenders includes $773 million of noncompetitive tenders and $9,038 million of competitive tenders from the public.

In addition to the $9,811 million of tenders accepted in the auction process, $378 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $644 million of tenders was also accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities.

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

For Immediate Release
May 22, 1986

Contact: Charlie Powers
566-8773

TREASURY DEPARTMENT ASSESSES PENALTY AGAINST
WELLS FARGO BANK UNDER BANK SECRECY ACT

The Department of the Treasury announced today that Wells Fargo Bank, San Francisco, has agreed to a settlement that requires the bank to pay a civil penalty of $75,000 for failure to report in excess of 300 currency transactions as required by the Bank Secrecy Act.

Francis A. Keating, II, Assistant Secretary (Enforcement), who announced the penalty, said the penalty represented a complete settlement of Wells Fargo's civil liability for these violations. Keating said that Wells Fargo came forward voluntarily, cooperated fully with Treasury in developing the scope of its liability, and has instituted measures to ensure full compliance with the Bank Secrecy Act in the future.

The Department of the Treasury has no evidence that Wells Fargo engaged in any criminal activities in connection with these reporting violations. The violations were not systemic, but limited to certain types of transactions by certain units of the bank.

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B-593

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-204

FOR IMMEDIATE RELEASE
May 22, 1986

CONTACT: CHARLEY POWERS
Phone: (202) 566-8773

TREASURY ANNOUNCES PENALTY AGAINST
SECURITY PACIFIC NATIONAL BANK

The Department of the Treasury today announced that Security Pacific National Bank, Los Angeles, has agreed to pay a civil penalty of $605,000 for violations of the Bank Secrecy Act. The violations consist of failures to file Currency Transaction Reports for cash transactions exceeding $10,000, as required under the Act. This represents a complete settlement of Security Pacific National Bank's civil liability under the Act.

The penalty was based on over 2,400 violations by Security Pacific. Based on the compliance review done by Security Pacific, examinations by the Comptroller of the Currency and a review of the bank's compliance history, Treasury is confident that the penalty amount is appropriate. Security Pacific has agreed to review further cash transactions and to late-file additional Currency Transaction Reports as required by Treasury.

Treasury has no information that the bank engaged in criminal activity in connection with these violations. Security Pacific cooperated in developing the scope of its liability and has taken measures to assure good future compliance.

The penalty was announced by Francis A. Keating, II, Assistant Secretary for Enforcement. Mr. Keating said, "We continue to encourage financial institutions to come forward to Treasury with information regarding past non-compliance with the Bank Secrecy Act. Treasury has not yet closed the door to volunteers. Mere late-filing of Currency Transaction Reports with the Internal Revenue Service without further communication with Treasury is not adequate notice to Treasury of past non-compliance."

"Treasury is now turning its attention to identifying banks with past violations which have not come forward to Treasury voluntarily. Such banks will be dealt with subtantially more severely."

In the last year, over sixty banks have come forward to Treasury to discuss past Bank Secrecy Act non-compliance. Since June 1985, seventeen other banks have been penalized in amounts ranging from $75,000 to $4.75 million. The cases of other banks are under review.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

Text as Prepared
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Remarks by Secretary of Treasury
James A. Baker, III
To the John F. Kennedy School of Government
Public Affairs Forum
Harvard University
Boston, Massachusetts
Thursday, May 22, 1986

Thank you Dean Allison, ladies and gentlemen, faculty and students of Harvard University. I am very pleased to be here tonight and deeply gratified to accept the Honorary Medal for Distinguished Public Service. If there is anything that Harvard represents, it is achievement in the public sector.

In my own years in public service I have been privileged to serve two U.S. Presidents. And so I have had the opportunity to observe the modern American Presidency at close range -- and to develop some opinions about that office that I would like to share with you tonight. In doing so I will touch on what I think are some of the elements necessary for the making of a strong Presidency, and why the strength of this political institution is important to the nation.

One of the keenest observers of the Presidency (whom I was fortunate enough to know through three campaigns) was Teddy White -- a son of Massachusetts and Harvard who I know we all will miss. In *The Making of the President 1960*, the first of five books on America's electoral process, White's concluding chapter reflects on an interview with the new young President about the unique requirements of that office. "The essence of leadership," wrote White, is whether the President "is moved by other people and outer forces or [whether he] moves them." He added: "A President governing the United States can move events only if he can first persuade."

B-595

The inauguration of John F. Kennedy seemed to initiate a new era for the American Presidency -- and the nation. We were at peace and relatively prosperous, yet he emerged on the national scene determined to provide vigorous national leadership to confront our problems.

At the same time another force that would have a profound effect on the institution of the Presidency also came on the political stage. In fact it would come more and more to shape the script and actors of governance, and that was television.

When Kennedy campaigned in the early primaries, the pencil press that followed him was sometimes joined by a cumbersome network quartet of producer, reporter, soundman, and cameraman, the curiously new participants on the campaign trail.

That same year television also played a key role in the advent of 20th century mass democracy -- the televised political debates. With their phenomenally high ratings these contests (it can be fairly said) gave the more skillful communicator, Kennedy, a boost that carried him to victory a few weeks later. What struck White most about the first encounter was not Kennedy's response to any specific question, but the effectiveness with which he communicated his vision for the future.

Once in office he mastered the new medium by being the first President to allow his press conferences to be televised live, satisfying the thirst of the new medium for drama on the national scene. His performances seemed to cement Americans' impression of him as the President who would lead and offer movement to a nation with seemingly unbridled prospects for growth and prosperity. Regrettably, events overtook our optimism.

By 1968 White commented in his third book on the presidential election process that President Johnson had "left behind a tradition of distrust in leadership, a repudiation of the presidential capacity unmatched, emotionally, since the repudiation of Herbert Hoover."

At the risk of oversimplifying, a credibility gap had taken hold of the Johnson Presidency engulfing his domestic and foreign initiatives. His vision for a harmonious "Great Society" was cracked by discordant riots in our cities and a new dissent on our campuses. His pronouncements that the Vietnam War was going well were repudiated by the reality of an escalating conflict.

And reflecting all of this was television, which had become, White wrote, the primary vehicle "for the new court of high criticism" of the Presidency. Many tests faced the next President, turmoil in the cities, social unrest, the war, but White thought Richard Nixon's real challenge would be to restore "the confidence of millions of Americans who no longer trust any government of the United States." This would only happen, White predicted, if the new president could convey his vision of conciliation to the nation.

But none of Nixon's accomplishments at home or abroad could offset the verdict of two summers' congressional hearings televised daily and nightly into America's homes. The office of the President had reached its lowest ebb. From a time when we once revered the image of Camelot at the White House, "imperial" had become a pejorative when used to describe our highest elective office. President Ford restored confidence and trust in the chief executive's post, but in the aftermath of Watergate, instead of turning to a strong Presidency in the next election, we looked to a different kind of Presidency.

The early Carter Presidency was a time of national catharsis. He scorned the customary limousine and walked with his family to the White House after his inauguration. When he greeted his first official audience at the White House, the ceremonial ruffles and flourishes was not played. Initially, the press applauded President Carter for "denoblizing" the presidency, stripping it of its pomp. The Carter Administration made the White House and the Presidency more ordinary and less mystifying, and removed any sense of awe and majesty from the Oval Office.

All of this, it seems, reflected the distaste for leadership that Americans had developed in the aftermath of Watergate and Vietnam. Accompanying (and perhaps feeding) this syndrome, was an increasingly popular tendency to denigrate the Presidency. It would reach its zenith in the Carter years.

Professor Henry Graff of Columbia University has noted how Lyndon Johnson, "the ablest congressional politician of this century, was somehow changed perceptually into a riverboat gambler unworthy of his high place," how Gerald Ford, "the best athlete ever to sit in the Oval Office, became a caricaturist's delight as an oafish stumblebum," and how Jimmy Carter, having been elected as "the outsider brought in to straighten out the mess, became a failure because he was not an insider."

During this period (from President Johnson to President Carter) at the other end of Pennsylvania Avenue, significant changes had taken place since the last Democratic administration that altered the environment for presidential persuasion, the critical tool of presidential power.

On Capitol Hill the overwhelming majority of congressional reforms were intended to provide more opportunities for more members to express themselves in the legislative process and not to enhance the integration of policy. Autocratic committee chairmen were overthrown in the caucus and subcommittee chairmanships had grown by more than 50 percent in the Senate and the House since Lyndon Johnson had left the White House.

Even with partisan control of the Congress a master technician like Johnson often found his will thwarted. He wrote in his presidential memoir, Vantage Point, about the limits to his power to force congressional compliance drawing on his experience in the Texas State Legislature.

It seems that a state senator named Alvin Wirtz arranged a meeting between Johnson and some private utility company owners to try and persuade them to make electrical power available to small farmers. During the course of their discussions Johnson was angered by one of the company presidents and told the man to "go to hell." The meeting broke up but later Senator Wirtz called Johnson aside and said: "Listen Lyndon, I've been in this business for a long time.... If I have learned anything at all in these years, it is this -- you can tell a man to go to hell, but you can't make him go." That bit of advice was offered to Johnson in 1937. He never forgot it.

In Vantage Point Johnson described how he thought about Senator Wirtz's advice many times during his Presidency when he was locked in a struggle with the House or Senate. "no matter how many times I told Congress to do something," wrote Johnson, "I could never force it to act."

The Presidency is an office held to high expectations. Yet the framers of the Constitution were determined that the President should not command Congress. Our chief of state has fairly modest and much-checked formal powers but, as your distinguished presidential scholar Dick Neustadt has observed, great resources for leadership by "persuasion." He must use those resources skillfully in order to secure the broad approval of the public and support from the political community -- especially Congress -- or he will be ineffective.

Now admitting my own bias and prejudice, I think that the perceived failure of the Carter Presidency, and conversely the success of Ronald Reagan's, center on their different attitudes towards governance.

President Carter's first hundred days certainly rivaled FDR's in number of initiatives. He sent a massive and far-reaching collection of complex legislation to Capitol Hill, including a tax cut bill, a major budget revision, executive reorganization authority, establishment of the new Energy Department, and packages for welfare, labor and social security reform, among others. Yet with the possible exception of the energy plan, there was no focal point for his Presidency to rally around, no vision of what his priorities were.

A kind of legislative "gridlock" resulted on Capitol Hill. Few of President Carter's proposals were even moved to the floor for consideration. And the President himself sent confusing signals to lawmakers. He abruptly withdrew the $50 personal rebate as part of his tax cut package without forewarning congressional leaders and some in his own administration. Congress was overloaded, the public was confused and disinterested.

The failure to establish an agenda was a strategic mistake on President Carter's part, but there were tactical ones as well. Much has been written about his perceived inability to negotiate effectively with Congress. Some said he handled the Congress with the same detached coolness that he accorded the Georgia State Legislature. And that he was less than a forceful communicator. One observer noted: "Carter blew the trumpet, yelled 'Charge' and [then]... nothing."

But perhaps the most fundamental flaw in the Carter Presidency was the philosophical premise that the task of governing can be achieved with a technocratic approach to problem solving. This is the idea that every public policy issue can be resolved with a specific plan or program, and that the activist President is the technocratic manager of a complex set of interrelated policies. Whatever appeal this may have to social scientists, it is of little help in the practical aspects of governing.

As opposed to being seen as a leader with a vision and effective capacity, President Carter was diminished by his approach to governance. He himself correctly lamented the problem towards the end of his term in the famous "malaise" speech: What you see in Washington he said: "is a system of governance incapable of action.... Often you see paralysis and drift...."

The elements of this crisis can be seen in the contradiction between the objectives of President Carter's government by technocratic management and the forces that accompanied his rise to power. The powers of the Presidency had been so degraded by the time he took office, that Carter did not command the respect and deference normally accorded a President.

And the reform impulse in Congress, the diffusion of power with the proliferation of subcommittees and the weakening of the congressional leadership expanded the opportunities for interest groups with inimical goals to influence the lawmakers.

As Teddy White observed: "President Carter... insisted on keeping all his promises at once, which left him exposed to all those with leverage in the offices of congressmen elected to represent their interests."

In response to this situation, a consensus among our elites began to develop that the structural design of government was inadequate to meet the tasks of governing. It was said that the President's personal and political resources were insufficient to overcome the fragmentation and disarray inherent in the American separation of powers.

President Carter's White House Counsel argued while his chief was still in office that the formal institutional resources for executive leadership were so insufficient that the Carter Presidency could not succeed. "In parliamentary terms, one might say that under the U.S. Constitution it is not now feasible to "form a government," he wrote in Foreign Affairs magazine.

Unfortunately, he said, no recent President had been able to get his programs through Congress in anything approaching coherent form. The United States, he suggested, needed to go to a parliamentary type of government to end this executive-legislative deadlock.

This was not the first time that structural reform was advised for the Presidency. Limiting the President to a single six-year term was discussed at the Constitutional Convention and proposed to Congress as a constitutional amendment as early as 1826! Proponents have reintroduced this measure into Congress more than 100 times since then, arguing that the President should be released from the constraints of seeking re-election.

More recently we've heard that our problems are too big for partisan control of the executive branch and that some form of coalition government should be considered.

I think we should question such proposals. When political institutions, like the Presidency, maintain relatively popular support for nearly 200 years, we should assume that they are doing something right! The American public has shown little dissatisfaction with the existing constitutional limits on the Presidency.

By successfully completing two successive terms, Ronald Reagan will have not only redefined the role of the President but reinvigorated the institution of the Presidency as well. This will be, I think, one of his most important legacies to the nation. He has reversed the commentary that Presidents were incapable of leading the nation.

The Presidency is still what Theodore Roosevelt once called a "bully pulpit." Much has been said and written of Ronald Reagan's ability to gain support for his programs by his skill as an educator, as a mobilizer of public opinion. His televised speeches are firm but not abrasive, persuasive without seeming hostile, a powerful combination in our political culture. The President has been able to use his skills as a communicator to take maximum advantage of the powers of persuasion that Dick Neustadt, has written about.

When President Reagan came into office the conventional wisdom was that it was very difficult for a President to maintain his power through television, and -- over time -- it would help destroy him. But now that view is subject to some revision I think. In his first term, by carefully marshaling his appearances before key congressional votes the President was able to maximize his leverage over the congressional agenda. And with each victory, the President enhanced his reputation as a strong and successful leader.

But having observed President Reagan interact with members of the House and Senate, I would place equal emphasis for his success upon what Neustadt called "the residual impressions of tenacity and skill" that the President conveys to the Congress and the rest of the Washington community. A President's high approval in public opinion polls is no guarantee that he will be able to lead effectively if the elite opinion of his abilities is low.

The political skills needed to persuade the Washington community are not always the ones a President uses to move public opinion. Strength, steady resolution, the ability to fight hard for one's policies without personalizing disagreements, and knowing when and how to compromise to achieve the most elements of one's objectives have all been critical to President Reagan's success.

By revitalizing the Presidency, Ronald Reagan has increased the likelihood of cooperation between Capitol Hill and the White House on public policy. The contest between the two branches of government is not a zero-sum game. The President's gain is not Congress's loss. In fact, polling data suggest that the President's popularity and success are positively influencing public attitudes toward other branches and levels of government, including Congress.

I have seen this cooperation work first hand. The Social Security compromise in 1983 was sensible legislation and defused perhaps the most sensitive political issue between Democrats and Republicans. And although it may be just a footnote now to the protracted turmoil in Lebanon, I think historians will favorably record the successful negotiations between the Congress and the President over the first use of the War Powers Act to deploy U.S. military forces. (Fundamental tax reform may become another product of this cooperation.)

As we approach the 200th year of our Constitution we should remember that America's government at its best is based on the strength of her institutions. Calling forth our best is not only for presidents and lawmakers, but for scholars and students and Americans of all walks of life. Twenty-five years ago that was the message of the president for whom this school is named.

The history of this university and its community kindles the honorable flame of duty and service in all of us. Just north of this building, a brief walk from here is the Memorial Church. Sons of Harvard who have fallen in battle for their country are memorialized there.

And a short distance from that point, due west, is the Cambridge Common, where George Washington took command of the Continental Army and members of this community volunteered to join his ranks.

In this city, at this university, we are constantly reminded that the founding fathers were men who dared to build a nation upon confidence and cooperation, not fear and disunity.

At the conclusion of his memoirs (In Search of History) White wondered whether "the old ideas that have made America a nation could stretch far enough to keep it one." I am confident that he believed they would. I agree. And as we continue with the challenges we face in the years ahead, I am sure that our leaders and institutions will prove equal to the tasks.

Thank you very much.

TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
May 27, 1986

Contact: Dorene Erhard
566-3021

WOMEN IN LAW ENFORCEMENT

The Interagency Committee on Women in Federal Law Enforcement will present a training program on May 28-29, 1986, at the Twin Bridges Marriott, Arlington, Virginia, entitled "Forward to the Future." More than 150 women and men from Federal, State, and local law enforcement agencies will attend the 2-day conference.

Keynote speakers are Francis A. Keating, II, Assistant Secretary for Enforcement, Department of the Treasury, and Victoria Toensing, Deputy Assistant Attorney General, Criminal Division, Department of Justice. Lois Haight Harrington, Assistant Attorney General, Office of Justice Programs, is addressing the conference participants at a luncheon to be held on May 28. Seminars and workshops offer topics ranging from career and personal development to enforcement-related subjects such as specialized weapons, computers as an investigative tool, and psychological profiling of criminals.

The Interagency Committee on Women in Federal Law Enforcement was established in 1977 as a special task force under the Office of Personnel Management to identify problems facing women in law enforcement and recommend solutions. It has evolved into an active organization sponsored by the Department of the Treasury and the Department of Justice and made up of representatives from over 30 Federal agencies with law enforcement reponsibilities.

The Interagency Committee has received nationwide recognition for its efforts in publicizing recruitment opportunities and the challenges of a career in law enforcement for women. It was cited in the 1984 report by the White House Task Force on Legal Equity for Women as an example of the type of initiative supported by the President to enhance opportunities for equality of women.

B-597

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M.

May 27, 1986

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $14,400 million, to be issued June 5, 1986. This offering will result in a paydown for the Treasury of about $100 million, as the maturing bills are outstanding in the amount of $14,500 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, June 2, 1986. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,200 million, representing an additional amount of bills dated September 5, 1985, and to mature September 4, 1986 (CUSIP No. 912794 KQ 6), currently outstanding in the amount of $15,642 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,200 million, to be dated June 5, 1986, and to mature December 4, 1986 (CUSIP No. 912794 LM 4).

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing June 5, 1986. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold $1,129 million as agents for foreign and international monetary authorities, and $3,667 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series).

B-598

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE May 27, 1986

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $ 7,200 million of 13-week bills and for $ 7,220 million of 26-week bills, both to be issued on May 29, 1986, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing August 28, 1986			:	26-week bills maturing November 28, 1986		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	6.12%	6.30%	98.453	:	6.19%	6.48%	96.853
High	6.16%	6.34%	98.443	:	6.22%	6.51%	96.838
Average	6.15%	6.34%	98.445	:	6.21%	6.50%	96.843

Tenders at the high discount rate for the 13-week bills were allotted 74%.
Tenders at the high discount rate for the 26-week bills were allotted 100%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 41,835	$ 41,835	:	$ 24,645	$ 24,645
New York	17,605,885	5,380,185	:	19,308,900	6,213,900
Philadelphia	29,010	29,010	:	13,760	13,760
Cleveland	44,095	44,095	:	25,585	25,585
Richmond	48,650	48,650	:	50,295	50,295
Atlanta	45,280	42,680	:	35,205	35,205
Chicago	1,530,110	465,050	:	1,532,715	262,715
St. Louis	84,455	58,455	:	76,225	48,225
Minneapolis	24,115	24,115	:	8,800	8,800
Kansas City	51,355	51,355	:	35,320	35,320
Dallas	43,090	38,090	:	24,515	14,515
San Francisco	1,400,985	673,685	:	997,640	242,640
Treasury	302,820	302,820	:	244,270	244,270
TOTALS	$21,251,685	$7,200,025	:	$22,377,875	$7,219,875
Type					
Competitive	$18,258,365	$4,206,705	:	$19,148,085	$3,990,085
Noncompetitive	1,018,235	1,018,235	:	687,090	687,090
Subtotal, Public	$19,276,600	$5,224,940	:	$19,835,175	$4,677,175
Federal Reserve	1,766,185	1,766,185	:	1,700,000	1,700,000
Foreign Official Institutions	208,900	208,900	:	842,700	842,700
TOTALS	$21,251,685	$7,200,025	:	$22,377,875	$7,219,875

1/ Equivalent coupon-issue yield.

B-599

TREASURY NEWS
epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE May 28, 1986

RESULTS OF AUCTION OF 5-YEAR 2-MONTH NOTES

The Department of the Treasury has accepted $7,756 million of $18,080 million of tenders received from the public for the 5-year 2-month notes, Series K-1991, auctioned today. The notes will be issued June 3, 1986, and mature August 15, 1991.

The interest rate on the notes will be 7-1/2%. The range of accepted competitive bids, and the corresponding prices at the 7-1/2% interest rate are as follows:

	Yield	Price
Low	7.50%	99.946
High	7.55%	99.734
Average	7.53%	99.819

Tenders at the high yield were allotted 65%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 7,738	$ 7,738
New York	16,211,962	7,107,962
Philadelphia	4,328	4,328
Cleveland	19,425	16,425
Richmond	32,667	31,617
Atlanta	34,277	30,177
Chicago	975,466	321,016
St. Louis	82,600	66,250
Minneapolis	11,983	11,683
Kansas City	25,624	25,624
Dallas	8,012	5,312
San Francisco	665,069	127,119
Treasury	816	816
Totals	$18,079,967	$7,756,067

The $7,756 million of accepted tenders includes $337 million of noncompetitive tenders and $7,419 million of competitive tenders from the public.

In addition to the $7,756 million of tenders accepted in the auction process, $15 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities.

B-600

TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
May 28, 1986

Contact: Charles H. Powers
566-8773

TREASURY STATEMENT

In public testimony before a Senate Foreign Affairs Subcommittee on Tuesday, May 13, 1986, Customs Commissioner William von Raab, in answer to a question, stated that he had information that the Governor of Sonora is alleged to own four ranches located near Alamosa in Sonora State on which marijuana and opium poppies are grown.

However, no information exists that the Governor of Sonora, Rodolfo Felix Valdez, has any knowledge of the growth of these plants on these ranches or even of the fact that it is alleged that such growth occurs.

The Customs Service does, however, have information that narcotics are grown on ranches and farms in the State of Sonora.

The initiative between the Attorneys General of Mexico and the United States is the proper vehicle for the resolution of these concerns.

The United States Government is supportive of the continuation of these mutually important efforts to eradicate the scourge of narcotics and narcotics trafficking.

Because this matter involves sensitive investigative information, any further comment on such information will be confined to channels that can assure its appropriate protection.

B-601

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
May 29, 1986

CONTACT: CHARLES POWERS
Phone: (202) 566-8773

TREASURY ANNOUNCES JUNE 30 TERMINATION OF U.S. OIL COMPANY OPERATIONS IN LIBYA

The Department of the Treasury announced today that it has amended the licenses authorizing the wind-down of U.S. oil company operations in Libya to require the termination of all Libyan operations by June 30, 1986.

Limited individual licenses were issued by the Office of Foreign Assets Control on February 7, 1986 to Amerada Hess Corporation, Conoco Inc., Marathon Oil Company, Occidental Petroleum Corportion, and W. R. Grace & Company. These licenses directed the companies to terminate their involvement in the operation of Libyan oil concessions and to end their Libyan connections by the removal or sale of their Libyan assets. The purpose of the licenses was to avoid giving an economic windfall to the Libyan Government by requiring hasty abandonment of U.S. companies' assets in Libya, while also affording the companies an opportunity to negotiate with Libya for the disposition of those assets.

In a May 7 press conference following the Tokyo Economic Summit, and in concert with other measures adopted by the Summit partners, President Reagan confirmed that the oil companies were to wind up operations in Libya by June 30. The Treasury Department amendments to the five oil companies' licenses require termination by June 30 of their sales of Libyan crude oil, payments to the Government of Libya, and participation in the operation and management of their oil concessions.

While the oil companies, as well as other companies, will be required to terminate completely their operations in Libya by June 30, they will be permitted to continue negotiations with the Government of Libya for the sale of their Libyan assets beyond that date. Any such sale would be concluded only if authorized in advance by the U.S. Government.

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B-602

TREASURY NEWS
epartment of the Treasury • Washington, D.C. • Telephone 566-204

TAX REFORM IN THE SEASON OF THE GOLDEN BEAR

REMARKS BY
RICHARD G. DARMAN
DEPUTY SECRETARY OF THE TREASURY

BEFORE THE
NATIONAL ASSOCIATION OF MANUFACTURERS
WASHINGTON, D.C. MAY 30, 1986

This is an unconventional time of day to have to listen to a speech. Indeed, it's a time when many are still wearing earplugs. And it's no wonder -- for it's a particularly unconventional time to have to listen to a speech about tax reform. With this in mind, I thought I'd best offer somewhat unconventional remarks.

Hope Springs Eternal: "This May Be the Red Sox Year"

This is the time when, before rushing off to the world of work, many would ordinarily be at the breakfast table completing a last-minute review of important statistics. The statistics, of course, are those found in the daily newspaper's sports section -- an essential buffer between the world of darkness and the world of light. Knowing that I might otherwise be depriving some of you of this source of stimulation and comfort, it occurred to me that I should combine tax reform and a sports report.

So that is what I'll try to do. And if at any point there seems to be too much of either tax reform or sports, I'd just ask you to think of the one as a metaphor for the other.

As a sometime son of Massachusetts, let me start with what is most important. I don't mean the Boston Celtics, who of course are again in the NBA finals. The Celts do have a proud tradition to uphold, and there is important human drama in their continuing quest for excellence. I refer, rather, to a more fundamental and poignant human drama: the eternal rite of spring, the hope that "This may be the Red Sox year."

It's a bit like Charlie Brown lining up one more time with Lucy holding the ball -- or like the seemingly endless, perennial drama of tax reform. With the start of each new season, each successive generation of fans and would-be heroes thinks and hopes: This may be the year.

The Red Sox, I'm pleased to report -- at this rather late date for them -- are still in first place. Their record is now 31 wins and 14 losses -- a winning percentage of .689. They lead the league in both hitting and pitching. Roger Clemens is 8-0. Clemens and Hurst rank 1-2 in strikeouts. Wade Boggs looks like he may be on his way to another batting crown. And old Bean Town is once again high with pennant fever.

It's almost like the euphoric effect of getting a tax bill with a top rate of 27% through the Senate Finance Committee on a 20-0 vote.

The fever of hope has even reached my 9-year-old and 5-year-old sons -- not in the form of hope for tax reform, but hope for the Red Sox. They've temporarily swapped their orange, black, and white Orioles hats for the distinctive Boston blue with the red "B". They think they know a winner when they see one.

But, of course, we all know that the Red Sox have a tragic flaw: a chronic habit of entrapping their fans with a strong start, only to leave them with a broken heart. Often the fall comes at the end of spring training. Sometimes it comes right after the July 4th break. Occasionally it doesn't come until the seventh game of the World Series. But every year since 1918, sooner or later, the fall has come; and hopes have been dashed.

The most remarkable thing, of course, is that the fans keep hoping -- year after year, game after game, inning after inning. Boston even has a ballpark especially designed to keep hope alive: Fenway, with its stolid "green monster," that threatens to convert a seemingly simple pop fly into anything from a game-winning homer to a ricochet single that might tempt a runner to stretch for a double, only to be thrown out at second. It's the one park in which the home team can be down by 9 runs in the bottom of the ninth, and the fans will still stay; for there's a reasonable chance that the game might be tied and go into extra innings. It's the field more than any other that validates the simple oracular wisdom of the Red Sox long-time nemesis, Yogi Berra: "It ain't over til it's over."

Quite obviously, Fenway Park is an ideal training ground for tax reform. A few seasons at Fenway are probably worth more -- at least spiritually -- than a few decades of practicing tax law. How better could one be prepared to deal with the ups and downs of a quest that has included the following selected highlights:

- Over the decades, there has been season after season with false starts, disappointed fans, and frustrated would-be heroes. The late Stanley Surrey first argued vigorously for a level playing field; but he went to his grave as seemingly misguided political grounds-keepers built mounds all over the field and then cut criss-crossing basepaths all around them.

Al Ullman sought to build support for a reformist approach that got him promptly ejected from the game. William Simon left office with his game plan still in the locker. Messrs. Bradley and Gephardt went to North Oaks, Minnesota in the campaign of '84 to try to sell their standard-bearer on reform -- only to have him continue to follow a strategy that seemed curiously designed to maximize his opponent's score. Even the team that produced Treasury I -- as they took the field after a year of closed practices -- was greeted by those holding the equivalent of season tickets and special concessions with a chorus of Bronx cheers.

- o Indeed, given the history, it's a wonder that anyone would wish to take the bat, and that fans would still be ready to cheer. Yet that is exactly what happened when the President and the Chairman of the Ways and Means Committee joined for one more try -- and millions of fans responded to the call, "Write Rosty."

- o But then again, hopes were dashed. The game stalled in the House with seemingly endless bickering over narrow interests. And just when that problem was solved, a fight suddenly broke out among players who were once thought to be on the same team, and who were calmed down only by a resonant last-minute plea to get one more for the Gipper.

- o The game then moved to the home of the Senators. But it had an inauspicious beginning. A pre-game retreat to build team spirit was abruptly called on account of snow -- literally.

- o When spring came and play resumed, it seemed for a while as if the players were interested in an entirely different game -- more like jai alai. But then a new coach and a new spirit came to life in the equivalent of a long locker-room session -- following which a united team emerged for a stunning 20-0 inning.

- o And that's where the game now stands as we move to the Senate floor -- where a mere 100 players can take the field at once, restrained only by the fact that for the first time their game will be televised.

There have, of course, been many points along the way at which people have thought, or even hoped, that the game was over -- but not the true fans of tax reform, the people fortunate enough to possess a touch of the Fenway spirit.

As an experienced Fenway fan, however, I should quickly add that "it ain't over til it's over" applies just as much when you're <u>ahead</u> as when you're behind. So 'though tax reform is ahead at the moment, it seems best to act with an appreciation that the game is by no means over. There are plenty of pitches yet to be thrown, and plenty of balls that will threaten to be off the wall.

Senators are being pressured to offer amendments that would seem to have some natural appeal. Indeed, there is a case for some of these on the merits -- except for the fact they threaten the larger enterprise.

- There's a proposed amendment to preserve the full current law treatment of IRAs. This is <u>notwithstanding</u> the fact that the Senate Finance Committee bill would fully preserve tax-deductible IRAs for all those who are not covered by a qualified pension plan; and would allow everyone else to benefit from tax-deferred growth of non-deductible IRA contributions -- so that many could take advantage of lower rates and come out better than they would under current law.

- There's a possible amendment to preserve the current exclusion for capital gains. This is <u>notwithstanding</u> the fact that the Committee bill dramatically reduces the top personal rate and contributes substantially to productive investment through, for example, lower corporate rates, the retention of the R&D credit, and the dramatic curtailment of incentives for unproductive tax sheltering.

- There are likely amendments to preserve the deductibility of state and local sales taxes. This is <u>notwithstanding</u> the fact that their deductibility complicates both personal recordkeeping and public law enforcement, while benefitting primarily the minority who itemize.

- And there are likely amendments to weaken the proposed limitations on the use of passive losses to offset unrelated income in order to avoid paying taxes. This is <u>notwithstanding</u> the fact that the current and growing use of passive losses is leading us from a society of productive workers and creative entrepreneurs toward a society of limited partners and passive shelterers, for whom the measure of creativity is "zeroing out" and the monument to productivity is an overstuffed steer or a "see-through" office building.

Fortunately for tax reform, preliminary reports from the field suggest that there has not been anything like the outpouring of support for these amendments that some had expected to materialize during the Memorial Day recess. The widespread appeal of a simple, low-rate tax system in which all must pay their fair share seems far greater than the attraction of amendments that would threaten to prevent that achievement.

The threat they pose is nonetheless real. It derives from the fact that most of the amendments are expensive. They would either have to be paid for by raising tax rates -- thus eroding a fundamental basis for tax reform's popular and economic appeal. Or they would have to be paid for with a host of other revenue-raising measures -- affecting, for example, banks, the insurance industry, the natural resources sector, or those who pay excise taxes -- and this, in turn, would probably destroy the basis of a workable political consensus on the Senate floor.

In this context, there are several basic legislative strategies available -- depending on one's general posture toward the Finance Committee bill. The best strategy for those who are at least roughly satisfied with the bill is to oppose all amendments on the Senate floor -- and save refinements for the House-Senate Conference. For those who are less satisfied, but who don't think their amendments would show well on the Senate floor, the best strategy would seem to be to avoid the risk of visible loss on the floor and try to gain satisfaction in Conference -- it being the case, presumably, that those who both threaten tax reform and show weakness on the floor would not, thereby, advantage themselves in what may be the most lobbied Conference in the history of the American legislative process. And for those who are extremely dissatisfied with the Senate Finance bill, the best strategy would seem to be to try to join with others and form a killer coalition -- seeking to pass a combination of popular revenue-losing amendments without the unpopular measures to pay for them.

There are, however, two significant problems for those who would adopt the bill-killing strategy. One is procedural: In the Gramm-Rudman world, a super-majority of 60 votes might be required for a revenue-losing package to be deemed to be in order on the Senate floor. That would depend on the status of the budget resolution and a ruling by the Parliamentarian. In any case, a revenue-losing approach will clearly be contrary to the spirit and intent of the Budget Act as amended by Gramm-Rudman. The second problem is more broadly political: Kill-the-bill strategists will have to justify their approach on national television. They would, in effect, have to be prepared to defend the preservation of the <u>current</u> tax system -- in the face of its overwhelming unpopularity with the American people. That, I think, is a formidable obstacle.

The Season of the Golden Bear

This is not to suggest that would-be bill-killers will be without resources. They have certainly demonstrated before that they can threaten the life of meaningful tax reform. Indeed, they have been so effective at times that one major news organization after another has been led to write tax reform's obituary.

Happily, however, each of these obituaries has been but the precursor of one more astonishing tale of tax reform's remarkable resurrection.

Almost a year ago, when the New York Times was analyzing the "death of tax reform," I thought that tax reform might follow the melodramatic path that it has pursued. At that time, the Red Sox had already begun their decline and were in fifth place. So I thought I'd better use a different metaphor. I used one that got a certain amount of attention. Back then I noted:

> "We're at that stage in the process of 'revolution' when, upon hearing shots fired, many presume there must be fatalities -- when, in some quarters, the crowd begins to run; and when, among instant historians, debate begins to rage as to how key battles were lost.
>
> "But to my ears at least, the sounds of early Summer have hardly risen to the level of the guns of August -- or in this case, the likely guns of the Fall. Indeed, the sounds I've heard seem to be more like the pops of a shooting arcade. And tax reform is like the target bear. It gets 'hit'. It rises, pauses, turns a bit -- and then it keeps on going."

I went on to ask the rhetorical question, "What if tax reform is delayed beyond this year [1985]? Does the game really stop?" I answered:

> "I think not. It might just become more difficult for a while. The substantive and conceptual character of the reformist interest might be expected to shift; and coalitions would probably have to be restructured....
>
> "Yet a response is bound to come. The dissatisfaction with the present system is unsustainably high and will demand a remedy from our democracy....
>
> "So the bear will keep on coming in its relentless pursuit of progress."

I believe that even more now -- in light of the Senate Finance Committee's bold action, and in view of the great good fortune that the tax reform debate will be the first major Senate debate to be televised. These developments have only strengthened the bear.

Yet, as you know, with tax reform and the Red Sox now riding high, I seem to have been tempted to abandon the metaphor of the bear and, like my kids, to try suddenly to fit tax reform into a Red Sox uniform. Tempted, yes. But I'm afraid I've had more experience with the Red Sox than my kids. While I'd love the Sox to make it all the way, I can't quite risk counting on them.

Still, just thinking about the all-American image of baseball at Fenway, I've been led to recognize the inadequacy of the bear-in-the-arcade metaphor. But I've concluded the problem is not the bear. It's the arcade. An arcade is just not wholesome and open and bright enough for a subject like good, clean -- even heroic -- tax reform.

So I've decided that though I can't risk putting the bear in a Red Sox cap, it's time to get the bear out of the arcade. I've decided to modify the image just a bit by recalling the recent Masters golf tournament and Jack Nicklaus' sensational finish -- and suggesting that tax reform is now like the Golden Bear.

Nicklaus, you'll recall, had not won a major tournament in six years, had missed the cut in both the U.S. and British Opens, and was greeted with newspaper headlines saying "Jack Should Quit" -- just as, I may say, they had said "Tax Reform Is Dead." But on the last day of the Masters, the Golden Bear charged from ninth place with a record back nine score of 30 to win the Masters for the sixth time. The Post's Thomas Boswell captured the scene:

> "As Jack Nicklaus walked up the 18th fairway . . . the sun was going down on Augusta National Golf Club, just as it is surely going down on Nicklaus' career. . . . Nicklaus slowly raised his left hand, then his right, his left and his right again, to acknowledge the waves of joyous ovation rolling from the crowd. In tens of thousands of minds, a camera shutter was clicking. This, among all the photos in the Nicklaus family album of our minds, would be the frontispiece.
>
> First, he was Ohio Fats, then the Golden Bear and now, finally, most unexpectedly, most sweetly of all, he is the Olden Bear, glorious once again, walking off the final green into legend with his son's arm around him."

It was a scene of pure American triumph; a picture of recovery, revitalization, renewal.

That's the way I suggest we should see tax reform. Just as a majority of distinguished pundits had written it off, tax reform came back for a dramatic recovery -- and what could be a glorious finish.

And what is more: this is not just revitalization for a process called tax reform. It promises to be a more fundamental revitalization for the American system.

Here we are in the second-term of a Presidency. Many supposed wisemen, seeming to have lost faith in our institutional arrangements, assume a second-term President must be a lame duck, and lament the seemingly endless stalemate between the Executive and Legislative branches. The public is beginning another of its periodic drifts toward cynicism about the culture of Washington.

The conventional wisdom has been growing a bit jaded. And all of a sudden there's now the surprising possibility of bold bipartisan action that would dramatically rebut the tiresome conventional wisdom.

Here we are, too, in what some might think of as the middle age of our economic development. Though there's still great strength in the economy, there have been troubling signs of lagging productivity and a slowness to adjust to new roles and new frontiers. And all of a sudden there's now the promise of a new stimulus to growth and creativity, a renewal of the basic American spirit of fairness and opportunity -- a revitalization of America's special claim to excellence and perennial youth. That fundamentally is what bold tax reform both offers and represents.

Now, as tax reform starts its charge up the back nine, waves of people are beginning to sense that they may witness, encourage, and even participate in an historic American victory -- in this the season of the Golden Bear.

Yes, there are traps ahead that must be avoided. And it's far too early to begin measuring the fabled green jacket. But the Golden Bear -- even after all it's been through -- is starting to look like a pretty good bet.

As for the Red Sox, it's best just to hope.

Thank you very much.

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 12:00 NOON

May 30, 1986

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for approximately $9,250 million of 364-day Treasury bills to be dated June 12, 1986, and to mature June 11, 1987 (CUSIP No. 912794 MP 6). This issue will provide about $725 million of new cash for the Treasury, as the maturing 52-week bill is outstanding in the amount of $8,533 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Thursday, June 5, 1986.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. This series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing June 12, 1986. In addition to the maturing 52-week bills, there are $14,464 million of maturing bills which were originally issued as 13-week and 26-week bills. The disposition of this latter amount will be announced next week. Federal Reserve Banks currently hold $1,820 million as agents for foreign and international monetary authorities, and $5,521 million for their own account. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rate of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold $85 million of the original 52-week issue. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-1.

B-604

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 12:00 NOON May 30, 1986

TREASURY OFFERS $5,000 MILLION OF 15-DAY
CASH MANAGEMENT BILLS

The Department of the Treasury, by this public notice, invites tenders for approximately $5,000 million of 15-day Treasury bills to be issued June 4, 1986, representing an additional amount of bills dated December 19, 1985, maturing June 19, 1986 (CUSIP No. 912794 KL 7).

Competitive tenders will be received at all Federal Reserve Banks and Branches prior to 1:00 p.m., Eastern Daylight Saving time, Tuesday, June 3, 1986. Each tender for the issue must be for a minimum amount of $1,000,000. Tenders over $1,000,000 must be in multiples of $1,000,000. Tenders must show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions must not be used.

Noncompetitive tenders from the public will not be accepted. Tenders will not be received at the Department of the Treasury, Washington.

The bills will be issued on a discount basis under competitive bidding, and at maturity their par amount will be payable without interest. The bills will be issued entirely in book-entry form in a minimum denomination of $10,000 and in any higher $5,000 multiple, on the records of the Federal Reserve Banks and Branches. Additional amounts of the bills may be issued to Federal Reserve Banks as agents for foreign and international monetary authorities at the average price of accepted competitive tenders.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m., Eastern time, on the day of the auction. Such positions would include bills acquired through "when issued" trading, futures, and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Those submitting tenders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923. Settlement for accepted tenders in accordance with the bids must be made or completed at the Federal Reserve Bank or Branch in cash or other immediately-available funds on Wednesday, June 4, 1986. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, and this notice, prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars may be obtained from any Federal Reserve Bank or Branch.

TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-204

For Immediate Release
May 29, 1986

Contact: Charles Powers
Phone: (202) 566-8773

TREASURY RELEASES REPORT ON JOBS TAX CREDITS

The Treasury Department today released THE USE OF TAX SUBSIDIES FOR EMPLOYMENT, a Report to Congress by the Departments of Labor and Treasury. The study examines the economic effects of the Targeted Jobs Tax Credit (TJTC) which was enacted to provide employers with incentives to hire certain persons--primarily youth from low-income families. The TJTC was enacted in 1978 and has been extended several times since its originally scheduled expiration date of December 31, 1981. The report primarily evaluates the initial experience with the credit in 1979-81. The study also evaluates the New Jobs Tax Credit (NJTC), which was available to certain employers for increasing their payrolls in 1977 and 1978.

Among the principal findings of the report are:

(1) While several studies indicate that the NJTC increased employment in certain firms and industries, these employment gains may have been offset by employment losses in other firms and industries without an increase in aggregate employment.

(2) Because most workers eligible for the TJTC found employment without the credit, the TJTC could have had only a minimal effect on total targeted employment.

(3) The NJTC had a total estimated cost of $9.7 billion in 1977-78 and the TJTC cost $730 million during fiscal years 1979-81.

B-606

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE June 2, 1986

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,212 million of 13-week bills and for $7,214 million of 26-week bills, both to be issued on June 5, 1986, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing September 4, 1986			26-week bills maturing December 4, 1986		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	6.29%	6.48%	98.410	6.41%	6.72%	96.759
High	6.33%	6.52%	98.400	6.42%	6.73%	96.754
Average	6.33%	6.52%	98.400	6.41%	6.72%	96.759

Tenders at the high discount rate for the 13-week bills were allotted 91%.
Tenders at the high discount rate for the 26-week bills were allotted 52%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 39,775	$ 39,775	$ 30,575	$ 30,575
New York	20,403,000	5,876,520	21,908,575	6,416,605
Philadelphia	23,070	23,070	18,775	18,775
Cleveland	47,290	44,215	24,505	24,505
Richmond	50,095	43,895	37,725	33,245
Atlanta	45,585	43,585	73,665	61,665
Chicago	1,271,310	309,810	1,384,340	166,840
St. Louis	77,340	52,840	70,350	46,350
Minneapolis	36,765	25,865	20,355	15,355
Kansas City	64,075	63,075	50,945	45,570
Dallas	33,675	33,675	10,815	10,815
San Francisco	1,044,510	317,470	1,320,545	58,345
Treasury	338,580	338,580	285,085	285,085
TOTALS	$23,475,070	$7,212,375	$25,236,255	$7,213,730
Type				
Competitive	$20,360,990	$4,098,295	$21,943,370	$3,920,845
Noncompetitive	1,126,980	1,126,980	777,185	777,185
Subtotal, Public	$21,487,970	$5,225,275	$22,720,555	$4,698,030
Federal Reserve	1,860,100	1,860,100	1,850,000	1,850,000
Foreign Official Institutions	127,000	127,000	665,700	665,700
TOTALS	$23,475,070	$7,212,375	$25,236,255	$7,213,730

1/ Equivalent coupon-issue yield.

B-607

TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-2041

Remarks by Secretary of Treasury
James A. Baker
To the 1986 International Monetary Conference
Boston, Massachusetts
Tuesday, June 3, 1986

I welcome this opportunity to address the International Monetary Conference and, in so doing, to reaffirm a tradition established by my predecessors. I've looked forward to sharing my perspective on some important global economic issues with such a distinguished group of leaders in the international financial community.

More and more, governments today realize that to a great extent their own domestic prosperity hinges on the condition of the international economy. That awareness has recently been focused on two issues -- the coordination of economic policies among the major industrial nations and the debt problems of the developing countries. Today, I would like to expand on our ideas for strengthening the framework of international cooperation in these two critical areas.

The impetus behind the program initiated at the Tokyo Summit to enhance economic policy coordination among the major industrial nations was the fact that such coordination is essential in an increasingly interdependent world.

The broad thrust of post World War II international economic policy has been to reduce barriers to the flow of goods and capital across borders. And although some barriers remain, and we are facing intense pressure to erect new ones, the current flow of trade and capital is probably greater than the architects of the postwar international economic system could reasonably have anticipated.

The great interdependence of nations that resulted from the expansion of an open system of trade and payments has, almost by definition, increased each country's vulnerability to developments in other nations.

Unfortunately, the evolution of our arrangements for cooperation among nations has not kept pace with the requirements of growing interdependence. Perhaps most importantly, political institutions have not fully adapted to that reality.

The international monetary system that emerged from Bretton Woods relied heavily on the discipline of fixed exchange rates to foster changes in domestic policies to adjust international imbalances. But, in practice, this discipline and the burden of adjusting payments positions fell primarily on deficit countries. The system also proved too rigid -- too successful in constraining the use of exchange rate changes for international adjustment. This rigidity, and the asymmetry in adjustment responsibilities, was instrumental in the system's breakdown.

The system of floating rates which succeeded Bretton Woods provided the international economy with much needed flexibility. This system, or non-system as some have characterized it, gave countries greater latitude to pursue domestic policies of their own choosing -- so long as they accepted the exchange rate consequences. However, this freedom was not always used wisely and the commitment to coordinate economic policies was inadequate. Despite the recent progress on inflation and growth under the current regime, domestic and external imbalances have grown and exchange rate volatility has increased, creating undesirable economic and political difficulties.

Thus, we turned at the Tokyo Summit toward a more effectively coordinated international economic system, with management responsibilities extending across a broad range of economic policies and performance. The system is designed to promote consistent domestic policies and compatible policies among countries, all the time focusing on achieving favorable fundamentals.

The Summit partners established a process for coordination and committed themselves to make that process work. The participating countries will review economic objectives and forecasts with their peers at regular intervals, taking into account a broad range of indicators such as those spelled out in the Tokyo Summit communique. The internal and external consistency of these projections will then be assessed with a view to necessary adjustments. If significant deviations from an intended course emerge, the participants have pledged to exert best efforts to adopt remedial action.

"Best efforts" and peer pressure may not seem like a prescription for fundamentally altering the economic course of nations. But with such efforts there is a better chance for a higher degree of external discipline than under normal practices. If nothing else, one could reasonably expect that the political process would lead countries to formulate and adapt economic policies with more awareness, at least, of external considerations.

The coordination of economic policies will not be easy. To specify, and then reconcile, national objectives and forecasts taking into account a broad range of indicators will raise a host of problems, some technical, some political. There will be deviations from intended courses, and there will be difficulties in determining which are significant and should have priority.

Nevertheless, we believe that the end result will be a greater likelihood that remedial actions will be taken when necessary. In addition to the high level commitment, other factors give us greater hope as we work out the details of the Tokyo arrangements.

Experience with the Plaza Accord last September is a good omen. The public agreement of the G-5 to implement important policy intentions and modify exchange rates was not easily or lightly reached. In addition, subsequent coordination of interest rate decisions was not easily achieved. But in the end, actions were taken in a coordinated fashion. These achievements encouraged us to seek approval of a better mechanism for policy coordination at the Tokyo Summit.

The process of economic policy coordination can also be made more manageable by a focus on exchange rates and current account positions to assess incompatibilities among nations. Countries may not always be able or willing to agree on the specific level for their currencies. But they can tell when currency values need to change and the appropriate direction of change. The Plaza Accord demonstrates that the major industrial countries could go this far. The Tokyo arrangements institutionalize the practice of discussing exchange rates on a regular basis. One result should be greater stability of exchange rate expectations.

Exchange rates have moved considerably since the Plaza Accord. This should play an important role in reducing external imbalances. At the same time, experience has shown that exchange rate change alone should not be relied upon to achieve the full magnitude of the adjustments required in external positions.

This is part of the reason we place such importance on strong, sustained and better balanced growth among the industrial countries. Not only is such a pattern of growth the foundation for dealing with the debt problems of the developing world, but without greater growth abroad, increased reliance will need to be placed on exchange rates in the adjustment of payments imbalances.

The achievement of improved, more balanced global growth will require a focus on the broad range of policies affecting a nation's economic performance. Therefore, the Tokyo arrangements specify that both domestic and external indicators will be used to assess the consistency and compatibility of national forecasts and objectives. This will help assure that attention is directed to underlying economic fundamentals.

The Tokyo arrangements do not involve any ceding of sovereignty, nor should they. But if the system is to work, participants will of their own volition -- to be sure, under the watchful eye of their peers -- have to take external considerations more heavily into account in formulating their domestic economic policies. For the United States this only reflects the reality that the time is long past when the U.S. could, in setting domestic policies, relegate external considerations to a second order of importance.

The major implications for U.S. policy at present are fairly clear. We must follow through on our program to reduce our budget deficit. The Congress has to complete action on tax reform. Monetary policy must continue to be directed toward sustained non-inflationary growth. And, we must avoid the folly of protectionism.

The system will only be viable, however, if other nations are prepared to accept similar responsibilities. If U.S. economic policies are to be adjusted to take into account international concerns, others too must be willing to adjust policies. Countries such as Germany and Japan with large trade surpluses must recognize the global need for stronger domestic demand to facilitate the adjustment of external imbalances.

The global community also has a strong stake in economic stability and growth in the debtor nations, and the successful management of their debt problems. Debt service difficulties affect all of us, in terms of reduced exports, lower growth, and a less stable international financial system. Cooperative efforts to deal with the debt problem therefore have a high priority on our policy agenda.

Recent progress in this area is heartening, and provides a solid basis for future improvements:

First, there is broad agreement among both creditors and debtors that improved growth in the debtor nations is essential to the resolution of their debt problems, and that growth-oriented reforms are needed to achieve this objective.

Second, centered on that growth theme, we have an agreed basis on which to proceed. The debt initiative which we outlined last fall in Seoul has received the strong support of the international community. It is now being actively implemented through individual debtor's discussions with the IMF and the World Bank.

Third, recent improvements in the international economy are providing significant and timely relief for the debtor nations. For example, stronger growth in the industrial nations this year will add approximately $2 billion to the major debtors' exports, while the sharp decline in interest rates since 1984 will save them $12 billion annually in debt service payments. Lower oil prices will also save the oil-importing members of this group some $2 billion annually.

I recognize that the debt situation for the net oil exporting debtors will be exacerbated by lower oil export earnings. This may require additional adjustment measures to meet the new external realities. But lower interest rates and stronger world growth will alleviate these added demands upon their economies.

Indeed, on an aggregate basis, these growth and interest rate changes if sustained, could be more important to a resolution of the debt problem than the amount of financing by the banks or the much-touted World Bank general capital increase.

Continued cooperative efforts among the key industrial nations will be important to sustain this positive global environment. But the adoption of growth-oriented policies by the debtor nations will remain crucial to provide the domestic stimulus to stronger growth. A number of them are already moving in this direction. We should not harbor any illusions that such policy changes will be easy to implement, or that they can be accomplished overnight. They will take time.

There has been some concern about how the three elements of the debt initiative will come together, and when in particular commercial bank financing should key in. Let me review briefly how we see this process working.

The World Bank, in close consultation with the IMF, is helping a number of the major debtor nations develop proposals for medium-term adjustment programs. They will focus in particular on efforts to increase growth and export capabilities, mobilize domestic savings, encourage increased investment, and liberalize trade. The privatization of public enterprises and domestic tax reforms may be important elements of this approach.

As these medium-term approaches are being developed, the IMF and World Bank are also working closely with the debtor nations on immediate policy steps to be supported by new IMF arrangements and World Bank sector or structural adjustment loans. The IMF continues to play a critical role. It has existing or pending arrangements with 11 of the 15 major debtor nations. In addition, the World Bank has structural or sector loan negotiations underway with 13 of these nations and has recently extended loans to Ecuador, Argentina, and Colombia to support adjustment efforts in some of their key sectors.

For the multilateral development banks to fulfill their role, however, they must have the necessary resources. While current concerns about the need for budget restraint make the task of securing Congressional support for the MDBs even more difficult than usual, I would underscore the importance of the MDBs as part of our international economic strategy and their cost effectiveness from a U.S. budgetary perspective.

I strongly believe that if we do not support the MDBs now, we may have to resort to more costly measures later. Building conditions for prosperity is our strongest bulwark for political stability in the developing world.

Commercial bank support for the debtors' reform efforts, however, is crucial. Once reforms have been agreed upon, commercial banks must be ready to lend without delay. For those debtors that have successfully implemented IMF programs and have adopted additional structural adjustment measures in concert with World Bank loans, the commercial banks should be responsive to requests for new lending.

Coordination among larger and smaller, U.S. and foreign banks, will be a vital part of this process. I would hope that the banks are using effectively the time they now have -- in advance of agreement on specific reforms -- to put mechanisms in place which will assure that financing packages can be assembled quickly when called upon.

I recognize that some regional and smaller banks are concerned about continued lending at a time when they may be swapping, selling off, or writing down existing loans to some debtor nations. The larger banks, on the other hand, need some assurance that net new lending arrangements will be concerted efforts and not fall disproportionately on a few banks. Resolving these diverse interests is an important task which cannot be placed indefinitely on the back burner.

Recent developments in the area of debt/equity swaps and the securitization of commercial bank loans are gaining increasing attention as an attractive means of both reducing outstanding debt obligations in the debtor countries and encouraging the return of flight capital.

We shouldn't overestimate the benefits or minimize the complexities involved in such transactions. The market for swaps is clearly limited, and swaps don't offer a panacea for resolving the debt problem. The banking community will also have to consider how shifts in exposure bases arising from these transactions will affect new lending -- which must, in any case, be assured.

I don't believe these pose insurmountable problems to the development of these and other innovative mechanisms which can improve both the investment and the debt climate in the debtor nations. Certainly they are worth exploring further.

The banking community as a whole has a major stake in the development of stronger debtor economies, in terms of the quality of their individual bank's outstanding loans, as well as the importance of debtor nations to trade flows, global economic growth, and international financial stability. We do not intend to twist the arms of U.S. banks or support special government or World Bank guarantees in order to secure new lending.

I am confident that the banks will lend if they perceive it to be in their interest to do so. Nevertheless, it is important for all of us to be able to plan ahead, and to count on the timely support of the commercial banks, as pledged, as one of the key elements of the debt initiative, and vital to its success.

In this context, I call on you, as the acknowledged leaders of the international banking community, to take a direct interest in the implementation of the debt initiative, and to set the positive, cooperative tone that will be necessary if it is to succeed.

We have made progress in resolving our major economic problems. That progress provides a golden opportunity to adopt cooperative arrangements to resolve remaining problems and enhance global prosperity.

Inflation is down sharply and is expected to remain low. Growth in the industrial countries is improving although important imbalances remain. Exchange rates among the key currencies are in much better alignment today than a year ago. Interest rates are down and the improved economic environment provides scope for further declines.

It is now up to all of us to use this opportunity wisely.

For the major industrialized countries, we must implement our plans for enhanced coordination of economic policies and bring about greater exchange rate stability, reductions in external imbalances, and stronger, more balanced, and sustained growth.

For the developing countries, the order of the day is to push ahead with the needed macroeconomic and structural adjustments.

For the private financial institutions, now is the time to position yourselves to respond promptly and effectively to the improving prospects in those developing countries implementing needed economic reforms.

All would be for naught, however, should we lapse into protectionist solutions. Indeed, the essential choice we have is to extend our cooperative efforts to a level that allows us to maintain and expand our interdependence, or to reduce that interdependence.

The experience of the interwar period convinced one generation that the only acceptable answer lay in greater cooperation. I am confident that the present generation need not relive history to absorb its lessons. To extend the framework of international economic cooperation will not be easy, but it is the only responsible course.

Thank you very much.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE June 3, 1986

RESULTS OF TREASURY'S AUCTION
OF 15-DAY CASH MANAGEMENT BILLS

Tenders for $ 5,000 million of 15-day Treasury bills to be issued on June 4, 1986, and to mature June 19, 1986, were accepted at the Federal Reserve Banks today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low	6.69%	6.81%	99.721
High	6.73%	6.83%	99.720
Average	6.71%	6.83%	99.720

Tenders at the high discount rate were allotted 28%.

TOTAL TENDERS RECEIVED AND ACCEPTED
BY FEDERAL RESERVE DISTRICTS:
(In Thousands)

Location	Received	Accepted
Boston	$ --	$ --
New York	23,218,000	4,869,200
Philadelphia	--	--
Cleveland	--	--
Richmond	--	--
Atlanta	--	--
Chicago	1,975,000	2,800
St. Louis	--	--
Minneapolis	1,000	--
Kansas City	--	--
Dallas	--	--
San Francisco	1,170,000	128,000
TOTALS	$26,364,000	$5,000,000

B-609

ɘpartment of the Treasury • Washington, D.C. • Telephone 566-2041

TREASURY NEWS

FOR RELEASE AT 4:00 P.M. June 3, 1986

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $14,400 million, to be issued June 12, 1986. This offering will result in a paydown for the Treasury of about $75 million, as the maturing bills are outstanding in the amount of $14,464 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, June 9, 1986. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,200 million, representing an additional amount of bills dated March 13, 1986, and to mature September 11, 1986 (CUSIP No. 912794 LC 6), currently outstanding in the amount of $6,868 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,200 million, to be dated June 12, 1986, and to mature December 11, 1986 (CUSIP No. 912794 LN 2).

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing June 12, 1986. In addition to the maturing 13-week and 26-week bills, there are $8,533 million of maturing 52-week bills. The disposition of this latter amount was announced last week. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold $1,828 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $1,913 million as agents for foreign and international monetary authorities, and $5,593 million for their own account. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

REMARKS OF THE HONORABLE
DAVID C. MULFORD
ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS

BEFORE THE ATLANTIC INSTITUTE
JUNE 5, 1986

It is a pleasure to be here today.

You have asked me to speak on a very timely topic, especially in view of the Atlantic Institutes' 25 year record of support for cooperative approaches to international challenges. Today I want in particular to speak about the last of those 25 years, because I believe that in the past twelve months there has been remarkable progress achieved in international economic policy coordination.

This progress is the result of efforts initiated by Secretary of Treasury, James Baker, almost exactly one year ago to prepare the G-5 exercise which has since become known as the Plaza Agreement. I use the word "initiative" advisedly because the September meeting at the Plaza Hotel in New York marked the beginning of a "process" in which other important steps have followed.

In the Plaza Agreement, the major countries of the industrial world explicitly recognized the interrelationships among exchange rates, external imbalances, and domestic economic policies and performance. The immediate impact of the Agreement on exchange rates was dramatic. The Japanese yen and German mark have now appreciated 50 percent from their lows against the dollar of February 1985. By the same token, the dollar has more than fully offset its appreciation against the yen in the early 1980s; and it has reversed two-thirds of its appreciation against the mark.

Less noticed, but perhaps of more lasting importance, was the Agreement itself which set out medium-term policy intentions that governments would follow to achieve more flexible economies and stronger non-inflationary growth.

B-611

The Plaza meeting was not a spontaneous occurrence. It was the end result of a great deal of planning and a series of informal, private discussions -- initially bilateral, subsequently multilateral -- during which the shape and specific content of the text of the Agreement were developed. This effort, led by the United States, reflected our growing concern and that of other major countries that an unsustainable international situation was developing, which needed to be addressed in a substantial and visible way. It was made effective by several important features:

-- First, the high degree of cooperation in expressing important long-term policy intentions;

-- Second, the preservation of secrecy so as to maximize the impact on markets;

-- Third, the fact that the Agreement underscored actual policy developments and changes in economic fundamentals, as well as the improving convergence of economic performances which at that time were not fully reflected in world currency markets;

-- Fourth, the acknowledgement that exchange rates are related to other aspects of the international economy, notably to large and persistent external imbalances, LDC debt problems, and to underlying causes of instability in the international economic system; and

-- Finally, the expressed willingness to engage in extensive coordination, consultation, and action for mutual benefit.

Thus on one level, the Plaza Agreement contributed to exchange rate relationships among the major currencies that better reflect underlying economic conditions.

But, on another level, it saw the beginning of a process to improve economic policy coordination. In the intervening months -- if you excuse the pun -- this process has been built upon by successful rounds of interest rate cuts, the deliberations of the spring Interim Committee, and the OECD Ministerial in April which focused on the need for sustained, balanced growth, the reduction of external imbalances, and the LDC debt situation. In the OECD Communique, Ministers emphasized that:

-- Macroeconomic policies to support growth and employment should also be directed toward reducing external imbalances, and be implemented in ways that promote greater exchange rate stability at rates reflecting economic fundamentals. In particular, surplus countries need to increase domestic demand to achieve full potential growth and employment, and reduce external surpluses.

-- Structural policies are also important to strengthening growth prospects, by enlarging opportunities for productive incentives. The OECD Communique explicitly included within its scope capital markets, as well as labor and product markets.

Last month, another major step forward was taken at the Tokyo Summit, where Heads of State agreed to put in place a stronger program to improve economic policy coordination. As Secretary Baker put it speaking a few days ago in Boston: "We turned at the Tokyo Summit toward a more effectively coordinated international economic system, with management responsibilities extending across a broad range of economic policies and performance. The system is designed to promote consistent domestic policies and compatible policies among countries, all the time focusing on achieving favorable fundamentals."

We have yet to implement these new elements in the process, but there is a clear commitment by the participating countries to review economic objectives and forecasts with their peers at regular intervals, and in doing so to take into account a broad range of indicators of the type spelled out in the Summit Communique. The compatibility of their projections will be assessed with a view to making necessary adjustments, and if significant deviations from an intended course emerge, the countries have made a commitment -- declared as a general principle, at a Summit meeting -- to exert their best efforts to adopt remedial action.

I believe that if we can complete the delicate task of implementing these undertakings, the process of international economic policy coordination will be greatly strengthened. A significant improvement will have been made in the international monetary system. Significantly, this will not be because nations have agreed to infringe their sovereignty, but because a better recognition of the international implications of domestic policy decisions will develop, backed by peer pressure and a "best efforts" commitment to adjust policies.

Meanwhile, we will be working to implement our arrangements in a better world economic environment than we have seen for many years.

-- Inflation has been cut sharply and is expected to stay low, in part -- but only in part -- reflecting the effects of the sharp reduction in oil prices. This has facilitated the substantial reduction in interest rates we have experienced over the past year.

-- Growth in the industrial countries will rise this year to an average level in the 3-1/2 percent range.

-- This industrial country growth will be approximately one percent higher than projected at the end of 1985, and inflation will be about two percent lower. We estimate that in 1986 this will add nearly $5 billion to developing nations' non-oil exports and reduce their non-oil import costs by approximately $4 billion.

-- Stronger industrial country growth means stronger demand for LDC exports, and lower inflation means less costly imports for LDCs.

-- The sharp decline in interest rates -- 3 percentage points since early 1985 -- will reduce annual debt service payments for all LDCs by about $12 billion, freeing up scarce foreign exchange resources for productive use elsewhere in the debtors' economies. For the 15 major LDC debtors alone, the savings will be nearly $8 billion.

-- The negative factor in the economic scene for developed and developing countries is the continued rise in protectionism and large external imbalances.

This makes it urgent that we not lose our momentum and that we move forward promptly in the next few months to implement the agreed improvement.

No doubt, in the discussion period following my remarks, you will certainly ask two central questions: How will the system actually work? What are the chances for successful implementation?

Most of you are well aware of the complications of building consensus among sovereign nations. Therefore, you will understand me when I say it is impossible to be specific at this time about procedures. To do so would be doctrinaire, and unhelpful for our efforts to build a consensus. In any case, we are talking about a process, and by definition a process is dynamic.

However, there are certain important elements we believe need to be included in the program:

-- Credible economic forecasts for individual countries must be developed.

-- These forecasts, taken together, must be reviewed for consistency in each country's case and external compatibility for all the countries together. A range of economic indicators should be used for this process. These indicators would include such variables as growth rates, inflation rates, unemployment rates, fiscal deficits, current account and trade balances, interest rates, monetary growth rates, reserves, and exchange rates. Exchange rates and current account and trade balances would be particularly useful in assessing the mutual compatibility of country forecasts.

-- The IMF, through Managing Director de Larosiere, will play an important role in this process.

-- Where there are significant deviations from an intended course, best efforts will be made to reach an understanding on appropriate remedial measures, focusing first and foremost on underlying policy fundamentals.

-- Intervention in exchange markets could also occur when to do so would be helpful.

This seems simple enough and there is already broad agreement on most of these principle elements. The focus on exchange rates and current account positions does, of course, pose extremely delicate problems. However, here we are less concerned with precise figures than with establishing recognition among countries of the need for change. Countries may not be able to agree on specific currency levels, but they can tell when currencies need to change and the appropriate direction of change. The Plaza Agreement has demonstrated this important point, and I feel confident that we can put this valuable experience to use in the improved arrangements called for in Tokyo.

Finally, can we succeed? Yes. And, bear in mind that we have already made important progress during the past year. Moreover, Heads of State have agreed on the need to improve the system. There is no reason to believe that the degree of commitment and cooperation that made reaching agreement at the Summit possible will not be just as apparent in the implementation. There is a shared interest among all participants to improve international economic policy coordination. All of us want the better growth and exchange rate stability needed to remove the world's present threatening imbalances. There is also the pressing need to resolve the international debt situation, a goal shared by all nations. Ultimately, there is the shared perception of the cost of failure -- namely rising protectionism and global recession and stagnation.

Thus, the discussions which lie ahead will be about methods, timing, and other resolvable problems. It will take time to continue to build trust and understanding as we test the way forward. And, as in the case in all difficult enterprises, patience and imagination -- and then more patience -- will be the essence of the business. But in the end -- I would cite to you the Chinese proverb, "Patience, and the mulberry leaf become a silk gown."

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE June 5, 1986

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $9,251 million of 52-week bills to be issued June 12, 1986, and to mature June 11, 1987, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	6.55%	6.99%	93.377
High -	6.62%	7.07%	93.306
Average -	6.59%	7.03%	93.337

Tenders at the high discount rate were allotted 2%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 11,170	$ 11,170
New York	19,668,005	8,388,505
Philadelphia	6,160	6,160
Cleveland	13,305	13,305
Richmond	20,625	20,625
Atlanta	12,665	12,665
Chicago	1,312,660	282,160
St. Louis	52,130	32,130
Minneapolis	12,780	12,780
Kansas City	31,300	31,300
Dallas	9,650	9,650
San Francisco	1,179,655	324,655
Treasury	106,145	106,145
TOTALS	$22,436,250	$9,251,250
Type		
Competitive	$19,769,565	$6,584,565
Noncompetitive	381,685	381,685
Subtotal, Public	$20,151,250	$6,966,250
Federal Reserve	2,200,000	2,200,000
Foreign Official Institutions	85,000	85,000
TOTALS	$22,436,250	$9,251,250

An additional $152,400 thousand of the bills will be issued to foreign official institutions for new cash.

B-612

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

June 6, 1986

Michael F. Hill
Appointed Deputy Assistant Secretary

The Treasury Department today announced the appointment of Michael F. Hill as Deputy Assistant Secretary for Departmental Management, responsible for Department-wide management programs and administrative policy. Mr. Hill has been with the Department of the Treasury since 1981 as Director of the Office of Revenue Sharing.

Before joining the Administration, Mr. Hill was an account executive with the E. Bruce Harrison Company. He also served as the project director for the firm's Clean Air Act program. From 1977-1979, Mr. Hill was Director of Government Affairs for the National Solid Wastes Management Association.

Mr. Hill had previous experience with the Revenue Sharing program between 1976 and 1977 as Special Assistant to the Director. Mr. Hill acquired local government experience in Knoxville, Tennessee while serving as the Director of Planning and Management and Assistant to the Mayor between 1973 and 1976. During this period, he was actively involved with local governmental commissions and councils. For the previous two years, Mr. Hill was Director of Medical Services for Knox County, Tennessee.

From 1965 to 1971, Mr Hill taught English at the University of Tennessee in Knoxville, while he pursued work on his Ph.D. in English. He received his M.A. degree in English from McNeese State University in Lake Charles, Louisiana in 1966 and his B.A. degree from the University of Hawaii in 1963.

Mr. Hill was born in 1940 in Abbeville, Louisiana.

B-613

TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery
Expected at 10:00 a.m., EDT
June 9, 1986

STATEMENT OF
J. ROGER MENTZ
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to discuss the Treasury Department's views regarding the Federal income tax treatment of "pass-through" entities. Pass-through entities include a wide range of entities, all or part of whose income is taxed to the entity's owners rather than to the entity.

This hearing comes at a time when the Congress is acting on a fundamental tax reform bill that can be expected to produce major changes in the operation and utilization of pass-through entities. In particular, it appears that the final bill will in some manner limit the ability of taxpayers to use "passive" losses (from pass-through entities or otherwise) to offset unrelated income. H.R. 3838, as passed by the House of Representatives, would disallow deductions for certain "excess passive activity" losses for purposes of the individual alternative minimum tax. The version of H.R. 3838 approved by the Senate Finance Committee would go further, by limiting such deductions for purposes of the regular income tax for individuals and certain corporations. The Finance Committee bill would, in general, prevent losses and credits from limited partnerships and other business activities in which the taxpayer does not materially participate from being used to offset personal service, active business, and portfolio investment income.

Although tax reform promises great changes in the tax law, the significance of the issues being discussed today will not be diminished. Indeed, a number of these issues take on added importance because of the provisions affecting pass-through entities that may be included in the tax reform bill.

The proper income tax treatment of pass-through entities is part of a broader question concerning the income taxation of business enterprises generally. A completely satisfactory resolution of this issue may not be possible, as it involves competing considerations of economic theory, administrative practicality, fiscal responsibility, and public perceptions of fairness. In my testimony today, however, I will attempt to identify the more important of these considerations, and suggest how they bear on the issue of pass-through entity taxation.

My testimony is divided into three parts. The first will provide an overview of the treatment of pass-through entities and will discuss the current tax rules applicable to certain of these entities. The second part will propose a limited change in the rules determining the classification of entities for Federal income tax purposes. The third part will discuss other issues that deserve additional study.

I. Background/Current Law

A. Introduction

Individuals engage in business enterprises through many different forms of business entities, which are governed by different sets of legal rules, both tax and non-tax. Most of the differences in legal rules involve differences in the extent to which, for any given purpose, the particular entity is, on the one hand, treated as a mere aggregation of the owners of the entity or, on the other hand, treated as a separate and distinct person.

As I will describe more fully below, the current Federal income tax treatment of different business entities ranges along a continuum. At one end of the continuum are entities, such as sole proprietorships and grantor trusts, whose separate existence is for most purposes ignored. At the other end are entities, such as Subchapter C corporations, that generally are treated as separate persons whose tax liabilities are in addition to and independent of those of their shareholders. Between these two extremes are entities such as partnerships, trusts, S corporations, regulated investment companies, real estate investment trusts, and cooperatives, the taxation of which reflect both aggregate and separate entity principles.

Along the continuum, significant differences in tax treatment include (a) whether the income earned by the entity is taxed to the entity in full, only to the extent not distributed to the owners, or not at all, (b) whether the entity's owners are taxed on distributed or undistributed income of the entity, (c) whether losses incurred by the entity can be deducted currently by its owners, or only upon a disposition of their interests in the entity, (d) whether the timing or character of any income of the entity that is passed through to the owners is altered when passed through, and (e) whether the owners of the entity are treated as engaging directly in the activities of the entity.

In our view, two fundamental questions must be addressed in deciding where along the continuum different entities should be classified for tax purposes. The first question is under what circumstances should a business entity be treated as a taxpayer separate from the owners of the entity. The stakes of this issue may be stated simply. Under current law, if an entity is classified as a corporation, and thus taxable separately from its owners, income earned by the entity and distributed to its owners is taxed at a combined maximum marginal rate of 73 percent. By contrast, if the entity is not classified as a separate taxpayer (e.g., a partnership), the income is taxed at a maximum marginal rate of 50 percent. The second question is, in the case of an entity that is not taxed in full at both the entity and individual levels, what method should be used to pass through the income of the entity to its owners.

Before I turn to these fundamental questions, it will be useful to examine the manner in which current law classifies entities along the continuum and the current law treatment under current law of many of the more significant tax regimes.

B. Classification Factors

The classification of an entity for Federal income tax purposes is based on the characterization of the entity for state law purposes, the presence in the entity of certain "corporate" characteristics, or the satisfaction by the entity of qualification requirements for special tax rules. If an entity is incorporated under the laws of a state, and operates lawfully under local law, the entity is classified as a corporation for Federal income tax purposes. Corporations with certain characteristics, however, such as S corporations, regulated investment companies, and real estate investment trusts, may qualify for relief from double taxation under special rules.

If an entity is unincorporated, or incorporated under the laws of a foreign jurisdiction, its classification as a corporation, partnership, trust, or other noncorporate entity depends on the existence of certain characteristics specified in regulations under section 7701 of the Code. Under these regulations, if an entity has the two characteristics of (1) associates and (2) an objective to carry on business and divide the gains therefrom, the entity is classified as either a partnership or an association taxable as a corporation, rather than as a trust or other noncorporate entity. Classification as a partnership or an association depends, in turn, on whether the entity possesses the following "corporate" characteristics: (1) continuity of life; (2) centralization of management; (3) limited liability; and (4) free transferability of interests. If the entity has no more than two of these characteristics, it is classified as a partnership; otherwise, it is classified as an association.

Although the classification of different business entities for tax purposes may produce profoundly different tax consequences, the classification is based on factors that may reflect only subtle differences in the actual operation of the entities or the interests of the owners therein. For example, in many situations the existence of the corporate characteristic of limited liability under state law may have little significance. Although not responsible under state law for corporate liabilities, the shareholders of closely held corporations frequently are required by creditors to guarantee corporate debt. Conversely, the unlimited liability of owners of a partnership may be rendered illusory by the use of limited partnerships, liability insurance, thinly capitalized general partners, and nonrecourse debt.

The application of the classification factors of current law to various business entities, and the consequences of such classification, are described below.

C. <u>Direct Taxation of Individuals</u>

If an entity lacks associates and an objective to carry on business and divide the gains therefrom, and is not organized as a trust or corporation, activities carried on by the entity are taxed as if they were carried on by the individual or individuals owning the entity. The simplest example of this is a sole proprietorship. In this case, for local law purposes the entity may consist of nothing more than the filing with the appropriate government office of a company name under which the proprietor is conducting the business. Direct taxation may also apply where more than one individual has an interest in income-producing assets. For example, two or more individuals may hold property as tenants in common. In such case, each individual owner includes in his taxable income a proportionate share of each item of income, gain, loss, deduction, and credit generated by the property.

Direct taxation of the individual owners also applies in the case of certain trusts that lack associates and an objective to carry on business and divide the gains therefrom and are treated as "grantor trusts." Whether a trust is treated as a grantor trust ordinarily depends on whether the grantor has retained an interest in the trust's assets or income or is able to exercise certain administrative powers. In general, a grantor trust is not treated as a separate entity for Federal income tax purposes. Instead, under the grantor trust rules, the grantor of the trust or, in certain cases, a person other than the grantor, is generally treated as the owner of the trust assets.

Finally, certain entities that would otherwise be classified as partnerships may be taxed as if their activities were carried on directly by the owners of the entity, if all of the owners so elect. This election is available in the case of entities that are availed of (1) for investment purposes only, (2) for the joint production, extraction, or use of property, or (3) by securities dealers for the purposes of underwriting, selling, or distributing a particular issue of securities, provided the income of the owners may be adequately determined at the individual level.

In general, only the simplest co-ownership arrangements can be handled in a satisfactory way through direct taxation. For example, differing forms or classes of ownership interests may make it difficult to determine the appropriate share of each owner in each item of income, gain, loss, deduction, and credit of the entity.1/ In addition, it is cumbersome to audit and assess tax deficiencies at the individual owner level. The issuance or redemption of interests in the entity in exchange for cash may be a taxable event to all of the owners. Significant complexity also may result from the need to make various elections and determinations (*e.g.*, holding period, method of accounting, and dealer status) at the individual-owner level.

1/ This difficulty was one of the reasons for the recent issuance of regulations that, in general, classify investment trusts with multiple classes of ownership as associations taxable as corporations or as partnerships. *See* Treas. Reg. sec. 301.7701-4(c).

D. Partnerships

Most unincorporated joint business enterprises are carried on as partnerships under state law, and are classified as partnerships for Federal income tax purposes. The partnership tax rules, which are found in Subchapter K of the Code, reflect a mix of aggregate and entity concepts. In general, items of partnership income, gain, loss, deduction, and credit are calculated at the partnership level, but passed through to the partners, so that no tax is imposed on the partnership as an entity. These items retain their character in the hands of the partners.2/ As in the case of direct taxation, partnership income is taxed to the partners regardless of whether the partnership distributes the income to the partners. Contributions and distributions to and from the partnership are generally nontaxable events, except to the extent cash distributions exceed the partner's tax basis in his partnership interest.

The rules of Subchapter K differ from direct proportional taxation of the partners in several important respects. First, Subchapter K was designed to provide flexibility, and thus permits so-called special allocations of partnership items, guaranteed payments to certain partners, and other arrangements that deviate from a simple pro rata sharing of all income and expenses of the business. Moreover, a partnership is explicitly treated as an entity for certain tax purposes. For example, a partnership calculates its income at the entity level using its own method of accounting and its own taxable year. Partners include in income the income and other items of the partnership for any taxable year of the partnership ending within or with the

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2/ Because all partnership income items are treated as if incurred directly by the partners, the activities of a partnership are, in effect, imputed to the partners. For example, if the partnership engages in an active trade or business, the distributive share of the income of a tax-exempt partner generally is treated as unrelated business taxable income. Similarly, if the partnership conducts a trade or business in the United States, the distributive share of income of a nonresident alien partner is treated as income effectively connected with a trade or business conducted in the United States.

taxable year of the partner. The use by a partnership of a taxable year different from that of its partners may produce a deferral of tax.3/ Also, the partnership is generally treated as an entity for purposes of determining the tax consequences of a purchase or sale of a partnership interest.

E. Trusts

As with the rules of partnership taxation, the rules of Subchapter J, which govern the income taxation of trusts and estates, are designed to produce one level of Federal income tax. Unlike the partnership rules, however, Subchapter J -- with the exception of the grantor trust rules described above -- does not employ a pure conduit system of taxation. Rather, trust income ordinarily is taxed directly to the beneficiaries only to the extent that it is distributed or required to be distributed currently. Trust income that is not distributed currently is taxable to the trust under the rate schedule applicable to married individuals filing separate returns (albeit with no zero bracket amount). Upon subsequent distribution of such accumulated trust income, double taxation is generally avoided by allowing the beneficiaries a credit for the taxes previously paid by the trust. In general, trust losses are not passed through to beneficiaries.

The modified conduit system applicable to trusts creates several troubling opportunities for tax avoidance. First, the treatment of trusts as separate taxpayers with a separate graduated rate schedule can cause income to be taxed at a rate lower than if the grantor had retained direct ownership of the trust assets or given the assets outright to the beneficiaries. The problems created by allowing trusts a separate rate schedule on their undistributed income have given rise to the "throwback rules," under which income accumulated by a trust in one year and distributed in a later year may become subject to additional tax. In addition, the ability to use multiple trusts to take advantage of separate graduated rate schedules is limited by the "multiple trust rule," which requires that certain trusts be treated as a single trust. Although intended to limit tax avoidance, these rules are imperfect, complex, and difficult to administer.

3/ Rules under current law that limit the ability of a partnership to use a taxable year different from that of its partners would be tightened in the Senate Finance Committee's version of H.R. 3838.

Second, the Subchapter J rules provide opportunities to allocate income among beneficiaries and the trust in a way that minimizes the aggregate tax burden. If income is not required to be distributed currently to a specified beneficiary, then the allocation of income between trust and beneficiary, or among various trust beneficiaries, is determined by the distributions made by the fiduciary.4/

In addition, because distributions of trust income are includible in the beneficiary's income in his or her taxable year in which or with which the trust's taxable year ends, the use by the trust of a taxable year that differs from that of the trust beneficiaries will result in a deferral of tax. Subchapter J currently contains no requirement that the taxable year of a trust correspond to the taxable year of any of its beneficiaries.5/

F. Corporations and Associations Taxable as Corporations

Corporations and associations taxable as corporations are taxed under Subchapter C of the Code unless another special provision applies. In general, Subchapter C imposes two levels of tax on the profits of a corporation. The corporation is taxed as a separate entity when the profits are earned, and the shareholders are taxed at their individual rates when the profits are distributed in the form of dividends.

4/ H.R. 3838, as passed by the House, would comprehensively reform Subchapter J in order to eliminate these opportunities for tax avoidance and to simplify the applicable rules. The Senate Finance Committee version of H.R. 3838 would not make major changes to Subchapter J, but would substantially reduce the benefit of the separate graduated rate schedule by taxing income above $5,000 at the maximum individual rate.

5/ Both the House-passed version of H.R. 3838 and the Senate Finance Committee version of H.R. 3838 include changes designed to minimize the tax benefits derived from fiscal year trusts.

Corporations taxed under Subchapter C typically operate in a manner that postpones or avoids double taxation of their income. Thus, double taxation encourages corporations to retain rather than distribute income, so as to defer the second level of tax and give shareholders the opportunity to realize such income through a sale of stock, gain on which is generally taxed at favorable rates. In addition, double taxation encourages corporations to raise new capital through the issuance of debt, interest payments on which are deductible, rather than through the issuance of stock, dividend payments on which are not deductible. Similarly, closely held corporations are encouraged to distribute income to their owners in the form of deductible salary or rental payments. Although current law attempts to restrict avoidance or postponement of the double tax on corporate income (for example, through the collapsible corporation provisions, the personal holding company tax, the accumulated earnings tax, rules characterizing debt as equity, and rules limiting the deduction of unreasonable compensation), the double tax is, in practice, to some extent mitigated.

Special provisions in the Code permit corporations or associations that otherwise would be taxed under Subchapter C to avoid, or pay a reduced amount of, corporate-level tax if they meet certain qualification requirements. These special provisions are discussed below.

G. S Corporations

In the case of an electing small business corporation, Subchapter S of the Code generally eliminates entity level taxation and instead taxes the shareholders of the corporation directly in a manner similar (though not identical) to the taxation of the partners of a partnership. Under Subchapter S, the S corporation's income or losses are passed through to shareholders in proportion to their stock ownership. Generally, in order to be an S corporation, the corporation may have only one class of stock, may not have more than 35 shareholders, and may have as shareholders only individuals who are subject to tax in the United States. Thus, the direct pass-through rules of Subchapter S are limited to entities that allocate income and expenses on a pro rata basis and have a small number of shareholders. There is, however, no limit on the size (other than the number of shareholders) of an S corporation.

H. Special Dividend Relief Provisions

Regulated Investment Companies. Relief from double taxation of the income of regulated investment companies ("RICs"), commonly known as mutual funds, is provided in order to give investors access to an expertly managed, diversified portfolio of investments without the imposition of a second (or, in the case of investments in corporate stock, third) level of tax. RICs are allowed a dividends paid deduction, and thereby avoid corporate-level tax on income distributed to shareholders. RIC losses, however, may not be passed through to shareholders.

To qualify as a RIC, an entity must derive at least 90 percent of its gross income from dividends, interest, payments with respect to securities loans, and gains from the sale or disposition of stocks or securities. In addition, limitations are placed on a RIC's ability to engage in short-term trading activities or to concentrate its investments in the securities of a relatively small number of issuers. Moreover, a RIC must distribute to its shareholders at least 90 percent of its net income (both taxable and tax-exempt) in each taxable year. We will discuss the treatment of RICs in greater detail in our testimony tomorrow.

Real estate investment trusts. As under the RIC provisions, relief from double taxation of the income of real estate investment trusts ("REITs") is provided in order to give investors access to an expertly managed portfolio of real estate investments without the imposition of a second level of tax. The method of relief (allowance of a dividends paid deduction) and the qualification requirements are similar to those that apply to RICs. Our testimony tomorrow also will contain a detailed discussion of the treatment of REITS.

I. Cooperatives

Subchapter T of the Code contains rules providing limited relief from the corporate-level tax to farmers' cooperatives and, with certain exceptions, to other corporations operating on a cooperative basis.6/ The issue of what constitutes operating on a cooperative basis has been the subject of controversy for many years.

6/ Cooperative housing corporations are taxed under different provisions and are not discussed in this testimony.

In its purest form, a cooperative is a corporation owned and patronized by the same persons, and the function of the cooperative is to serve each patron at cost. Any profit derived by the cooperative from dealing with a patron is returned to the patron in the form of a patronage dividend. Amounts returned to patrons as patronage dividends are not included in the cooperative's taxable income. To the extent the patronage dividend is attributable to a business transaction of the patron, it increases the patron's income. Profits derived by a cooperative from transactions with nonmembers generally are subject to entity-level tax under the rules applicable to corporations. Subchapter T contains a set of complicated rules designed to translate the simple goal of relieving double taxation of patronage earnings into a framework that corresponds to the real and more complex world of cooperative businesses.

The special tax treatment of cooperatives gives rise to a number of basic concerns. The principal concern relates to the deferral of tax. A cooperative is permitted to deduct currently the amount of a patronage dividend as long as the distribution to the patron is made within eight and one-half months after the end of the year. A second concern arises where a cooperative deriving earnings from business transactions with patrons returns those earnings to the patrons in the form of bargain sales of personal items. In such cases, it may be difficult to enforce imposition of the appropriate level of tax on either the cooperative or the patrons. There is no legislative proposal currently pending that would address either of these concerns.

II. Taxation of Entity and Owners

A. In General

As discussed above, the first question that must be addressed in considering the proper taxation of business enterprises is under what circumstances should an enterprise be treated as a taxable entity separate from its owners. Most economists agree that income from business activities carried on through separate legal entities should not be taxed more onerously than income from activities not conducted in entity form.7/ This view is grounded in the proposition that a market economy operates most efficiently if all business activities are subject to the same rate of tax.

Under current law, significant differences in effective tax rates result from subjecting certain business activities to an extra level of tax. With maximum corporate and individual income tax rates of 46 percent and 50 percent, respectively, the current maximum effective tax rate on corporate earnings distributed to shareholders is, as noted above, 73 percent, nearly one and one-half times the maximum effective tax rate on income taxed only to individuals. Inefficiencies resulting from the higher effective tax rate on corporate income include the shift of production away from goods produced more readily in the corporate sector, the favoring of debt capital over equity capital, and the favoring of retention rather than distribution of corporate earnings.

Many who criticize the uneven effects of the current tax system argue that the corporate and individual income taxes should be integrated. In general, two significantly different methods for achieving integration are available. The first, commonly referred to as dividend relief, is to impose a lower effective tax rate on corporate income that is distributed to shareholders. This is done either by allowing shareholders a credit against their own tax for the tax paid by the corporation on income distributed to the shareholder or by allowing the corporation a deduction for dividends paid to shareholders (or taxing at a lower rate income that is distributed to shareholders). Dividend relief does not permit losses of the corporation to be passed through to shareholders. The second method, known as pure or partnership-model integration, is to attribute all corporate income (whether or not distributed) and all corporate losses to the shareholders.

7/ Charles E. McLure, Jr., Must Corporate Income Be Taxed Twice?, Brookings Institution, 1979. George F. Break and Joseph A. Pechman, Federal Tax Reform: The Impossible Dream?, Brookings Institution, 1975, pp. 90-104. Proponents of a consumption tax argue that even a single level of tax on income from business activities is inappropriate if the income is reinvested rather than consumed by the individual owners. See, e.g., David F. Bradford, "The Case for a Personal Consumption Tax, in Joseph A. Pechman, ed., What Should be Taxed: Income or Expenditure?, Brookings Institution, 1980, pp. 75-111.

The tax systems of most of our major trading partners provide some degree of integration of the corporate and individual income tax systems. In all cases, this integration is achieved through dividend relief rather than partnership-model integration. For example, Japan relieves 38 percent, and West Germany 100 percent, of the double tax on income distributed by corporations by applying a reduced corporate tax rate to distributed income and allowing shareholders a tax credit for part or all of the tax paid by the corporation on the distributed income. Canada relieves 40 percent, France 50 percent, and the United Kingdom 80 percent, of the double tax on distributed income by allowing shareholders a tax credit for a portion of the tax paid by the corporation on income distributed to shareholders.

B. Current Prospects for Integration

As a matter of ideal tax policy, income from different business activities should be taxed at equivalent rates, irrespective of the form of business entity. We recognize that a failure to integrate the corporate and individual income tax systems will perpetuate differences in effective tax rates. Such differences will exist not only among different types of entities engaging in the same activity, but among different sectors of the economy, with the production of those goods and services that are more readily produced by corporations discouraged relative to the production of other goods and services.

Nonetheless, it does not appear that a significant level of integration will be achieved in the foreseeable future. In our November 1984 report to the President on tax reform, the Treasury Department proposed that partial integration be achieved by allowing corporations a 50 percent dividends paid deduction, phased in over a ten-year period. In the President's tax reform proposals to the Congress, a ten percent dividends paid deduction was proposed. The President's proposal, which was intended to represent a meaningful first step toward elimination of the double tax, was limited solely because of revenue concerns. In H.R. 3838, as passed by the House of Representatives, a ten percent dividends paid deduction would be provided, phased in over a ten-year period. The tax reform bill recently approved by the Senate Finance Committee does not provide for any dividend relief. This sequence of events suggests that the prospects for significant integration in the near future are not bright.

The apparent reasons for a lack of strong support for integration are significant. One reason is the substantial revenue cost of any integration proposal. The dividends paid deduction proposed in the Treasury Department's report to the President was estimated to cost over $30 billion in 1990, when the amount of the deduction would have been 40 percent of dividends paid. Restoration of these revenues would require either substantial changes in the tax base or significant increases in tax rates.

The prospects for significant integration are also weakened by the public and political support for a corporate income tax. Corporations, and large corporations in particular, are widely viewed as separate entities that should contribute, through tax payments, to the cost of government. It is noteworthy as well that prior integration proposals have not received strong support from the corporate sector. Many corporate managers may prefer either reduced income tax rates on all corporate earnings or increased tax preferences for investment over dividend relief or other methods of integration. Some may also be concerned that integration in the form of dividend relief would force larger distributions of corporate income and thus reduce the capital available to corporations for reinvestment.

C. Proposal to Revise Classification Standards

As long as the Federal income tax system does not provide for full integration of the corporate and individual income tax systems, purely equivalent tax treatment of income generated through different business entities can be achieved only by subjecting all business entities (including sole proprietorships) to separate entity and individual levels of tax. We would obviously not support achieving equivalent tax treatment of different entities in this manner. Such a rule, by taxing all income from equity investment at a higher effective rate than other income, would seriously discourage investment. Moreover, we believe that such a dramatic expansion of the entity level tax would be an inappropriate extension of the double tax to entities that bear no significant resemblance to corporations.

If we accept the premise that corporations and sole proprietorships -- the entities at the opposite ends of the continuum of business entities -- will continue to be taxed in fundamentally different ways and at significantly different effective rates, we must also accept that it is impossible to achieve a completely level playing field for different types of business enterprises engaging in similar income generating activities. Moreover, given the many different types of business entities and the wide differences in practical operation between particular entities of the same type, we must recognize that any lines that are drawn to classify entities for tax purposes will be, to some degree, arbitrary and unsatisfactory.

Kintner Regulations. The difficulty in drawing acceptable classification lines is illustrated by recent experience with the rules distinguishing partnerships from associations taxable as corporations. As described earlier, the current association regulations under section 7701 (commonly referred to as the "Kintner" regulations) 8/ treat an unincorporated association as a corporation only if the association has more than two of the four relevant corporate characteristics (continuity of life, centralization of management, limited liability, and free transferability of interests). Under these regulations, only in rare situations will a partnership formed under a uniform partnership or limited partnership act be classified as an association taxable as a corporation.

The Kintner regulations were issued at a time when corporations were allowed to take advantage of certain qualified pension plan and other beneficial rules not available to partnerships. The regulations reflected the desire to limit the ability of unincorporated entities to gain access to these rules. Since the issuance of the regulations, the advantages of corporate classification have generally been eliminated 9/ while the advantages of partnership classification have grown (largely due to the reduction in individual tax rates and the expansion of tax preferences). Because of the "bias" in the Kintner regulations in favor of partnership classification, the regulations have permitted the formation of limited partnerships that, in operation, bear little resemblance to traditional partnerships. Since all entities incorporated under state law are taxed as corporations, taxpayers in effect are allowed to elect to be taxed as a corporation or a partnership.

8/ The regulations were developed largely in response to the classification of a professional service organization as a corporation in Kintner v. United States, 216 F.2d 418 (9th Cir. 1954).

9/ The advantages of corporate classification were reduced significantly by changes in rules relating to qualified pension plans and personal service corporations contained in the Tax Equity and Fiscal Responsibility Act of 1982.

Proposals for Change. Although the Kintner regulations have been criticized because they make corporate status virtually elective, various proposals to revise the classification rules have met with no greater acceptance. The Treasury Department's report to the President on tax reform proposed to treat as a corporation any limited partnership having more than 35 limited partners. Although this proposal was made in the context of a tax reform plan that would have reduced significantly the differences in taxation of corporations and partnerships, it was heavily criticized and was not included among the President's tax reform proposals to the Congress. Among the criticisms of the proposal were that no logical basis existed for distinguishing limited partnerships with more than 35 limited partners from those with 35 or fewer limited partners and that the proposal favored wealthy individuals who would be able to invest in partnerships raising large amounts of capital from a small number of partners.

Earlier attempts to substitute a more subjective and restrictive resemblance test for the Kintner regulations also were unsuccessful. In 1977, the Treasury Department proposed new regulations that would have revised the standards for determining whether each of the four corporate characteristics exists in a particular case, and eliminated the rule that a majority of the corporate characteristics must exist for an unincorporated association to be classified as a corporation. In the face of heavy criticism, these regulations were withdrawn two days after their publication. 10/

The experiences described above make us cautious in suggesting any change in the classification standards. We do, however, believe that one limited change is appropriate.

In suggesting a change in current classification standards, we do not wish to move from a set of objective rules as provided under current law. Although objective classification rules may be criticized as arbitrary and unfair, there is a compelling need on the part of both taxpayers and the government for certainty. Moreover, we question whether subjective classification rules would be significantly more fair than objective rules, since even subjective rules would provide widely dissimilar tax treatment for similar entities falling on either side of the subjective line.

10/ Prop. Treas. Reg. sec. 301.7701-1-3, 42 Fed. Reg. 1038 (Jan. 5, 1977), withdrawn, 42 Fed. Reg. 1489 (Jan. 7, 1977).

Consistent with the above, we believe that the characterization of an entity under state law should ordinarily be respected. Thus, an entity organized and operated as a corporation under state law should be classified as a corporation for Federal income tax purposes, notwithstanding that the enterprise may more closely resemble a sole proprietorship than a corporation. Likewise, an entity that is organized as a partnership under state law generally should be treated as such for tax purposes.

Notwithstanding our general acceptance of state law characterization, we believe that, unless pure "partnership-model" integration is achieved for corporations generally, access to such pass-through treatment by noncorporate entities should be limited in certain instances. In our view, this limit should apply to require corporate classification in the case of an entity that (1) has a large number of owners, substantially all of whom are not involved in the management or operation of the entity, (2) has ownership interests that change hands frequently, (3) has access to capital markets in a manner comparable to large corporate entities, and (4) is carrying on significant business activity and dividing the gains therefrom.

The application of pass-through taxation principles to a partnership or similar entity possessing each of these characteristics produces tax results that are inordinately complex. Moreover, it is likely that non-tax considerations make the partnership form relatively unwieldy for such entities, so that the advantage of pass-through taxation is sought at the expense of economic efficiency. Finally, an entity possessing the characteristics described above operates and is commonly and appropriately viewed as an entity that is separate and independent from its owners. For these reasons, we believe that such a partnership or similar entity exceeds the practical and appropriate limit for pass-through taxation and should be treated as a corporation for Federal income tax purposes. We have no illusions that we can identify the precise point at which this limit is reached. We do suggest, however, that it is exceeded in the case of business activities organized as limited partnerships, the interests in which are publicly traded.11/

11/ We do not in this testimony propose a standard for determining when the interests in a limited partnership would be treated as publicly traded. We note, however, that the Code already contains the related concept of whether securities are "readily tradable" or "regularly traded" on an "established securities market." *See, e.g.*, sections 170(e)(5)(B)(i), 453(f)(5), 897(c)(3), 1273(b)(3), and 1445(b)(6). Whether a partnership is publicly traded could also be determined by reference to the Federal securities laws. As we indicated earlier, it is essential that any standard that is chosen be clear and based on objective factors.

Administrative Complexity. For tax purposes, the partnership model is best suited to entities that have a small number of owners who are involved in, or at least closely aware of, the activities of the partnership. Utilization of this model for complex entities, the interests in which are widely held and frequently transferred, creates difficulties both for the Internal Revenue Service and for the partnerships and partners themselves.

Because adjustments to the items of income, gain, loss, deduction, and credit of the partnership produce adjustments to the taxable income of all of the individual partners, the tasks of auditing the returns of a large partnership, and collecting any deficiency from, or returning any refund to, the individual partners are not easy ones. Some of the problems of auditing large partnerships have been reduced as a result of the partnership-level audit provisions adopted in the Tax Equity and Fiscal Responsibility Act of 1982. Nonetheless, audit and collection procedures are significantly simpler in the case of corporations, including corporations, such as RICs and REITs, that qualify for dividend relief.

In addition, it is difficult for both the Internal Revenue Service and the partnership and partners themselves to apply the pass-through rules where the proportionate interests of the owners are changing frequently. Among the most difficult of the rules to apply are section 708(b) (under which a partnership is treated as terminated if within a 12-month period there is a sale or exchange of 50 percent or more of the interests in the partnership), 12/ sections 734 and 743 (which provide for optional adjustments to the basis of partnership property as a result of certain distributions of partnership property or transfers of partnership interests), section 751 (under which amounts received upon the sale of partnership interests that are attributable to certain ordinary income property of the partnership are characterized as ordinary income rather than an amount from the sale of a capital asset), and section 704(c) (under which tax items relating to property contributed to a partnership are shared so as to take account of the variation between the tax basis of the property and its fair market value).

12/ Termination of the partnership under section 708 produces a deemed distribution of the assets of the partnership and a deemed formation of a new partnership.

Publicly traded partnerships typically do not know who many of their partners are, because interests are often held in "street name." Therefore, they have no way of knowing whether transfers of partnership interests have resulted in a termination of the partnership under section 708(b), and such partnerships are incapable of properly applying the relevant rules. The making of section 734 and 743 adjustments by publicly traded partnerships requires the use of sophisticated computer programs, and even then is feasible only if simplifying assumptions are made. The proper application of section 751 to publicly traded partnerships also is virtually impossible, because the individual partners have insufficient knowledge regarding the partnership's assets to determine the applicable tax consequences. In addition, interests in a partnership must be fungible in order to be traded readily. Yet, the tax treatment under section 704(c) of partners in a partnership to which property having a value different from its tax basis has been contributed may cause interests in the partnership not to be fungible.

At the partner level, one need only examine the difference between a Form K-1, the information return provided by a partnership to its partners, and a Form 1099, the information return provided by a corporation to its shareholders, to appreciate the difference in level of complexity. Additional complexity is present in the case of partners that are tax-exempt organizations or foreign persons. Because the activities engaged in by the partnership are, in effect, passed through to the partners, income from the partnership may be treated as unrelated business taxable income to a tax-exempt partner or income effectively connected with a U.S. trade or business to a foreign partner. The depreciation deductions of a partnership may in certain cases be affected by the existence of a tax-exempt partner. A level of complexity that may be appropriate where a small number of persons hold large interests in an entity becomes unacceptable where a large number of persons hold small interests in an entity.

The administrative difficulties of applying the tax rules on a pure pass-through basis to widely held business entities is a major reason that the partnership model generally has been rejected as an acceptable way to achieve integration of the corporate and individual taxes. The foreign countries that have adopted full or partial integration have uniformly done so through dividend relief rather than the partnership-model. Similarly, the integration provided in our tax system for RICs and REITs and the partial integration that has been considered in connection with tax reform have taken the form of dividend relief through the allowance of a dividends paid deduction.13/

Non-Tax Considerations. Independent of the administrative difficulties of applying the partnership tax rules to a publicly traded limited partnership, many non-tax factors make the partnership an unwieldy vehicle for a publicly traded business enterprise. Limited partnerships lack the relatively well developed body of law that exists with respect to the business activities of corporations and the respective rights and obligations of the owners and managers of the entity. State limited partnership laws are in large part based on the assumption that the partners will have a continuing interest in the partnership and will be familiar with the operations of the partnership. Because partners are generally free to govern their own affairs through the partnership agreement, partners have a greater burden in understanding the terms of their investment. State law restrictions on the transferability of partnership interests may prevent the purchaser of an interest from acquiring all of the rights of a partner. In addition, partners may become liable for state and local income taxes in many of the jurisdictions in which the partnership operates.

The uncertainties, complexities, and risks associated with operating an entity in partnership form make the limited partnership a less efficient vehicle for operation of a publicly traded business enterprise than a corporation. Tax considerations aside, it is unlikely that any publicly traded business entity would be organized and operated as a partnership. The inefficiencies borne by an entity and its owners are not irrelevant to the choice of appropriate tax rules. The strongest argument against taxing publicly traded limited partnerships as corporations is that the uneveness and consequent inefficiency of the double tax system should not be expanded by extending double tax treatment to entities now taxed as partnerships. We question the extent of the efficiency benefits that actually result from permitting pass-through tax treatment for those publicly traded business entities that utilize the unwieldy partnership vehicle.

13/ We note that the Treasury Department in 1977, while acknowledging potential administrative problems, proposed a partnership-model integration scheme. See Blueprints for Basic Tax Reform (January 17, 1977). During our most recent study of this issue, the Treasury Department concluded that administrative and other problems make such a scheme infeasible at this time, and, as described above, we proposed a system of dividend relief.

<u>Resemblance to Corporations.</u> The tax and non-tax factors that make the limited partnership an unwieldy vehicle for a publicly traded business enterprise all derive from the fact that the partnership rules are, on the whole, designed to treat the partnership as an aggregation of its individual partners. An entity that is engaged in an active business and has a large, and frequently changing, group of partners, few of whom are engaged in the management or operation of the partnership, does not fit easily within the partnership rules for the simple reason that such an entity cannot reasonably be viewed as an aggregation of its owners. Rather, the entity is, like a corporation, appropriately and, indeed, necessarily viewed as separate and distinct from its owners. The current ability of certain entities to escape corporate taxation while behaving like corporations in all important respects raises questions both of fairness and, in the long-run, of the integrity of the corporate income tax base. Given the evident public and political support for a corporate income tax, it is inappropriate as a matter of tax policy to permit that tax to be avoided by entities functionally indistinguishable from corporations.

<u>Prior Proposals for Change.</u> Classifying publicly traded limited partnerships as corporations for Federal income tax purposes is not a new idea. In 1982, the American Law Institute, in its Federal Income Tax Project on Subchapter K, proposed to classify any limited partnership whose interests are traded in an established securities market as an association taxable as a corporation. In 1983, the staff of the Senate Finance Committee released a preliminary report on Subchapter C reform ("The Reform and Simplification of the Income Taxation of Corporations") containing the same proposal. (In the final version of the Finance Committee staff report, released in 1985, the issue of how to classify publicly traded limited partnerships was determined to be beyond the scope of the report and was not addressed.)

In 1983, when we testified before the Senate Finance Committee concerning the preliminary staff proposals on Subchapter C reform, we opposed the publicly traded limited partnership classification proposal. Our principal objection was that the proposal was beyond the scope of the Subchapter C reform project and required additional study. We also expressed doubt that the degree of marketability of an entity's equity interests should determine the manner in which the entity is taxed and were concerned about the impact of the proposal on certain activities that have traditionally raised capital through limited partnerships.

As we did in 1983, we recognize now that some publicly traded limited partnerships will differ in only minor respects from other widely held, but not publicly traded, limited partnerships. The proposal we make today is not based on the view that publicly traded limited partnerships are different in kind from all other partnerships, but on the view that public trading in the interests of a limited partnership is indicative of the existence of the other, more relevant, classification factors (discussed above) that may, to a lesser extent, be present in many other partnerships. If it is determined that certain activities (such as natural resource exploration or development, research and experimentation, and housing development) should be permitted to continue in the form of publicly traded entities not subject to a double level of tax, we suggest that alternatives to the partnership model be considered. In particular, the double tax could be avoided through additional dividend relief provisions comparable to those applying to RICs and REITs.

Conclusion. For the reasons discussed above, we recommend that current law be amended to provide for the classification of publicly traded limited partnerships as associations taxable as corporations. We believe such a provision would represent a reasonable balancing of considerations of economic efficiency, administrative feasibility, fiscal responsibility, and equitable treatment of different entities that operate in a similar manner. If such a proposal is to be enacted, additional study is needed regarding such issues as the proper standard for determining whether interests in a limited partnership are publicly traded, the proper treatment of existing publicly traded limited partnerships, and possible alternative methods of relief from double taxation for certain activities. We will be pleased to work with the Subcommittee to resolve these and other issues.

III. Issues Under Subchapter K

A. In General

To the extent partnerships will continue to operate free of an entity-level tax, as we believe is appropriate for the vast majority of businesses currently organized in partnership form, the question remains as to how partnership income should be passed through to the partners. Currently, the answer to this question is provided by Subchapter K of the Code.

Subchapter K, which is a complex melding of entity and aggregate notions of taxation, allows greater flexibility to taxpayers than any other scheme of taxation in the Code. This flexibility reflects the freedom partners are afforded under state law to structure their economic affairs, and thus is appropriately intended to conform partnership tax consequences to a partnership's economic results.

In providing flexibility, however, Subchapter K requires a complex set of rules to allocate partnership income among the partners. These rules were not overly difficult to apply to the relatively small and simple business arrangements that typically were conducted in partnership form at the time Subchapter K was developed. In recent years, however, as partnership arrangements have grown more complex, Subchapter K has become vastly more difficult to apply, increasing administrative burdens on taxpayers and the Internal Revenue Service, and raising significant tax policy concerns as to the appropriateness of the tax results achieved in some transactions.

The growth in complexity of partnership arrangements in part simply reflects the increased sophistication of commercial arrangements, and the fact that businesses traditionally conducted in partnership form also have become more complex. A more troubling source of complexity, however, is the use of the partnership form either to transfer Code-based tax incentives among partners or to obtain tax results that are inconsistent with the economic results that the partners expect to achieve from the partnership's activities. The number of these arrangements appears to have grown dramatically as tax incentives have increased and marginal tax rates have remained at relatively high levels.

In recent years, Congress has adopted a number of statutory changes designed to limit the use of the partnership form to achieve inappropriate tax consequences. 14/ For the most part, these changes have been targeted responses to specific transactions or arrangements, amending particular provisions of Subchapter K while leaving its structural flexibility in place. Moreover, prior to the beginning of the tax reform process, little had been done to reduce the high marginal tax rates and broad tax incentives that prompt tax-motivated partnership arrangements.

As noted above, Congress is now acting on fundamental tax reform legislation that would dramatically alter this country's tax system. The versions of H.R. 3838 passed by the House and approved by the Senate Finance Committee would substantially reduce marginal tax rates and would reduce or eliminate many incentives now in the Code. In addition, both bills would extend to real estate a limited version of the at risk rules, expand the minimum tax, and limit the deductibility of interest expense. Finally, as noted earlier, the Senate Finance Committee version also would directly limit the ability of passive partners to use partnership losses to shelter their other incomes.

These changes, if enacted, would significantly limit current incentives for tax-motivated partnership arrangements. We should not assume, however, that tax reform will eliminate all problems in this area, and, indeed, it is only prudent to expect that dramatic changes in the tax system may prompt new tax-motivated uses of the partnership form. It thus remains important to examine the use of partnerships under current law and to consider what changes to Subchapter K might be appropriate if tax-motivated partnership arrangements persist.

14/ For example, in addition to other less significant changes affecting partnerships, the Tax Reform Act of 1984 amended sections 704(c), 706, 707, 734, and 752, and added new sections 386 and 761(e).

B. Perceived Problems

In exploring possible changes to Subchapter K, it is appropriate to focus on its system of partnership allocations, which is the principal source of the flexibility afforded to partnerships. As mentioned earlier, under current law each partner takes into account separately his distributive share of the partnership's items of income, gain, loss, deduction, and credit. The partners are free to allocate these items in any way they choose, so long as the allocations made by the partnership agreement have "substantial economic effect."

The notion of substantial economic effect is straight-forward in the abstract -- the manner in which the partners share the economic consequences of partnership activities should dictate the tax consequences to the partners of those activities. In other words, if a partner enjoys economic income or bears an economic loss as a result of partnership activities, he should realize a corresponding amount of taxable income or loss.

For example, if a partner in a law firm receives a disproportionately large share of the firm's income in a particular year because of his unusual contribution to the firm in that year, the lawyer, and not his partners, would be taxed on that income. Thus, if the economic results of the partnership are shared among the partners other than on the basis of a fixed percentage ownership interest in the partnership, Subchapter K provides the flexibility for the partners to be taxed consistently with that business arrangement. Even though the partnership may be quite large and there may exist a complex formula for measuring each lawyer's contribution to the firm, the resulting complexity in determining the tax consequences under Subchapter K may be acceptable because no other system would as accurately reflect how the partners share the economic results of the partnership's activities.

As applied to other partnerships, however, in which allocations are intended less to reflect economic reality than to minimize taxes, the concept of substantial economic effect has proven much less satisfying. Take, for example, a partnership to which Partner A (a high-bracket investor) contributes $150,000 and Partner B (a service provider) contributes $50,000. 15/ The partnership borrows $800,000 on a recourse basis and constructs a building for $1,000,000. The partnership leases the building to

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15/ The partnership agreement provides that (1) capital accounts will be maintained properly, (2) upon liquidation of the partnership or any partner's interest, liquidating distributions will in all cases be made in accordance with capital accounts, and (3) partners are required to restore deficit capital account balances, all as described in Treas. Reg. sec. 1.704-1(b)(2)(ii)(b).

a financially secure corporation for 20 years under a "net lease" with a rental inflation adjustment provision. In its first taxable year, the partnership expects to receive rental income of $90,000, incur interest expense of $80,000, and be entitled to a cost recovery deduction of $47,000. The partnership agreement provides that net losses of the partnership will be allocated 99 percent to Partner A and 1 percent to Partner B, and that net profits of the partnership will be allocated 99 percent to Partner A and 1 percent to Partner B until all prior losses have been "charged back." Thereafter, all profits of the partnership will be allocated equally between the partners. 16/ Traditionally, the allocation of the partnership's $37,000 first year loss $36,630 to Partner A and $370 to Partner B has been considered to have substantial economic effect because, if the partnership were to sell the building subject to the lease for $953,000 (the adjusted basis of the building) at the end of the first taxable year, Partner A would have suffered an economic detriment of $36,630, and Partner B would have suffered an economic detriment of $370.

Nevertheless, the appropriateness of the results achieved under this traditional approach may be questioned in the context of an incentive depreciation system, such as ACRS, where tax depreciation deductions are likely to be far in excess of economic depreciation. For instance, if the partners expect to sell the building at the end of the year and reasonably believe (on the basis of several appraisals and offers they have received from potential purchasers) that they will receive no less than $1,000,000, it is questionable whether 99 percent of the tax loss, which appears not to be matched by a corresponding economic loss, should be allocable to Partner A. Put another way, should 99 percent of the subsidy provided by faster than economic depreciation deductions (intentionally provided by the Code to stimulate investment in real estate) be available to Partner A merely because Partner A agrees to accept the real, but relatively small, risk that the tax deduction will reflect economic reality? 17/

16/ In fact, the partners probably consider themselves equal partners except that Partner A is to receive the "tax benefits."

17/ If, at the end of the year, the property is subject to a contract for sale at a price of $1,000,000 or if the debt is nonrecourse, the risk of Partner A bearing an economic loss corresponding to the tax loss is even smaller. Moreover, if the tax incentive being allocated is a tax credit, rather then a deduction, there is absolutely no economic risk corresponding to the tax allocation.

Similarly, consider a partnership to which Partner C (who has an expiring net operating loss carryover) contributes $100,000, and Partner D (who is a high-bracket taxpayer) contributes $900,000. 18/ The partnership uses the contributed capital to purchase a retail store for $1,000,000. The partnership agreement provides that the partnership's net profit, if any, in its first taxable year will be allocated to Partner C, who will be able to offset the income with his NOL. Thereafter, all profits and losses of the partnership will be allocated 10 percent to Partner C and 90 percent to Partner D. Nonliquidating cash distributions will be made 10 percent to Partner C and 90 percent to Partner D, except that, in each of years 10 through 30, Partner C will receive additional annual cash distributions in an amount necessary to amortize the amount of net profit allocated to Partner C from the partnership's first taxable year plus an agreed-upon rate of interest that is less than a market rate. The partnership agreement further provides that Partner C may not cause the partnership or his interest in the partnership to be liquidated without Partner D's consent.

If the partnership realizes net income of $100,000 in its first taxable year, Partner C will be allocated that $100,000 of income. Nevertheless, C's right to receive the actual cash attributable to that $100,000 profit has a present value that is far less than $100,000 because that amount will be distributed to Partner C over time and will earn a below-market rate of interest. Should Partner D be able to avoid paying tax on the entire $100,000 of taxable income earned in the partnership's first year even though Partner C is prevented from enjoying the full economic benefit corresponding to that income? Final regulations published in December of 1985 contain rules intended to prevent this result. 19/ The rules have been criticized by some, however, as being ineffective and by others as beyond the scope of the substantial economic effect requirement. 20/

These relatively simple examples illustrate the conflict between the intentional flexibility of Subchapter K and the general policy against the transfer of tax attributes independent

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18/ The partnership agreement contains the requirements described in footnote 15 above.

19/ Treas. Reg. sec. 1.704-1(b), 50 Fed. Reg. 53420 (December 31, 1985).

20/ The version of H.R. 3838 approved by the Senate Finance Committee includes in the amendments to section 382 a provision explicitly giving the Treasury Department authority to deal with this and other such arrangements involving a corporate partner with an NOL carryfoward.

of any economic incidents to which they relate. 21/ Although the current law substantial economic effect requirement is intended to prevent the separation of tax from economic consequences, its effectiveness for this purpose is unclear in the situations described. As mentioned above, final regulations defining substantial economic effect have only recently been published. Although there are early indications that these regulations may not have stopped certain transactions that may be viewed as abusive, the basic approach taken in the regulations, perhaps with modifications, may ultimately prove workable and effective. Moreover, as noted above, pending tax reform legislation would, by limiting tax incentives and reducing tax rates, ease existing pressures on the rules of Subchapter K.

C. Further Study

Although it may be premature to make significant changes in the structure of Subchapter K, we believe this is an area that will require close and continuing scrutiny. If exploitation of Subchapter K through tax-motivated partnership arrangements persists, it may be appropriate to consider revisions of Subchapter K that would substantially restrict its flexibility.

One approach deserving study would be a partnership allocation system similar to that employed in Subchapter S. Under this more rigid system, each unit of ownership interest in the partnership would be required to share equally in each item of partnership income, gain, loss, deduction, and credit and in each distribution made by the partnership. If the partnership did not meet this requirement, it would be taxed as a corporation under Subchapter C, just as an S corporation that is found to have two classes of stock. Under such a regime, any shift in a partner's percentage interest in partnership items would, as with a transfer of shares in an S corporation, be characterized and taxed appropriately (as, for example, a purchase of an additional interest for capital, a receipt of an additional interest for services, or a gift). In developing such an approach, it could be desirable to analyze the possibility of a single system of pass-through taxation for all non-publicly traded business entities, which could replace Subchapters K and S of current law.

21/ Limitations on the transfer of NOL carryforwards in the context of corporate acquisitions have long been part of the Code. Similarly, the right to depreciation deductions has historically followed "ownership" of property, thus preventing separation of depreciation benefits from the property's economic incidents. Although the "safe harbor leasing" rules contained in the Economic Recovery Tax Act of 1981 permitted taxpayers the right to transfer depreciation and credits independent of economic ownership, these rules were largely repealed in the Tax Equity and Fiscal Responsibility Act of 1982. Moreover, despite continuing debate over the merits of free transferability of tax benefits, Congress has shown no willingness to move in this direction.

Obviously, this possible approach to revising Subchapter K, as well as any other possible revision of this magnitude, would require extensive consideration before enactment. We recognize, moreover, that significant restrictions on the flexibility of Subchapter K could adversely affect economic arrangements that appear to be taxed appropriately under current law. In this regard, it could well be appropriate to retain more flexible treatment for certain identified activities or industries. For example, service organizations might be permitted to shift allocations of bottom line income or loss without regard to units of ownership where such shifts respond to the shift from year to year in the relative values of services provided by the various partners.

We recognize that any recommendation even to study the basic structure of Subchapter K may be met with alarm in some quarters. We should not be dissuaded, however, from efforts to strike the appropriate balance between flexibility for taxpayers and the integrity of the tax system. The Treasury Department will continue to study how that balance should be struck with respect to the taxation of pass-through entities. If the Subcommittee wishes to pursue this general subject, we will of course be pleased to participate fully in such efforts.

This concludes my prepared statement. I will be happy to respond to questions.

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TREASURY NEWS

epartment of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE June 9, 1986

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,201 million of 13-week bills and for $7,208 million of 26-week bills, both to be issued on June 12, 1986, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing September 11, 1986			:	26-week bills maturing December 11, 1986		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	6.26%	6.45%	98.418	:	6.34%	6.64%	96.795
High	6.32%	6.51%	98.402	:	6.41%	6.72%	96.759
Average	6.31%	6.50%	98.405	:	6.39%	6.69%	96.770

Tenders at the high discount rate for the 13-week bills were allotted 79%.
Tenders at the high discount rate for the 26-week bills were allotted 27%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 48,100	$ 48,100	:	$ 29,545	$ 29,545
New York	19,022,500	5,794,000	:	17,580,315	6,291,865
Philadelphia	33,260	33,260	:	13,695	13,695
Cleveland	49,240	49,225	:	31,910	31,910
Richmond	87,010	37,010	:	35,685	35,685
Atlanta	53,340	43,340	:	46,420	46,420
Chicago	1,575,715	400,715	:	1,127,935	214,935
St. Louis	86,820	53,980	:	83,130	48,210
Minneapolis	16,510	15,460	:	18,630	18,630
Kansas City	66,910	65,860	:	42,290	42,290
Dallas	46,170	40,120	:	32,005	27,005
San Francisco	945,645	284,935	:	645,385	127,135
Treasury	334,590	334,590	:	280,300	280,300
TOTALS	$22,365,810	$7,200,595	:	$19,967,245	$7,207,625
Type					
Competitive	$19,120,905	$3,955,690	:	$16,866,975	$4,107,355
Noncompetitive	1,137,875	1,137,875	:	778,970	778,970
Subtotal, Public	$20,258,780	$5,093,565	:	$17,645,945	$4,886,325
Federal Reserve	1,691,130	1,691,130	:	1,750,000	1,750,000
Foreign Official Institutions	415,900	415,900	:	571,300	571,300
TOTALS	$22,365,810	$7,200,595	:	$19,967,245	$7,207,625

1/ Equivalent coupon-issue yield.

B-615

TREASURY NEWS

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STATEMENT OF
DENNIS E. ROSS
TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to discuss the Treasury Department's views regarding the following four bills that would affect the tax treatment of certain pass-through entities: (1) H.R. 1658, relating to the treatment of business development companies; (2) H.R. 3397, relating to the treatment of regulated investment companies; (3) H.R. 4916 and H.R. 2571, relating to the treatment of real estate investment trusts; and (4) H.R. 4448, relating to the treatment of multiple class mortgage pools. In addition to discussing the specific provisions of each bill, I will discuss certain other issues relating to the treatment of several of these entities under current law.

Broader issues concerning the proper method of taxing different types of business entities and their owners were discussed at yesterday's hearing. The Treasury Department's testimony at that hearing focused, in part, on whether limits should be placed on the ability of certain noncorporate entities to avoid being treated for Federal income tax purposes as corporations, thus eliminating one of the two levels of tax generally imposed on corporate earnings that are distributed as dividends. All of the entities that are the subject of today's hearing are either corporations or noncorporate entities that are nevertheless treated as corporations. The entities being considered today, however, are (or would be under proposed legislation) governed by special tax regimes that limit (or eliminate) the double taxation of corporate income that is distributed to shareholders. The common issues explored in my testimony today will be first, what limits should exist on the activities of organizations benefiting from these special regimes, and second, what rules should apply to ensure proper taxation to the owners of the income earned by the entity.

H.R. 1658

Business Development Companies

Current Law

The Internal Revenue Code ("Code") permits certain corporations that qualify as "regulated investment companies" ("RICs"), commonly called mutual funds, to deduct dividends paid to their shareholders, and thereby avoid the double taxation that would otherwise be imposed on distributed corporate earnings. In order to qualify as a RIC for Federal income tax purposes, a domestic corporation must meet several requirements. 1/ In particular, a corporation may qualify as a RIC only if it is registered with the Securities and Exchange Commission at all times during the taxable year as a management company or as a unit investment trust under the Investment Company Act of 1940 (the "1940 Act"), or, if it is a common trust fund or similar fund, that it be excluded from the definition of common trust fund under the Code and from the definition of investment company under the 1940 Act.

The Small Business Investment Incentive Act of 1980 (the "1980 Act") amended the 1940 Act to permit a closed-end company that provides capital and significant managerial assistance to small businesses to elect, subject to certain requirements, to register as a business development company. A company is eligible to register as a business development company under the 1980 Act only if it would otherwise be required to register as a management company under the 1940 Act. An eligible company that registers as a business development company is not required to register under the 1940 Act.

The alternative form of regulation available under the 1980 Act was specifically designed in lieu of registration under the 1940 Act, and imposes less burdensome regulatory requirements than the requirements otherwise applicable to corporations required to register as management companies. For example, a business development company registered under the 1980 Act is subject to less stringent restrictions regarding its capital structure and its ability to engage in transactions with affiliated persons than a similar company registered under the 1940 Act. Thus, a corporation eligible to register as a business development company under the 1980 Act would generally find such registration to be preferable to registration as a management company under the 1940 Act. Because the definition of a RIC has not been changed to reflect this new type of registration, a corporation can obtain the benefits of registration as a business development company only if it foregoes the pass-through treatment available to RICs under the Code.

1/ The RIC qualification requirements are described more fully in the following section of the testimony.

Description of the Bill

H.R. 1658 would amend present law to provide that any domestic corporation that registers as a business development company under the 1940 Act, as amended by the 1980 Act, would be eligible for the tax treatment applicable to RICs, subject to the requirements generally applicable in determining whether an investment company qualifies as a RIC. Thus, business development companies could both elect to register with the Securities and Exchange Commission under the streamlined procedures provided by the 1980 Act and be treated as a RIC for Federal income tax purposes. H.R. 1658 would apply to taxable years beginning on or after October 21, 1980 (the effective date of the 1980 Act).

Discussion

The Treasury Department has previously testified in favor of this legislation (introduced in the prior Congress as H.R. 2686) before this Subcommittee. As we expressed at that time, we have some concern as to whether the degree of activity engaged in by a business development company is consistent with the traditional purposes underlying the RIC provisions. Nevertheless, we continue to support H.R. 1658, because it would remove Federal income tax treatment as a factor in the determination by an otherwise eligible company of whether it will elect to be regulated under the securities laws as a business development company or as a management company.

A company can qualify as a business development company for securities law purposes only if it would otherwise fall within the definition of a management company under the 1940 Act. Hence, H.R. 1658 would not expand the class of corporations that can elect to be treated as RICs. Rather, the bill's effect would be that a closed-end management company, which is already eligible to be treated as a RIC for Federal income tax purposes, would not lose that eligibility by electing to be regulated under the securities laws as a business development company.

A business development company is permitted under the 1980 Act to provide "significant managerial assistance" to the companies in which it has invested. Such a company may thus arguably engage in a higher level of activity than the passive investment companies for which Subchapter M was designed. As noted above, however, a corporation registered as a management company under the 1940 Act may engage in many of the same activities as a business development company without ceasing to qualify as a RIC. In this regard, we note that section 851(e) grants an exception from the diversification rules generally applicable to RICs in cases in which, under regulations of the Securities and Exchange Commission, such companies are principally engaged in providing capital to other corporations engaged in developing or exploiting new inventions, technology, products, or processes. Thus, the existing rules already contemplate RIC status for companies registered under the 1940 Act that are engaged in such activities. As long as such companies continue to be eligible for RIC status, we see no reason to deny such treatment to business development companies registered under the 1980 Act. At the same time, we believe that consideration should be given to whether any company engaging in a significant degree of activity, regardless of whether registered under the 1940 Act or the 1980 Act, should be eligible for taxation under Subchapter M.

Although we support H.R. 1658, we believe that several technical changes should be made to the bill. First, because registration as a business development company is in lieu of registration as a management company, we believe that the provisions of Parts I and III of Subchapter M should apply to a corporation meeting the definition of a business development company as if it were registered as a management company. Such a change would clarify that a business development company can qualify as a RIC only if it is registered throughout its taxable year as a business development company or as a management company. This change also would make it clear that section 851(e) would apply to a business development company. Finally, such a change would help clarify that a business development company electing tax treatment under Subchapter M would be treated as a RIC for all purposes of the Internal Revenue Code, and not just for purposes of Subchapter M.

Second, the exception contained in H.R. 1658 for business development companies that are personal holding companies or that would be personal holding companies but for the application of section 542(c)(8) should be deleted. By making such companies ineligible to become RICs, H.R. 1658 is consistent with the RIC provisions as they existed prior to 1984. The Tax Reform Act of 1984, however, deleted the prohibition against election of RIC status by a personal holding company (although a RIC that is a personal holding company is subject to tax at the maximum corporate rate on its undistributed income). Because a personal holding company that is registered under the 1940 Act as a management company may now elect to be treated as a RIC if it meets all the other applicable requirements, we see no reason that a personal holding company that elects to be regulated as a business development company should be forced to forego the opportunity for taxation as a RIC, as long as its undistributed income is subject to tax at the highest corporate rate.

Finally, our endorsement of H.R. 1658 is predicated on its being prospective in application. Because the legislation is designed to remove a tax disincentive to registration as a business development company, it should not be extended to companies that have previously decided to forego RIC status by registering as business development companies. Accordingly, we strongly urge that H.R. 1658, if enacted, apply only to taxable years ending after the date of enactment.

H.R. 3397

Regulated Investment Companies

Current Law

In order to qualify to be taxed as a RIC, an entity must satisfy certain organizational, income source, income distribution, and asset diversification requirements, and must elect (or have previously elected) to be so taxed. First, as discussed in the previous section of this testimony, the entity must be a domestic corporation (or an association taxable as a corporation) that is registered under the 1940 Act as a management company or unit investment trust (or is exempt from registration as a common trust fund or similar fund). Second, the entity must satisfy two income source requirements: (i) at least 90 percent of the entity's annual gross income must be derived from dividends, interest, payments with respect to certain securities loans, and gains from the sale or other disposition of stock or securities; and (ii) less than 30 percent of the entity's gross income must be derived from the sale or other disposition of stock or securities held for less than three months. Third, the entity must distribute to shareholders each year at least 90 percent of the sum of its taxable income (without regard to capital gains) and its net tax-exempt income. Fourth, the entity must satisfy asset diversification requirements, which limit the extent to which the assets of the RIC may include securities (other than Government securities and securities of other RICs) either of any one issuer or any issuers a substantial portion of whose voting securities are owned by the RIC.

Corporations that qualify as RICs are generally taxed under the rules applicable to regular Subchapter C corporations. Unlike regular corporations, however, RICs are allowed a deduction for dividends paid to shareholders, and thereby avoid the corporate-level tax on any income distributed to shareholders. In addition, any undistributed taxable income of a RIC (other than capital gains) is taxed at the highest corporate tax rate.

Shareholders treat most distributions from a RIC as they would distributions from any other corporation. Thus, dividends received by individual shareholders generally are taxed as ordinary income to the extent of the RIC's earnings and profits. Special rules, however, provide that dividends paid out of net capital gains or, in the case of certain RICs, tax-exempt interest are treated by the shareholders as long-term capital gains or tax-exempt interest, respectively.

Many RICs are organized as "series" funds. A series fund is a single legal entity (either a corporation or a business trust) that is made up of several investment funds, each of which issues a separate class of stock of the entity. The owners of each separate class of stock have an interest only in the assets and income of the separate fund. In Union Trusteed Funds v. Commissioner, 8 T.C. 1133 (1947), acq., 1947-2 C.B. 4, the Tax Court held that a series fund organized as a corporation was a single corporation for Federal income tax purposes. In Revenue Ruling 56-246, 1956-1 C.B. 316, the Internal Revenue Service reached the same conclusion. Although the Internal Revenue Service has consistently followed this case and ruling with respect to series funds organized as corporations, it has issued a number of private rulings holding that each series of a series fund organized as a business trust would be taxed as a separate corporation. Recently, however, the Internal Revenue Service has been studying this area and has stopped issuing such rulings.

Description of the Bill

H.R. 3397 would make a series of amendments to the provisions of the Code relating to RICs. In particular, the bill would remove the limitation on the short-term trading activities of RICs, expand and clarify the types of income that may be earned by RICs, revise and clarify the treatment of RICs organized in series form, and make several other minor changes.

First, H.R. 3397 would repeal the existing requirement that a RIC derive less than 30 percent of its annual gross income from the sale of stock or securities held by the RIC for less than three months. Accordingly, while RICs would remain subject to the other limitations on their activities, a corporation could qualify as a RIC regardless of the extent to which it engaged in short-term trading activities.

Second, the bill would liberalize the types of income to be considered in determining whether a RIC has satisfied the requirement that it derive 90 percent of its income from permitted sources. In particular, the bill would treat the following as permitted income: (i) gains from options and futures contracts that are related to a RIC's portfolio assets; (ii) gains from foreign currency transactions; and (iii) certain other amounts, such as State tax refunds and recoveries of excessive management fees, derived with respect to the ric's investment activities. The bill also would provide that the term "securities" as used for purposes of determining whether a corporation satisfies the income source rules would have the same meaning as under the 1940 Act.

Third, H.R. 3397 would revise the treatment of rics organized in series form. The bill would treat each separate fund of such a RIC as a separate corporation, regardless of whether the RIC is organized as a corporation or a business trust. A separate fund would be defined as a segregated portfolio of assets beneficially owned by the holders of a class or a series of stock that is preferred over all other classes or series in respect of the segregated portfolio. By treating each fund as a separate corporation, the income source, income distribution, and asset diversification requirements would be applied separately to each fund. A particular fund could thus qualify as a RIC regardless of whether other funds within the same corporation satisfied the requirements.

Finally, the bill would make two other minor changes. First, it would extend the time period within which a RIC is required to provide certain notices to shareholders from 45 days to 60 days. Second, the bill would treat RICs in the same manner as other financial institutions for purposes of the rules applicable to third-party summonses.

Discussion

In general, the Treasury Department supports the provisions of H.R. 3397. As explained below, however, we believe that certain revisions are necessary to narrow slightly the proposed expansion of the income source rules and to provide additional rules for series funds that are treated under current law as a single corporation. In addition, we note that we have not at this time completed an analysis of the bill's revenue consequences. Our support for the bill assumes that it would move forward only in the context of legislation that would not produce any significant revenue loss.

Short-Term Trading Activities of RICs

H.R. 3397 would liberalize the income source requirements applicable to RICs by repealing the requirement that a RIC derive less than 30 percent of its gross income from the sale of stock or securities held for less than three months. The underlying purpose of this requirement of current law is to restrict the favorable RIC tax provisions to "passive" investment entities that are not engaged in the active business of dealing in securities.

As discussed at yesterday's hearing, the single tax imposed on RICs and their shareholders is, as a matter of ideal tax policy, preferable to the classical system of taxation that applies generally to corporations and their shareholders. Thus, some have questioned the need for any restriction on the activities of RICs. Moreover, because double taxation of the distributed income of RICs is avoided through the allowance of a dividends paid deduction, rather than through partnership-model integration, many of the administrative concerns we expressed yesterday concerning publicly traded limited partnerships do not apply to RICs. Nonetheless, in a system in which the double taxation of corporate earnings is standard, we believe that the types of activities that can be carried on by a RIC without being subject to double taxation must be limited. Specifically, we believe that RIC treatment should be available only to entities that are not engaged in an active business. In our view, however, a restriction on short-term trading activities is not essential to this policy and is not justified on other grounds.

Our support for the repeal of the restriction on short-term trading activities is, in large part, based on the fact that the trading of portfolio securities is generally treated for Federal income tax purposes as less "active" than other comparable business activities. This difference in treatment is evident in a number of areas.

First, the standard for determining whether property is held for investment (and will thus produce capital gain or loss upon sale) or is held for sale to customers in the ordinary course of business (and will thus produce ordinary income or loss upon sale) differs depending upon whether the property is stock or securities or other property. Among the most important factors that determine whether other property, such as real estate, is held for sale to customers in the ordinary course of business are the number, frequency, and continuity of sales of the property by the taxpayer. By contrast, these factors are not relevant in determining whether securities are held for sale to customers in the ordinary course of business. Thus, an extremely active securities trader, without more, is not considered by the tax law to be in the active trade or business of dealing in securities. Instead, securities generally are treated as held for investment unless the seller performs a merchandising function comparable to buying the securities in the wholesale market and selling them in the retail market. 2/

Second, among the requirements that must be satisfied in order for a distribution of securities of a controlled corporation to be tax-free under section 355 of the Code is that both the distributing and the controlled corporation must be engaged in the active conduct of a trade or business. The trading by a corporation of stocks and securities held for its own account, regardless of the size of the portfolio or the amount of activity involved in the management of the portfolio, is not treated as the active conduct of a trade or business for purposes of section 355. 3/

Third, certain "S corporations" (*i.e.*, corporations taxed under Subchapter S of the Code) may be penalized, or lose their status as S corporations, if they have excessive amounts of "passive investment income." For this purpose, passive investment income is defined to include all gains from sales or exchanges of stock or securities, regardless of the number of shares or the holding period of the securities sold.

2/ Treas. Reg. Sec. 1.1236-1(c)(2); Treas. Reg. Sec. 1.471-5.

3/ *See* Rev. Rul. 66-204, 1966-2 C.B. 113.

Finally, tax-exempt organizations generally are subject to tax on any "unrelated business taxable income." Gains or losses from the sale or exchange of property (other than property held for sale to customers in the ordinary course of business) are excluded from the definition of unrelated business taxable income. One of the reasons for this exclusion was the view of Congress that such gains and losses are "passive" in character. H.R. Rep. No. 2319, 81st Cong. 2d Sess. 38 (1950). As described above, sales or exchanges of securities do not generally produce ordinary income, and are thus not generally subject to the unrelated business income tax.

Thus, in these other areas of the tax law, a distinction is drawn between sales of securities and sales of other property. The distinction is not drawn between sales of securities held for a short period and sales of securities held for a longer period. While we believe strongly that RICs should be precluded from engaging in an active business, we do not believe that a distinction based upon the holding period of securities sold should be drawn for purposes of determining whether a RIC is engaged in an active business.

We also note that an independent limitation on the permissible activities of a RIC is generally imposed by the requirement that a RIC register as an "investment company" (or qualify as a common trust fund or similar fund exempt from registration) as defined in the 1940 Act. 4/ This requirement did not exist when the limitation on the short-term trading activities of RICs was first enacted. Registration with, and regulation by, the Securities and Exchange Commission under the 1940 Act both limits the ability of active business corporations to qualify as RICs and makes applicable numerous rules designed to protect the shareholders of investment companies.

Some have argued that a restriction on short-term trading protects shareholders of RICs by limiting speculative trading or portfolio "churning." We question whether such a restriction, in fact, provides any meaningful protection to RIC shareholders. More importantly, however, we believe that regulation of the relationship between corporations and their shareholders should be achieved through the securities laws, rather than the tax system.

4/ In this regard, we note that certain management companies (discussed in the prior section of this testimony) that are registered under the 1940 Act arguably engage in activities that are inconsistent with the traditional activities of a RIC. As we discussed earlier, we support the bill permitting business development companies registered under the 1980 Act to qualify as RICs because corporations engaging in similar activities can qualify as RICs if registered under the 1940 Act. We question, however, whether such a level of activity is appropriate for corporations eligible to be taxed under a regime that was designed to apply to passive investment vehicles.

The restriction on short-term trading activities, in addition to being unnecessary as a matter of tax policy, imposes substantial costs on RICs and their shareholders, both by limiting the RIC's ability to make investment decisions on economic grounds and by forcing RICs to monitor their compliance with the rule. In order to comply with the three-month restriction, RICs are in some cases forced to forego the realization of gains on securities held for less than three months or to reduce such gains as a percentage of gross income by selling securities held for a longer period. We do not believe that the tax system should require RICs to make such uneconomic choices.

The costs of monitoring compliance with this restriction also have grown in recent years as the volatility of investment markets has increased, and the rules for determining the holding period of securities have become more complex. For example, it may be prudent for a RIC to hedge a portfolio of securities against price fluctuations. Hedging activities, however, may produce less-than-three-month gains with respect to securities that have been held for more than three months. This would occur if gain is realized on the hedging side of the transaction, or if the holding period of the underlying securities is affected by rules (such as the short sale and straddle transaction rules) that suspend the running of, or create new, holding periods for securities. Additional uncertainty concerning the application of the three-month restriction has resulted from the rule requiring that unrealized gains and losses on regulated futures contracts be recognized at the end of each taxable year.

In summary, because we believe that the restriction on short-term trading activities serves no legitimate tax policy concerns, forces RICs to make uneconomic decisions, and needlessly imposes substantial compliance costs on RICs, we support the proposal in H.R. 3397 to repeal the limitation on the extent to which a RIC's income may consist of gains on sales of securities held for less than three months.

Sources of RIC Income

As discussed above, a RIC is required to derive at least 90 percent of its gross income from dividends, interest, payments with respect to certain securities loans, and gains from the sale or other disposition of stock or securities. This listing of permitted income, which was last amended in 1978, fails to include certain types of investment-related income now commonly received by RICs.

Despite the apparent inflexibility of the Code, the Internal Revenue Service has often gone beyond the literal terms of the statute to give a reasonable interpretation to the income source rules. For example, the Internal Revenue Service has ruled privately that certain investment products, such as options and futures contracts on securities, which are not specifically listed in the Code, will be treated as securities, gains from the sale or disposition of which constitute permitted income. 5/ In addition, the Internal Revenue Service has ruled that the receipt of certain other kinds of income, although not permitted income, will not result in loss of RIC status even though the amount of such income exceeds ten percent of the RIC's annual income. 6/ Despite the flexibility that has been shown by the Internal Revenue Service, however, RICs often can be certain of the treatment of various income items only by obtaining a private ruling.

H.R. 3397 would expand the list of permitted income to include gains from the disposition of "foreign currency, and other income (including but not limited to gains from options or futures contracts) derived with respect to its business of investing in such stock, securities, or currencies." The Treasury Department generally supports liberalization of the types of income RICs may receive to include the passive investment income sources specified in the bill.

We must again emphasize, however, that RICs should not be permitted to engage in an active business. In this regard, we note that the proposed repeal of the restriction on short-term trading activities, while independently justified, places additional importance on the income source rules as a limit on the activities in which RICs may engage. We believe, therefore, that it is essential that two limits on the activities of RICs be retained. First, permitted income should be limited to income from property held for investment, as opposed to property held for sale to customers in the ordinary course of business. Second, such income should be limited to income from stocks and securities, as opposed to other property. (The reimbursement or recovery of expenses and similar items should be treated as falling within these limits because they generally represent amounts that were offset against such income in past years.)

H.R. 3397 would treat all foreign currency gains as permitted income. Although foreign currency is a commodity and not a security, the purchase and sale of stocks or securities denominated in a foreign currency cannot be accomplished without the purchase and sale of foreign currency. Hence, foreign currency gains and losses are an inherent part of any investment in foreign-currency denominated securities.

5/ See G.C.M. 37233 (August 25, 1977) (options on securities); G.C.M. 38994 (January 21, 1983) (futures contracts on securities); and G.C.M. 39316 (July 31, 1984) (stock index futures, options on stock indexes, and options on stock index futures).

6/ See Rev. Rul. 64-247, 1964-2 C.B. 179 (recovery of excess management fees); Rev. Rul. 74-248, 1974-1 C.B. 167 (recovery of damages from investment advisor for breach of fiduciary duty); Ltr. Rul. 8530016 (April 24, 1985) (recovery of state taxes).

We believe that investments in foreign-currency denominated securities are a type of passive investment that should be permissible for RICs. Moreover, foreign currency investments that are made to hedge investments in foreign-currency denominated securities are, in our view, an appropriate part of the passive investment activity of RICs. Accordingly, we believe that gains from investments in foreign-currency denominated securities and from establishing offsetting foreign currency positions with respect to such securities should be treated as permitted income.

While we generally support expanding the definition of permitted income to include additional securities, we oppose any expansion of these rules to include gains from sales of other types of assets, such as commodities. Because foreign currency is a commodity, not a security, we believe that any foreign currency gains that are not related to investments in foreign-currency denominated securities should not be treated as permitted income. We recognize, however, that attempting to distinguish between qualifying and nonqualifying foreign currency gains would be difficult, and we are not prepared at this time to propose statutory rules that would draw the appropriate distinction. Consequently, we do not oppose including foreign currency gains on the statutory list of permitted income, as contemplated by H.R. 3397. We believe, however, that the Treasury Department should be provided with regulatory authority to exclude from permitted income any foreign currency gains that are not derived with respect to investment in a foreign-currency denominated security or from establishing offsetting positions with respect to such a security. 7/

Series Funds

As discussed above, some RICs are made up of several investment funds, each of which is beneficially owned by a separate class of shareholders. Under current law, if a RIC is organized as a corporation, it is treated as a single corporation, even if it consists of several funds. By contrast, there is uncertainty whether a series RIC organized as a business trust is treated as a single corporation or multiple corporations.

H.R. 3397 would end the current distinction between RICs organized as corporations and those organized as business trusts, and would treat each separate series of a series fund, regardless of whether organized as a corporation or as a business trust, as a separate corporation. Thus, the qualification tests would be applied on a fund-by-fund basis.

7/ We note that S. 2155, a bill containing provisions similar to H.R. 3397, would provide such regulatory authority.

In our view, treating each series as a separate corporation reflects the economic substance of RICs organized in series form. Moreover, the contrary rule, which now applies to RICs organized as corporations, may permit avoidance of many of the requirements that are imposed on RICs. For example, it may be possible within a series RIC to have a fund that does not meet the diversification requirement, a fund that does not meet the income source requirement, and a fund that does not meet the income distribution requirement, provided that, in the aggregate, all of the funds meet these requirements. In addition, treatment of a series fund as a single corporation creates several technical problems. For example, the capital losses of one series offset the capital gains of another series, thereby providing an unintended shift of tax benefits among the shareholders of the different series. Similarly, the straddle transaction and wash sale rules may prevent the deduction of losses by one series because of investments made by another series. Consequently, we support the provision in H.R. 3397 that would treat each fund within a series RIC as a separate corporation.

If H.R. 3397 is enacted, rules should be provided to clarify the tax consequences of the "deemed reorganization" resulting from the bill's treatment of existing series funds that are now treated as a single corporation as more than one corporation. Although such rules are highly technical and are beyond the appropriate scope of this testimony, we note that a set of such rules would be provided by S. 2155.

Shareholder Notice Requirements

Current tax rules require a RIC to send various notices to its shareholders within 45 days following the end of the RIC's taxable year. These notices are customarily included as part of the RIC's annual report. The Securities and Exchange Commission has recently extended the time for mailing annual reports to shareholders from 45 days to 60 days after the end of the RIC's taxable year.

H.R. 3397 would make a conforming change in the Internal Revenue Code notice requirements to permit information contained in a timely annual report to satisfy these notice requirements. In our view, each of the notices that RICs are required to send their shareholders would provide timely information if received within 60 days after the RIC's taxable year. Moreover, we believe that it would be wasteful to require RICs to send repetitive mailings to their shareholders. Consequently, we support the proposal to extend the notice deadline.

Third-Party Recordkeeper Summons

Section 7609 of the Code provides certain procedural rules applicable to summons served on "third-party recordkeepers." This term is defined to include various types of financial institutions such as banks, savings institutions, and brokers.

H.R. 3397 would expand the definition of "third-party recordkeepers" to include RICs. For this purpose, we believe RICs should be treated in the same manner as these other financial institutions. Consequently, we do not object to this proposal.

Sliding Scale Dividends

Representatives McGrath, Flippo, and Kennelly have requested the view of the Treasury Department concerning a possible modification to H.R. 3397. In particular, the modification would permit RICs to pay higher dividends per share to large shareholders to reflect the lower per share fees or costs incurred with respect to those shareholders.

Under current law, RICs are allowed a dividends paid deduction only for dividends that are strictly pro rata. 8/ No preference may be provided to any share of stock as compared with other shares of the same class. If a dividend distribution is preferential, the dividends paid deduction is disallowed. The deduction disallowance is not limited to the preferential portion of the distribution, or to the distribution to the shareholders who are given the preference, but applies to the entire amount of the dividends paid by the RIC. The legislative history of the restriction on preferential dividends explains that the dividends paid deduction was withheld in the case of such dividends to prevent injustice to certain shareholders and to eliminate the potential for tax avoidance. 9/

The problem that the proposed modification seeks to address is illustrated by a recent private ruling issued by the Internal Revenue Service. 10/ This ruling involved a proposed arrangement under which the fee received by the manager of a RIC for certain administrative services would have been assessed directly against the account of each shareholder at a rate that, on a per share basis, would vary with the value of shares owned by the shareholder. Larger shareholders would have been assessed lower per share fees. The Internal Revenue Service determined that the administrative fees were expenses of the RIC rather than of the individual shareholders. The consequences of this determination

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8/ This rule is contained in section 562(c) of the Code. Sections 561 and 562 provide rules for determining the amount of the dividends paid deduction allowed to RICs and real estate investment trusts for purposes of the regular tax and to other corporations for purposes of the accumulated earnings tax, personal holding company tax and foreign personal holding company tax.

9/ H.R. Rep. No. 1860, 75th Cong. 3rd Sess. 23 (1938).

10/ Ltr. Rul. 8552063 (September 30, 1985).

were, first, that the expenses could be deducted only by the RIC, and second, that the arrangement caused the dividends paid on some shares of the stock to exceed the dividends paid on other shares of the same class of stock. Viewing the arrangement as a sliding scale dividend arrangement, the Internal Revenue Service ruled that all dividends paid by the RIC would be treated as preferential dividends for which no dividends paid deduction would be allowed.

The proposed amendment would except from the preferential dividend rules differences in dividends paid by a RIC "which reflect management fees or cost savings attributable to particular shareholders or groups of shareholders." Differences in dividend levels attributable to other factors would continue to be subject to the preferential dividend rule. Moreover, the rule would continue to apply without exception to dividends paid by a RIC for purposes of the accumulated earnings tax and the personal holding company tax.

In the case of a sliding scale dividend arrangement that reflects management fees or cost savings, we do not believe that the concerns that motivate the disallowance of a deduction for preferential dividends -- the potential for shareholder injustice or tax avoidance -- are present. Although it may appear to be unfair for large shareholders to receive higher per share dividends than small shareholders, the costs per share of administering a shareholder's account may indeed be greater in the case of small shareholders than in the case of large shareholders. Accordingly, a sliding scale dividend arrangement may serve the valid business purpose of allocating administrative costs to the shareholders who generate those costs. We do not regard this as unjust. More importantly, while we realize that one of the historical policies underlying the preferential dividend provision is shareholder fairness, we believe that the relationship between RICs and their shareholders is more appropriately regulated by the Securities and Exchange Commission through the securities laws than by the Internal Revenue Service through the Internal Revenue Code.

We believe strongly, however, that the preferential dividend rule appropriately applies to dividend arrangements that have a tax avoidance purpose. In our view, a sliding scale dividend arrangement that truly reflects management fees or cost savings is unlikely to serve as a tax avoidance device. Nevertheless, it is possible for such a preferential dividend arrangement to reduce the overall taxes paid by the shareholders of a RIC. This would result, for example, if the larger shareholders of the RIC tend to be pension plans and other tax-exempt organizations and the smaller shareholders tend to be taxable individuals. We believe, however, that sliding scale dividend arrangements that reflect management fees or cost savings are primarily motivated by business reasons rather than tax avoidance. Accordingly, we would not oppose a provision to permit the deduction of dividends paid under such sliding scale arrangements.

Although the concerns that motivate the preferential dividend rule are not present in the case of a sliding scale dividend arrangement that reflects varying management or administrative costs, two significant tax policy issues are raised by such an arrangement. The first issue is whether any deduction should be allowed to a RIC for administrative, investment, and other expenses. As discussed earlier, RICs are treated as pass-through entities only to a limited extent. In the case of partnerships and other pure pass-through entities, items of income and expense are generally passed through to the owners of the entity and included in income or deducted by the owners. By contrast, while RICs may pass through to shareholders the character of certain income, such income is net of expenses deducted at the RIC level.

If expenses were passed through to RIC shareholders, the expenses would generally be deductible by the shareholders as an itemized deduction to the extent permitted under section 212 of the Code, which permits deductions for expenses incurred for the production of income or for the management of property held for the production of income. Accordingly, no deduction would be allowed to shareholders who do not itemize deductions. Under current law, this distinction between itemizing shareholders and nonitemizing shareholders would be the principal effect of denying RICs an entity-level deduction for investment expenses, and passing such amounts through to shareholders.

It is significant, however, that limits would be placed on certain itemized deductions under both fundamental tax reform bills now being considered by Congress. Under H.R. 3838, as passed by the House, investment expenses would be deductible only to the extent that such expenses, together with certain other miscellaneous and employee business expenses, exceed one percent of the taxpayer's adjusted gross income. Under the version of H.R. 3838 approved by the Senate Finance Committee, no deduction would generally be allowed for investment expenses. If either of these approaches is ultimately adopted by the Congress, the importance of allowing a RIC an entity-level deduction for investment expenses would be greatly magnified.

The second tax policy issue is whether RICs should be allowed to make special allocations of items of income and expense. As discussed in the Treasury Department's testimony at yesterday's hearing, we have some concerns regarding special allocations by partnerships of items of income and expense. Although special allocations may serve the useful purpose of accurately reflecting the economic arrangement among partners, such allocations increase the complexity of the partnership rules and create the potential for tax avoidance. Traditionally, RICs have not been permitted to make special allocations of items of income or expense. A sliding scale dividend arrangement, however, is a limited form of special allocation. While we do not oppose allowing a deduction for such preferential dividends, we must be cautious in adopting any change that would move away from the simple pass-through regime that has worked well for RICs.

Taxable Years and Spill-over Dividends

As discussed earlier, RICs are generally allowed a dividends paid deduction, thereby avoiding corporate-level tax on income distributed to shareholders. For purposes of determining the amount of the deduction for dividends paid to shareholders, certain dividends paid following the close of the taxable year may be treated by a RIC as paid during the taxable year. Such "spill-over" dividends are taxed to the shareholders of the RIC in the year they are actually received (often the succeeding year). The payment of such spill-over dividends, which frequently allows a deduction to the RIC in the year before the corresponding amounts are included in income by the shareholders, may produce a significant deferral of tax. Significant deferral of tax also may result from the use by RICs of a taxable year other than the calendar year.

The version of H.R. 3838 approved by the Senate Finance Committee would eliminate both of the tax deferral consequences described above by requiring that all RICs adopt the calendar year as their taxable year and by imposing a five percent excise tax on spill-over dividends. We support this provision, and encourage the Subcommittee to consider adoption of a similar provision.

While we support attempts to foreclose the deferral opportunities available to RICs, we recognize that significant burdens may be imposed on mutual funds and on regulatory agencies if all RICs are required to adopt the calendar year. In addition, we recognize that RICs may not readily be able to avoid paying some spill-over dividends and that, in this situation, the five percent excise tax may be a higher interest charge for the deferral of tax than is appropriate. We are certainly willing to work with the Subcommittee to accomplish the purposes of the Finance Committee provision -- the elimination of the deferral of tax -- in a manner that imposes the least burden on the industry. In this regard, we suggest that exceptions from the Finance Committee provision might be provided for RICs that distribute substantially all of their income not less often than monthly and for RICs substantially all of whose dividends qualify as exempt-interest dividends.

H.R. 4916 and H.R. 2571

Real Estate Investment Trusts

Current Law

As in the case of a RIC, in order to qualify to be taxed as a real estate investment trust ("REIT"), an entity must satisfy organizational, income source, income distribution, and asset requirements, and must elect (or have previously elected) to be so taxed.

First, the entity must be a domestic corporation (or an association classified as a corporation for tax purposes), which has at least 100 shareholders and does not meet the stock ownership test of the personal holding company definition. This stock ownership test is met if five or fewer individuals own, directly or indirectly, more than 50 percent of the value of the stock at any time during the last half of the taxable year. In applying this test, the ownership of stock by an individual may be treated as including stock owned by certain related persons, including any persons who are members of the same partnership as the individual.

Second, the entity must satisfy three income source requirements: (i) at least 75 percent of the entity's gross income must be derived from certain passive real estate sources, such as rents and mortgage interest; (ii) at least 95 percent of its gross income must be derived from these passive real estate sources and certain other passive sources, such as dividends and nonmortgage interest; and (iii) less than 30 percent of its gross income must be derived from certain sales of property. For purposes of the 75 percent and 95 percent income source requirements, rental income includes charges for services customarily furnished or rendered in connection with the rental of real property. Rental income is not treated as qualifying income, however, if the REIT (either directly or indirectly through persons in which the REIT has a financial interest) furnishes services to the tenants or manages or operates the property. Instead, all such tenant services must be performed by independent contractors.

Real estate lenders commonly make loans (and real estate lessors commonly enter into leases) that provide for a participation by the lender (or lessor) in some portion of the income or earnings of the borrower (or lessee). Under one form of such equity participation, a portion of the lender's interest (or lessor's rent) may be based on the gross, or more commonly, net income of the borrower (or lessee). The ability of REITs to take advantage of this form of equity participation is limited. In particular, any portion of rent or interest the amount of which is determined by the net income of another person is not treated as qualifying rent or interest income to the REIT.

Another form of equity participation is the shared appreciation mortgage, under which the lender receives a contingent return based upon appreciation in the mortgaged property. Substantial uncertainty exists under current law concerning the proper treatment of shared appreciation mortgages. The Internal Revenue Service has issued a revenue ruling characterizing payments under a shared appreciation mortgage on residential property as additional interest. 11/ The ruling was expressly limited to noncommercial loans to individuals and the Internal Revenue Service has not issued further guidance in this area. It is thus currently disadvantageous for REITs to enter into shared appreciation mortgages because of the risk that income from the mortgage might not be treated as qualifying income.

Third, the entity must satisfy income distribution rules requiring that at least 95 percent of the sum of the entity's "real estate investment trust taxable income" ("REITTI") and its after-tax income from "foreclosure property" must be distributed to shareholders.

Fourth, at least 75 percent of the entity's assets must be invested in certain real estate assets, government securities, or cash items, and any other assets must meet a diversification test. One effect of these asset diversification requirements is that no more than 25 percent of the assets of a REIT may consist of the stock of another corporation (other than a REIT).

Except as otherwise provided, REITs are taxed under the rules applicable to regular corporations. The principal difference between REITs and other corporations is that REITs, like RICs, are allowed a deduction for dividends paid to shareholders, and thereby avoid the corporate-level tax on any income distributed to shareholders. A REIT, however, may not use shareholder distributions to avoid corporate-level tax on two classes of income. First, a REIT is taxed at the highest corporate rate on net income from certain property that the REIT has acquired by foreclosure or similar action and elected to treat as "foreclosure property." Second, a REIT is taxed at a 100 percent rate on net income (and is unable to deduct net losses) derived from "prohibited transactions."

A prohibited transaction is any sale of property that is held by a REIT primarily for sale to customers in the ordinary course of business. Sales of "foreclosure property" and sales that qualify under a safe harbor are not considered prohibited transactions. The safe harbor applies to sales of real property if (1) the REIT has held the property (generally, for the production of rental income) for at least four years, (2) the aggregate expenditures made by the REIT to improve the property

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11/ See Rev. Rul. 83-51, 1983-2 C.B. 48.

in the four years prior to sale do not exceed 20 percent of the net selling price of the property; and (3) the REIT does not make more than five sales of property (other than foreclosure property) during the taxable year.

Shareholders of a REIT treat most distributions from a REIT as they would distributions from any other corporation. Thus, dividends generally are taxed as ordinary income to the extent of the REIT's earnings and profits. A special rule, however, provides that dividends paid out of the net capital gains of the REIT in the taxable year of the distribution are treated by the shareholders as long-term capital gains.

In general, an organization may not elect to be a REIT unless it adopts a calendar taxable year. Entities that elected to be taxed as REITs for taxable years beginning before October 5, 1976, are excepted from the calendar year rule. In addition, REITs, like RICs, are permitted to pay spill-over dividends. Some limits, however, are imposed on the payment of spill-over dividends by REITs. Unless a REIT distributes at least 75 percent of its REITTI (determined without regard to the dividends paid deduction and any net capital gains) before the end of the taxable year, a three percent excise tax is imposed on a portion of the spill-over dividends paid during the succeeding year.

If the taxable income of a REIT for a prior taxable year is increased by a judicial or administrative determination, the REIT may retroactively increase its dividends paid deduction for the prior year (thereby satisfying the distribution requirement and reducing its taxable income) by distributing to shareholders a "deficiency dividend." For purposes of determining the amount of interest and additions to tax charged by the Internal Revenue Service on underpayments of tax, the amount of the deficiency dividend is treated as an underpayment of the REIT's tax liability for the prior taxable year. In addition, a nondeductible penalty tax equal to the amount of the interest charged on the deficiency dividend (but not in excess of one-half of the amount of the deficiency dividend) is imposed.

Description of the Bills

H.R. 4916 and H.R. 2571 would make numerous changes in the taxation of REITs and their shareholders. 12/ The changes are designed primarily to enable REITs to compete more effectively in the real estate market.

12/ We note that the provisions of H.R. 4916 are identical to the provisions of the Senate Finance Committee's version of H.R. 3838 relating to real estate investment trusts.

First, H.R. 4916 would revise the prohibited transaction rules in several respects. In particular, the prohibited transaction safe harbor would be expanded as follows: (a) the maximum number of sales during a year would be increased from five to seven; (b) an unlimited number of sales would be permitted to qualify for the safe harbor provided that the gross income from such sales does not exceed 15 percent of the REIT's REITTI (determined without regard to the dividends paid deduction); and (c) the amount that a REIT is permitted to spend to improve a property in the four years before a sale would be increased from 20 percent of the net selling price of the property to 30 percent. In addition, REITs would be permitted to deduct losses from prohibited transactions in computing REITTI, but would not be permitted to net gains and losses from such transactions.

Second, H.R. 4916 would revise the definition of qualifying rental and interest income. The rule treating rental income as nonqualifying if the REIT directly furnishes services with respect to the property would be liberalized by permitting REITs to perform any services in connection with the rental of property that a tax-exempt organization could perform without being treated as receiving unrelated business taxable income. In general, under the unrelated business income standard, services in connection with the general maintenance of the building, such as the furnishing of heat or light and the cleaning of public areas, would be permissible, while services provided primarily for the convenience of a tenant, such as janitorial services for tenant areas, would be prohibited. In addition, rental (or interest) income of a REIT that is based on the net rental income of another person would be treated as qualifying income, provided that (1) the income of the other person is derived from the subleasing (or leasing) of real estate and (2) such income would be treated as qualifying rental income if received directly by the REIT.

Third, for purposes of determining whether the REIT meets the stock ownership test of the personal holding company definition, H.R. 4916 would narrow the rules used to attribute ownership of stock among related persons. Specifically, attribution of stock ownership among partners would be eliminated. In addition, consistent with an amendment to the RIC rules enacted in the Tax Reform Act of 1984, a corporation would be permitted to qualify as a REIT only if it distributes to shareholders any earnings and profits accumulated in taxable years in which it was not taxed as a REIT. H.R. 4916 also would suspend the shareholder concentration rule, and the rule requiring that a REIT have 100 or more shareholders, for the first taxable year in which an entity elects to be a REIT.

Fourth, H.R. 4916 would permit REITs to form wholly owned subsidiaries to hold real estate assets, thereby allowing REITs to limit their loss exposure from separately incorporated real estate projects. The REIT and any subsidiary that has, at all times, been wholly owned by the REIT would be treated as a single corporation for Federal income tax purposes. The ceasing of a subsidiary to be wholly owned by the REIT would be treated as the organization of a new corporation.

Fifth, H.R. 4916 would repeal the penalty tax on deficiency dividends.

Sixth, H.R. 4916 would provide several exceptions from the requirement that the REIT distribute 95 percent of its REITTI, determined without regard to the dividends paid deduction. A REIT would not be required to distribute non-cash income that is imputed to the REIT under rules adopted in the Tax Reform Act of 1984 (i.e., imputed interest under section 1274(c) and rents accrued under section 467) and income from putative tax-free exchanges under section 1031 that are subsequently determined to be taxable exchanges. The exemption would apply only to the extent that such income exceeds five percent of the REIT's REITTI. As under current law, a REIT would be taxed at corporate rates on any undistributed income.

Finally, H.R. 4916 contains other amendments that would (1) permit entities that have not engaged in any trade or business to change to the calendar year (which all new REITs are required to adopt) without IRS approval, (2) treat certain income and assets attributable to sales of stock by a REIT as qualifying income and assets for a period of one year, (3) permit a REIT to pay capital gain dividends to shareholders notwithstanding the existence of operating losses, (4) permit certain shareholder notices to be mailed with the REIT's annual statement, and (5) provide that a REIT's current earnings and profits cannot be less than the REIT's REITTI, determined without regard to the dividends paid deduction.

Discussion

During the consideration of H.R. 3838 by the Ways and Means Committee, the Treasury Department objected to the addition of the provisions in H.R. 2571. Our objections at that time concerned certain proposed changes that we viewed as inconsistent with the policies that Congress has traditionally applied to REITs. The proposed changes to which we objected were modified or not included in H.R. 4916. Accordingly, we do not oppose the provisions contained in H.R. 4916. 13/ We note, however, that the provisions in H.R. 4916 have a revenue cost of between $50 and $100 million, and that our position assumes inclusion of the bill in legislation that would not result in any significant revenue loss.

13/ Because we understand that the provisions of H.R. 2571 that differ from those in H.R. 4916 are no longer being pursued, our testimony will address only the provisions contained H.R. 4916.

Permissible Activities of REITS

The harsh treatment of a REIT's income and losses from prohibited transactions -- 100 percent taxation of net gains and nondeductibility of net losses -- is designed to enforce the basic rule that REITs are not permitted to engage in the conduct of active business operations. The legislative history of the original REIT provisions states that:

> your committee has also undertaken to draw a sharp line between passive investments and the active operation of business, and has extended the regulated investment company type of tax treatment only to income from the passive investments of real estate investment trusts. Your committee believes that any real estate trust engaging in active business operations should continue to be subject to the corporate tax in the same manner as is true in the case of similar operations carried on by other comparable enterprises. 14/

Some have questioned the need for any restriction on the activities of REITs, and as a matter of ideal tax policy, the single tax imposed on REITs and their shareholders may be preferable to the system of double taxation that applies generally to corporations and their shareholders. Nonetheless, in a system in which the double taxation of corporate earnings is standard, we believe strongly that it is important to restrict the types of activities that can be carried on by a REIT without being subject to double taxation.

Under the original REIT provisions, the holding of any property for sale to customers in the ordinary course of business would prevent an entity from qualifying as a REIT. This rule was unsatisfactory because of the absence of an objective test for determining whether property is held for sale to customers in the ordinary course of business. In 1976, the rules imposing a 100 percent tax on gains and making losses nondeductible were adopted to prevent the inadvertent disqualification of REITs that were determined to have held property for sale to customers in the ordinary course of business, while at the same time assuring "that a REIT would not intentionally undertake the conduct of an active business." 15/ The safe harbor exception was adopted in 1978 to permit a REIT to make a limited number of asset sales without risking forfeiture of all profits from the sales. The restrictions in the safe harbor were designed to "prevent REITs from using the safe harbor to permit them to engage in an active trade or business such as the development or subdivision of land." 16/

14/ H.R. Rep. No. 2020, 86th Cong. 2d Sess. 4 (1960).

15/ S. Rep. No. 94-938, 94th Cong. 2d Sess. 470 (1976).

16/ S. Rep. No. 95-1263, 95th Cong. 2d Sess. 179 (1978).

The prohibited transaction rules of current law may be somewhat arbitrary and harsh in application. The principal source of arbitrariness is the limitation of the prohibited transaction safe harbor to five sales of property. The fixed maximum number of sales provides a needed objective rule that can be relied upon to avoid the subjective determination of when property is held for sale to customers in the ordinary course of business. Moreover, the number of sales of real estate made by a taxpayer is one of the significant factors used to determine whether the taxpayer is holding property for sale to customers in the ordinary course of business. Nonetheless, the five sale limit fails to take into account the size of the REIT or of the properties sold. We do not regard the sale by a large REIT of more than five, relatively small, properties as necessarily indicative that the REIT is engaging in impermissible business activities.

Thus, we do not believe that the essential passivity of REITs would be lost by allowing them to make a larger number of sales of property, provided that the gains from such sales constitute an insubstantial portion of the REIT's taxable income, determined without regard to the dividends paid deduction. Accordingly, we do not oppose the provision in H.R. 4916 that would increase the number of permissible safe-harbor sales from five to seven. In addition, we regard the additional 15 percent of income safe harbor proposed in H.R. 4916 as an appropriate standard of insubstantiality. We also note that the expanded safe harbor under H.R. 4916 appropriately will continue to be limited to properties that have been held by the REIT for not less than four years and that the expenditures by the REIT during the prior four years in improving the property may not exceed 30 percent (increased from 20 percent) of the net selling price of the property. Finally, if the 15 percent of income safe harbor is used, substantially all of the marketing and development expenditures with respect to the property would have to be made through an independent contractor.

The repeal of the nondeductibility of net losses from prohibited transactions, as proposed in the bill, would eliminate a harsh result under current law, while the corresponding elimination of netting of gains and losses from prohibited transactions would serve as an even greater disincentive to intentionally engaging in prohibited transactions. Thus, we do not oppose these provisions of the bill.

The rule restricting REITs from performing services for tenants is designed to prevent REITs from engaging in active business operations. The unrelated business income rules that apply to tax-exempt organizations are intended to serve the same purpose. We believe that it is appropriate for the same standard to define the permissible activities in connection with the rental of real property for both REITs and tax-exempt organizations. Hence, we support the proposal in H.R. 4916 to apply the unrelated trade or business rules in determining whether a REIT has performed permissible services.

Income Determined by Profits of Another Person

The restriction that the qualifying income of a REIT does not include any amount of rent or interest that depends on the income of another person was adopted to give "assurance that no profit-sharing arrangement will in effect make the trust an active participant in the operation of the property." 17/ Although intended to prevent REITs from indirectly participating in the active operation of property, current law does so by disqualifying the income from any net profit-sharing arrangement, whether or not the arrangement results in the REIT participating indirectly in the active operation of the property. In general, H.R. 4916 would permit a REIT to share in the net profits of a lessee or borrower from the REIT, provided that the income of the lessee or borrower would be qualifying rent to the REIT. Because the bill would not permit a REIT to engage indirectly in activities in which it could not engage directly, we do not oppose this provision.

We understand that many REITs are concerned that this provision of the bill will be of little practical significance given the restrictions that apply to the qualifying rents of REITs. Of particular concern is the requirement, discussed above, that all services with respect to the property be performed through independent contractors. Although H.R. 4916 would liberalize this requirement, many lessees or borrowers from a REIT may be unwilling to restrict their own activities in order to preserve the qualifying character of the REIT's income. We would be willing to consider modified approaches that would increase the utility of this provision without permitting REITs indirectly to engage in substantial active operations. Possible approaches include requiring a separate accounting of income from activities in which the REIT could not engage directly or relaxing the independent contractor requirements as applied to a person, if the REIT shares less than a given percentage of that person's income.

A similar issue is raised in connection with shared appreciation mortgages. Although we do not believe it is appropriate to resolve the broader issue of the characterization of commercial shared appreciation mortgages in the narrow context of REIT legislation, we think it would be possible to identify circumstances in which income received by a REIT from a shared appreciation mortgage is qualifying income. Again, the issue is whether any rules that are adopted would have the effect of allowing a REIT to participate indirectly in the active operation of property. For example, such a result could occur in the case of a shared appreciation mortgage on property with respect to which development activities are being undertaken. While this issue requires some additional study, we suggest that applying the prohibited transaction rules on a look-through basis to income from such mortgages would be a useful starting point.

17/ H.R. Rept. No. 98-432, Part 2, 98th Cong. 2d Sess. 1746.

Shareholder Concentration

The qualification standards for RICs were amended in 1984 to eliminate the requirement that a RIC not meet the shareholder test of the personal holding company definition and to require that corporations initially electing RIC status distribute all of their earnings and profits accumulated in years in which they were taxed as regular corporations. The reasons for these changes were that, because closely held investment companies could qualify for pass-though treatment under Subchapter S, it would be anomalous to deny pass-through treatment under the RIC rules, and that it was appropriate to require distribution of previously accumulated earnings when the corporation first qualifies for pass-through tax treatment. 18/ Because the reasons underlying the RIC rule are applicable to REITs as well as RICs, we do not oppose the provision extending the earnings and profits distribution rule to REITs.

In addition, the bill would narrow the attribution rules for purposes of applying the stock ownership test of the personal holding company definition. The requirement that the stock ownership not be met, however, would be retained. We believe it would be simpler, and consistent with the RIC rules, to repeal this limitation entirely. Nonetheless, we do not oppose this amendment.

REIT Subsidiaries

H.R. 4916 would treat a REIT and certain wholly owned subsidiaries as a single corporation for Federal income tax purposes. We recognize that such a rule is inconsistent with conventional tax principles. We do not believe, however, that REITs should be prevented from limiting exposure to loss by separately incorporating different properties. Moreover, we believe that more conventional means of achieving this result, such as by treating a REIT and its wholly owned subsidiaries as a consolidated group of corporations and applying the REIT rules on a consolidated group basis, probably would be more complicated and serve no more effectively to minimize tax avoidance opportunities.

Deficiency Dividend Rules

The deficiency dividend rules were enacted in 1976 to prevent an inadvertent error in calculating the taxable income of a REIT from causing a failure to meet the distribution requirement (and hence disqualification of the REIT). The interest charge and penalty tax imposed on deficiency dividends were intended to be burdensome in order to assure that "the net cost to the REIT of

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18/ H.R. Rept. No. 98-432, Part 2, 98th Cong. 2d Sess. 1746.

borrowing money from its shareholders (that is, the net cost of underdistributions) is high enough to discourage such action and to encourage the distribution of earnings to shareholders currently." 19/

A deficiency dividend is, in effect, borrowed in part from the REIT shareholders and in part from the government. The portion of the deficiency dividend that is borrowed from the government is the tax that would have been paid by the REIT shareholders had the distribution been paid currently. The remainder of the deficiency dividend is borrowed from the REIT shareholders. Because the REIT must pay interest to the government on the full amount of the deficiency dividend, the government receives interest both on the portion of the deficiency dividend borrowed from it and on the portion borrowed from shareholders. We believe that this rule will, by itself, act as a sufficient disincentive to the intentional utilization of the deficiency dividend procedure. Accordingly, we do not object to the repeal of the penalty tax on REIT deficiency dividends.

Distribution Requirement

As discussed above, a REIT generally is required to distribute currently to shareholders an amount that equals or exceeds the sum of 95 percent of the REITTI (determined without regard to the dividends paid deduction and by disregarding net capital gains) and 95 percent of its after-tax income from foreclosure property. H.R. 4916 would except from this requirement certain non-cash income and income from failed section 1031 exchanges.

We question whether the non-cash income that would be excepted under the bill should be distinguished from economically equivalent income that is received by a REIT and reinvested. Nonetheless, we recognize that, in certain situations, the receipt of large amounts of non-cash income may force a REIT that lacks liquid assets to borrow funds in order to satisfy the distribution requirement. The proposed amendment is limited to situations of this type. We note, moreover, that the consequence of a failure to distribute income currently is an entity-level tax on the undistributed income. For these reasons, we do not oppose the amendment.

Taxable Year and Spill-over Dividends

As discussed earlier, the version of H.R. 3838 approved by the Senate Finance Committee would eliminate the deferral of tax resulting from the utilization by RICs of a taxable year other than the calendar year and the payment of spill-over dividends. We believe the Subcommittee should consider extending the calendar year provision to those REITs that remain entitled to use a fiscal year.

19/ S. Rep. No. 94-938, 94th Cong. 2d Sess. 466 (1976).

In addition, we believe the Committee should consider extending to REITs the spill-over dividend provisions that the Senate Finance Committee's version of H.R. 3838 would apply to RICs. The spill-over dividend excise tax contained in that bill would permit significantly less deferral of tax than the rules that apply to spill-over dividends of REITs under current law.

H.R. 4448

Mortgage-Backed Securities

Overview

Treasury supports legislation which would provide rules for the tax treatment of multiple class mortgage pools and the investors in such pools. Uncertainty under current law may result in inconsistent reporting of income by holders and issuers of interests in multiple class mortgage pools, as well as the conversion for holders of ordinary interest income into capital gain. Since we expect the market for multiple class mortgage pools to grow, we are seriously concerned about the potential revenue loss from continued uncertainty in this area. We thus support legislation clarifying the proper reporting of income and deductions with respect to mortgage-backed securities. We also support, subject to appropriate safeguards, legislation that would impose a single level of tax with respect to the underlying mortgages.

Although we support legislation in this area, we remain concerned about the growth of Federal credit, including that of the Federal agencies active in the secondary mortgage market. As we have testified previously, we believe it important to encourage private issuers of mortgage securities to enter that market. To this end, Treasury supports limiting legislation in this area to prevent participation in multiple class mortgage pools by the Federal agencies.

Background

Recent years have seen not only substantial growth in the secondary mortgage market, but also the development of new forms of mortgage-backed securities. Traditionally, mortgage-backed securities have been issued as certificates of undivided beneficial interest in "fixed investment trusts," which are viewed for tax purposes as grantor trusts. In this format, the certificate holders are treated as the beneficial owners of the mortgages and bear all income taxes with respect to the mortgages. The grantor trust format, however, prevents issuers from taking advantage of the fact that long-term yields exceed those for short-term obligations or from offering investors any degree of protection against uncertainty as to the maturity of their investments arising from the possibility of prepayments of the underlying mortgages.

Because individual mortgages typically are composed of a series of equal monthly payments, the cash flow from a pool of mortgages has the same temporal pattern as a series of short- and long-term obligations. A mortgage pool may thus be used to collateralize an issue of debt obligations with differing terms by allocating the anticipated mortgage payments among the different classes of securities. Such arrangements, known as "fast-pay/slow-pay" or "multiple class" pools, permit the issuer to price interests in the mortgage pool so as to take advantage of the different maturities and to offer the various classes some degree of predictability as to the term of their investment. In this fashion, multiple class mortgage pools permit an issuer to secure a better return from a secondary marketing.

The Multiple Class Trust Regulations

In an attempt to incorporate the advantages of the multiple class structure in the grantor trust format, Dean Witter Reynolds, Inc. and the Sears Financial Network in 1984 structured two grantor trusts offering investors differing temporal interests in the payment rights on $500 million pools of residential mortgages. Dean Witter and Sears successfully marketed the first pool, but in April 1984, before interests in the second pool were sold, the Internal Revenue Service proposed regulations denying trust status to arrangements having multiple classes of ownership interests.

Historically, whether an investment trust is classified as a trust or as an association taxable as a corporation has focused on whether the investors' interests were fixed or could instead be varied under the terms of the trust agreement. A power to vary the investors' interests, even though only in contingent form, is sufficient to deny the arrangement trust status. Thus, the investment trust regulations limit trust classification to "fixed investment trusts" where there is no power under the trust agreement to vary the investors' interests.

At the time these regulations were first promulgated in 1945, fixed investment trusts had only one class of investment certificates. The certificates represented undivided interests in the trust property and were, in form, receipts for the securities held by the trust. This use of a trust to hold investment assets and facilitate direct investment in a pool of assets by investors is consistent with the custodial purposes that have traditionally limited trust classification.

A multiple class investment trust, such as that formed by Dean Witter and Sears, departs from the traditional form of a fixed investment trust in that the beneficiaries' interests are not undivided, but diverse. The existence of varied beneficial interests indicates that the trust is not employed simply to hold investment assets, but serves the additional purpose of providing investors with economic and legal interests that could not be acquired through direct investment in the trust assets. Such use of an investment trust introduces the potential for complex allocations of trust income among investors with the possibility that the timing and character of the investors' aggregate income will differ from that of the trust.

The difficult questions that arise concerning the allocation of income to investors with diverse interests are properly foreign to the trust area. The complexity necessary to accommodate varied forms of commercial investment, including an economic substance requirement to limit artificial allocations of income for tax purposes, would certainly result in a set of rules that would be virtually incomprehensible to all but the most sophisticated fiduciaries. Thus, Treasury recently issued final regulations which affirm the general rule of the proposed regulations and provide that trust status generally is denied to investment trusts with multiple classes of ownership.

Collateralized Mortgage Obligations

Because the traditional grantor trust format is inconsistent with the multiple class structure for mortgage pools, issuers have increasingly employed thinly-capitalized, single purpose financing entities (typically corporations) that hold pools of mortgages and issue classes of debt securities collateralized by the underlying mortgages. This type of debt obligation is known as a collateralized mortgage obligation ("CMO"), and nearly $33 billion have been issued since 1983.

The CMO structure is a relatively inefficient vehicle for marketing a pool of mortgages. The issuer ideally would prefer to have no residual economic or tax consequences from its holding of the underlying mortgages. Although this economic result might be accomplished in many cases by leaving the issuer without significant capital and issuing obligations that, in the aggregate, exactly mirrored the characteristics of the underlying mortgages, this would threaten the issuer's status for tax purposes as the owner of the mortgages and the issuer of debt. The CMOs could be deemed to constitute equity interests in the issuer or to represent instead direct interests in the underlying mortgages. Either characterization could leave the issuer with a tax liability on the mortgage income that would more than offset the economic advantages of the multiple class structure.

To ensure that the issuer will be respected as owner of the mortgages and that the CMOs will be characterized as debt for tax purposes, careful issuers have attempted to satisfy minimum capitalization requirements and to retain some residual interest in the underlying mortgages. This approach introduces a degree of economic inefficiency to the transaction, however, since it ties up capital in the issuer and prevents the issuer from borrowing fully against the underlying mortgages. To avoid this inefficiency, less cautious issuers have taken aggressive positions, providing little if any capitalization and retaining no significant residual interest in the underlying mortgages. Since the Internal Revenue Service has not yet publicly challenged the formal structure of a CMO transaction, the net effect at present is a secondary market in which conservative issuers operate at a disadvantage.

Taxation of CMOs

Current Uncertainty

The taxation of issuers and holders of CMOs under current law is uncertain. In particular, if a CMO is issued at a discount, it is unclear whether the likelihood of prepayments on the underlying mortgages must be taken into account in determining the allocation of original issue discount ("OID") to the various accrual periods under the obligation. Since prepayments generally have the effect of accelerating the accrual of OID, it is probable that most holders are ignoring the possibility of prepayments (at least until they actually occur) while at least some issuers are anticipating prepayments as a way to accelerate their OID deductions. Such inconsistent positions are obviously a source of revenue loss to the Treasury.

The potential revenue loss is even greater to the extent CMO holders that have reported less OID than has accrued economically are able to sell these obligations for their true value, converting ordinary income into capital gain. On the other hand, issuers who do not properly estimate the effect of prepayments suffer an acceleration in the timing of the income that they are required to include as holders of the residual economic interest in the underlying mortgages. Because the expectation of prepayments is a critical factor in the formation and pricing of multiple class mortgage pools, any legislation addressing the taxation of such pools must also address the effect of prepayments on the proper accrual of original issue discount.

Phantom Income

Under current law, an issuer of CMOs includes in taxable income the interest it receives on the underlying mortgages, and receives a deduction for interest passed through to the holders of the CMOs. Although this result is consistent with the taxation of other corporations earning income and paying interest to creditors, in the case of the CMO issuer it produces a timing discrepancy between its taxable and economic income. The explanation for this result is the phenomenon of so-called "phantom income," which is, in turn, a function of the differing yields on investments of different maturities.

Two points should be emphasized regarding phantom income. First, phantom income is always offset by an equal phantom loss in later periods, so that the total income from the mortgage obligations, although accelerated, is not overstated. Second, phantom income arises not from the creation of multiple class mortgage pools but from an inaccuracy in the taxation of the underlying mortgages. Because interest rates on short-term loans are typically lower than those on long-term loans, and because a mortgage calls for principal payments during every period of the loan term, the true economic interest rate on a fixed-rate mortgage will be slightly below the stated rate in the early years of the loan and slightly above the stated rate in the later years. For reasons of simplicity and administrability, mortgagors and mortgagees are required to account for interest on mortgage loans using a single yield to maturity, which has the effect of front-loading the interest accruals relative to the pattern of economic accrual. This occurs on every mortgage loan, whenever long-term interest rates exceed short-term rates.

As long as a mortgage is held by a single taxpayer, the accelerated interest deductions to the borrower are offset by accelerated interest income inclusions for the lender. If, however, the economic interests in the mortgages are split into two or more pieces with differing maturities, and if each piece is taxed correctly on its economic income, the accelerated interest deductions are no longer offset and a net revenue loss is virtually certain. If, on the other hand, the holders of all the interests in the mortgage pool are taxed in the aggregate on all the income of the underlying mortgages, one or more of these holders will necessarily be taxed on more income than has economically accrued, with an offsetting deduction in a later taxable year.

A simplified example, involving no contingencies and hence no residual economic interest, may serve to illustrate this phenomenon. Suppose A borrows $1 million from B in exchange for A's debt instrument calling for two equal annual payments of $576,190. In effect, A and B have entered into a two-payment mortgage with an effective interest rate of 10 percent. Now suppose that, on the same day, B borrows $528,615 from C, agreeing to pay C $576,190 at the end of one year (reflecting an interest rate of 9 percent) and borrows $471,385 from D, agreeing to repay $576,190 at the end of two years (reflecting an interest rate of 10.56 percent).

B now has no possibility of economic gain or loss from the transactions (assuming no default by A) since he has recouped his $1 million in loan proceeds and the two payments from A will exactly cover his obligations to C and D respectively. Nevertheless, B's interest income will not be offset by interest deductions on a year-by-year basis, as is shown by the following table:

Year	Interest Income on Loan to A	Deduction on Loan from C	Deduction on Loan from D	Total Interest Deductions
1	$100,000	$47,575	$49,775	$97,350
2	52,381	---	55,031	55,031

Thus, B has "phantom income" of $2,650 in Year 1 and a "phantom deduction" of $2,650 in Year 2.

Description of the Bills

H.R 4448

In general, H.R. 4448 allows the issuance of interests in a pool of mortgages to be treated as a sale of the mortgages to the investors, if certain conditions are met. Treated in this manner, no entity level tax is imposed on the mortgage pool. Investor interests in an "issue" (i.e., the mortgage pool) must constitute either "regular" or "residual" interests. A regular interest is a registered transferable interest which entitles the holder to a fixed stated principal amount and periodic interest payments or accruals on the outstanding principal balance. A regular interest is analogous to a typical CMO. A residual interest is also a registered transferable interest, but the holder's rights to payments are wholly contingent on the extent of prepayments on the underlying mortgages, income from temporary investments, and contingent payments (e.g., equity kickers) on the underlying mortgages. Both residual and regular interests are taxed as debt obligations and are treated as qualifying assets for purposes of the thrift bad debt deduction and REIT rules. In addition, H.R. 4448 prescribes new information reporting rules for regular and residual interests. These rules would extend existing reporting requirements to virtually all holders of these interests.

Under H.R. 4448, the issue must consist of only a fixed pool of residential mortgages and certain short-term "permitted investments." The issuer may not engage in any trading activities or in other prohibited transactions, including the receipt of compensation for services. In addition, a holder of mortgages generally would recognize gain (but not loss) upon transfer of the mortgages to the issuer in exchange for regular interests. Loss that is deferred when the originator transfers mortgages to an issuer and retains one or more of the interests in the issue would be allowed over the term of the interest as market premium.

To provide rules for the taxation of regular interests, H.R. 4448 would amend the original issue discount provisions of the Internal Revenue Code to provide specific rules for the accrual of original issue discount on a mortgage-backed security, including a regular interest. Under H.R. 4448, the accrual of OID on an obligation collateralized by mortgages is based initially on the stated maturity of the underlying mortgages, *i.e.*, the yield to maturity is calculated on the assumption that no prepayments will be made. Each time a prepayment on an underlying mortgage is received, shortening the maturity of the obligation, investors accrue additional OID equal to the increase in the present value of the stream of payments resulting from the prepayment (discounting at the yield based on the stated maturity).

Because the payments on a residual interest are contingent, H.R. 4448 adopts a different set of rules for taxing such investors. The bill essentially taxes residual holders on the excess of amounts "paid or credited" to them over the basis recovery amount for such period. The basis recovery amount is determined by allocating the price paid for the interest ratably over the estimated duration of the interest.

Under H.R. 4448, an issuer of mortgage-backed securities is relieved of any tax liability for income not taxed directly to regular or residual holders. The aggregate income of the underlying mortgages, however, generally will exceed the aggregate income of the regular and residual holders. This excess arises both from inaccuracies in the taxation of the regular and residual interests and from the phantom income problem discussed above. To limit the revenue loss that would arise from forgiveness of excess income, the bill allocates such income to the holders of the regular interests in proportion to the OID on these interests (subject to certain limitations) or, to the extent not so allocated, to the residual holders. The theory behind this allocation presumably is that the largest component of this excess income results from errors in reflecting prepayments accurately in the accrual of OID on the regular interests rather than from differing yields on debt instruments of different maturities.

Senate Finance Committee Bill

H.R. 3838, as reported by the Senate Finance Committee, contains provisions which relate to the tax treatment of entities issuing multiple interests in a pool of real estate mortgages, as well as the taxation of investors in such pools. The Finance Committee bill would authorize a new elective entity, known as a "Real Estate Mortgage Investment Company" or "REMIC." Although many of the technical aspects of the Finance Committee bill are drawn from S. 1959 (which is identical to H.R. 4448), the approach of the Finance Committee bill differs from S. 1959 and H.R. 4448 in that it would impose a corporate level tax on the issuer of multiple interests in a mortgage pool. This tax would be imposed on the difference between the mortgage income received by the issuer and the income of the regular and residual holders. Thus, the REMIC would pay tax on phantom income and also to the extent the income of holders of regular and residual interests is understated.

A REMIC may be organized as a corporation, association, trust or partnership. To qualify as a REMIC, the entity must meet many of the requirements applicable to an issuer under H.R. 4448, including the nature of its assets and the type of interests which it may issue. In addition, the REMIC must distribute 100 percent of its net cash flow within 15 days after the end of each taxable year.

The taxation of regular interests under the Finance Committee bill is similar to that under H.R. 4448, except that the holder is required to account for all interest on the accrual method, whether or not subject to the original issue discount rules. The bill also provides that an intention to call such obligations prior to maturity will be presumed; thus, gain on sale or retirement of a regular interest will be ordinary to the extent of unaccrued original issue discount. In addition, the bill grants the Treasury Department the authority to issue regulations prescribing rules for the recognition of market discount on an obligation, such as a regular interest, where principal is paid in installments.

Under the Finance Committee bill, the taxation of residual interests differs substantially from the treatment of such interests under H.R. 4448. In general, holders of residual interests are taxed only to the extent of actual payments. Payments to a residual holder are characterized as income to the extent accrued, computed by applying a deemed yield equal to the applicable Federal rate on the adjusted issue price of the interest. Distributions in excess of the amount of income deemed to accrue are first applied against the adjusted basis of the interest and, once basis has been fully recovered, are treated as gain from the sale or exchange of the residual interest. Taxable income received by a foreign holder of a residual interest is subject to the withholding tax on dividends. Assuming the proper yield to maturity is chosen, this method should result in a slower recovery of basis than under H.R. 4448 and, if the imputed yield approximates the actual expected yield, in a more accurate measure of the economic income of the holders of residual interests.

If an entity meets the qualification requirements and elects to be treated as a REMIC, the entity is subject to tax at the highest corporate rate. The taxable income of a REMIC is computed in the same manner as a regular corporation, except that a REMIC may claim a deduction for distributions to residual holders to the extent income is deemed to have accrued on the interest. Capital gain distributions, on the other hand, are not deductible by the REMIC. Thus, to the extent the economic yield to the residual holder exceeds the applicable Federal rate, payments from the REMIC to the residual holder are subject to a double tax. In addition, a REMIC is permitted an unlimited carryback of net operating losses. The purpose of this provision is to allow phantom losses to be carried back to offset phantom income in earlier years. Finally, a REMIC is required to accrue market discount currently.

The Finance Committee bill also provides that any entity which is formed to hold real estate mortgages and issue multiple interests in the pool is treated as a taxable corporation, without regard to its form for state law purposes. Thus, any multiple class arrangement which under current law might be treated as a conduit for tax purposes, would be treated as a corporation.

In addition, the bill treats regular interests in a REMIC as a qualified asset for REIT purposes and as a qualifying real property loan for purposes of the bad debt deduction for thrift institutions. Finally, the Finance Committee bill adopts compliance provisions similar to those contained in H.R. 4448.

Discussion

As stated previously, the Treasury Department supports legislation that would clarify the taxation of multiple class mortgage pools and investors in such pools. Without such legislation, we would be forced to address these difficult issues by regulation or ruling. While development of current law through the administrative process might ultimately lead to a satisfactory set of rules, this would follow many months or even years of uncertainty. Continued uncertainty in this area will encourage taxpayers to take inconsistent and aggressive positions, with a consequent revenue cost to the Treasury.

Taxation of Regular Interests

With respect to the taxation of holders of regular interests, we generally support the method of OID accrual contained in H.R. 4448 and the Finance Committee bill and believe it will result in a much closer approximation of the manner in which OID accrues economically. We would be willing to work with this Subcommittee and with interested taxpayers, however, to develop an even better approximation of the economic accrual of OID, bearing in mind that any approach that attempts to anticipate prepayments will necessarily entail greater complexity. Given this additional complexity, it may be appropriate to make any rules that anticipate prepayments elective by the issuer.

Taxation of Residual Interests and the Issuing Entity

As to the taxation of income not credited to holders of regular interests, the issues are far more complex. In concept, investors in a multiple class mortgage pool should be taxed on their economic income, and the entity established to issue interests in the pool should be exempt from tax if wholly passive. There are two problems, however, with this approach. First, while it is feasible to create a system that produces a reasonable approximation of economic income for regular interests, it is far less clear that a system for approximating the economic income of a residual interest holder can be devised, given the purely contingent nature of these interests and their extreme sensitivity to differences in the prepayment pattern on the underlying mortgages. Second, exempting interest holders and the entity from tax liability on phantom income would result in inconsistent taxation of the interest income and deductions in respect of the underlying mortgages. Although holders of regular or residual interests would be taxed only on their economic income, interest deductions would continue to accrue to individual mortgagors on an accelerated basis. Such asymmetry would produce a substantial revenue loss. Since it is not practical to alter the method under which mortgage interest deductions accrue, revenue considerations dictate that the matching that occurs under current law be retained by reflecting phantom income in some manner in the income of the entity or the holders of regular or residual interests.

As noted above, H.R. 4448 attempts to deal with these problems generally by taxing residual interests only on amounts paid or credited (with a straight-line basis recovery) and by taxing all additional amounts (including phantom income) to holders of discount regular interests. While this approach preserves the taxable income base, we are concerned that some significant loss of revenue would nevertheless result because the principal holders of discount regular interests (typically the slower-paying interests) will be pension funds and other tax-exempt or low-tax entities.

In general, the Treasury Department supports the provisions of the Finance Committee version of H.R. 3838 in this area. Because of concern that legislation not facilitate the allocation of phantom income to persons not subject to tax, the Finance Committee effectively traps phantom income at the entity level. This is, of course, the most direct way to assure that phantom income does not escape taxation.

We are concerned, on the other hand, that the specific provisions contained in the Finance Committee bill may go farther than is necessary to protect against revenue loss. By limiting the return on residual interests to the applicable Federal rate and by taxing all phantom income at the highest corporate rate, significantly more income may be subject to tax at the highest corporate rate than under current law and some income may be subject to a double tax. In addition, representatives of the mortgage industry have voiced concern that a substantial entity-level tax may pose difficulties to the issuer that, in many cases, outweigh the economic benefits of creating multiple-class mortgage pools.

The Treasury Department believes that it is in the mutual interests of the Congress, the Treasury Department, and the mortgage industry to continue to work together to devise a workable solution to these problems that does not entail significant revenue cost. In particular, Treasury would be willing to work on approaches that would minimize or even eliminate the impact of the entity-level tax without significant loss in revenue.

Treasury is also of the view that whatever rules are finally enacted to deal with the problem of multiple class mortgage pools should be the exclusive rules in this area. Thus, we support the elimination of other conduit vehicles for multiple class mortgage pools. We suggest, however, that an appropriate transition period be provided which would allow issuers to continue to offer existing types of multiple class pools available under current law. This interim period would permit issuers to adjust to the new rules and would help avoid disruptions in the secondary mortgage market.

Other Assets

Although neither H.R. 4448 or the Finance Committee bill pose the issue directly, it is appropriate to consider whether legislation allowing multiple class debt pools should be limited to pools of real estate mortgages. If legislation in this area is adopted, we believe it is appropriate that multiple class arrangements for which pass-through treatment is granted be limited at this time to debt obligations in the nature of real estate mortgages or mortgage-backed securities. Although multiple class pools of auto loans, lease receivables, corporate bonds, and various other obligations would appear closely similar in concept to multiple class mortgage pools, we believe it appropriate to proceed with some caution in this area. Thus, Treasury believes it appropriate that we gain experience with multiple class mortgage pools before extending these concepts to multiple class pools of other debt obligations. Moreover, because of real estate mortgages' typically long term and significant incidence of prepayment, they present the most pressing case for the allowance of multiple class arrangements.

To summarize the Treasury Department's views with regard to the pending legislation, we hope the efforts to clarify the tax rules in this area will move forward and that an approach that satisfies the concerns of the industry without a loss in revenue can be found. To that end, we offer our support for these efforts and pledge to work with this Subcommittee and industry representatives to achieve a practical solution to these difficult tax issues.

O o O

This concludes my prepared statement. I would be pleased to respond to questions.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

STATEMENT OF THE HONORABLE DAVID C. MULFORD
ASSISTANT SECRETARY OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON WESTERN HEMISPHERE AFFAIRS
OF THE
COMMITTEE ON FOREIGN RELATIONS, U.S. SENATE
Washington D.C.

June 10, 1986

Mr. Chairman, I welcome the opportunity to appear before this subcommittee to discuss Mexico's economic situation. My remarks today will focus on the present state of the economy and address the major problems facing Mexican policymakers. I will review the developments leading to the 1982 financial crisis and the measures taken by the Mexican government to cope with it. This provides the necessary context for an understanding of how Mexico is managing its present problems.

Introduction

Mexico and the United States share a close economic and financial relationship. Mexico is our third largest trading partner. U.S. direct investment in Mexico is estimated at $5 billion with the presence of some 2,900 U.S. firms. Although Mexico has attracted substantial equity capital from other nations, the United States remains the largest single source of private foreign direct investment.

Mexico has also become a major player in the world economy. It is the twelfth largest economy and the second largest LDC debtor, with an estimated $97.4 billion in outstanding obligations. Of this, nearly $74 billion is owed the commercial banks, including $24.4 billion to U.S. banks -- about one-third. This has made Mexico one of the focal points in our debt strategy.

We enjoy a close working relationship with Mexican financial officials who have repeatedly demonstrated Mexico's commitment to being a responsible member of the international financial community. Unlike a number of other nations, Mexico has not permitted significant accumulation of payments arrears and the adjustment of its external accounts after 1982 was impressive. Through determination and perseverance, Mexico became a model adjuster in the post-1982 period as it eliminated its current account deficit even in the face of sharply reduced economic output.

The sacrifices of the Mexican people after 1982 have made the impact of the sudden oil price collapse in 1986 all the more onerous. This year will be the third out of the last five that Mexicans will have to endure economic contraction. Against this background, the rapid adjustment required by the sudden loss of oil revenues becomes all the more difficult.

Mexican officials are well aware of the dimensions of their current problems and the need for early resolution. The government has already taken numerous steps to deal with these problems, including actions to cut spending, sell off state enterprises, and shift debt into equity. These difficult steps have not received the recognition they deserve and Mexico has not been given credit due. When it comes to Mexico, there is a tendency to be quick with criticism and cautious with praise.

Events Leading to the 1982 Crisis

Mexico's present situation can only be understood and assessed against the background of the 1982 crisis and events since then. The oil windfall of the late 1970's was used to spur economic growth, with only modest efforts to diversify the economy's export base. In this regard, Mexico behaved no differently than most other oil exporters. The rapid pace of economic growth, which averaged 8.5% from 1978 to 1981, created serious structural bottlenecks. As a result, inflation began accelerating, reaching 99% in 1982, compared with 29% in 1981. Instead of dealing with the root causes of these problems, Mexico resorted to additional foreign borrowing. In 1981 alone, Mexico's foreign debt increased by $18 billion.

In part, this was because the commercial banks continued to lend and at low spreads. Real interest rates in the late 1970's were negative. Thus, as was the case with other large debtors, Mexico's continued borrowing from abroad was not surprising.

However, most of Mexico's external debt carried floating interest rates. As interest rates peaked in 1981, the real interest rate on the foreign debt became sharply positive and Mexico's debt service increased substantially. With the world recession, softening oil prices and Mexico's own economic performance, banks became concerned about Mexico's creditworthiness. They began to reduce their lending to that country and before long the probability of a financial crisis became very high.

Mexico's announcement over the weekend of August 13, 1982 that it was suspending payments on its external obligations caused a near panic in the financial markets. There were widespread fears that other major debtors would follow suit and cause irreparable damage to the financial system.

However, with the close cooperation of official and private creditors and the IMF, Mexico quickly implemented a major stabilization program, and serious disruption to the financial system was avoided.

Stabilization After the Crisis

The economic stabilization program that the de la Madrid administration undertook in the wake of the 1982 crisis brought Mexico's external accounts under control in a relatively short time. However, as was the case with a number of debtor nations in the first round of the adjustment to the new financial and economic conditions of 1983-1984, the degree of internal adjustment accomplished by Mexico was limited. This was in part due to the high political and economic costs associated with it

Following the 1982 crisis, the Mexican government took some very tough measures on the fiscal, monetary and foreign exchange fronts. As a result, economic activity dropped by 0.5% in 1982 and another 5.3% in 1983; imports were reduced by 40% in 1982 and a further 45% in 1983. The current account swung from a deficit of $6 billion in 1982 to a surplus of over $5 billion in 1983. During this period because of its good progress on the external side, Mexico was seen by many as a model adjuster.

In 1984, the economy grew by 3.5% and the current account registered a surplus of $4 billion, despite a 31% growth in imports. But the external adjustment began to slow late in the year since further improvement on the balance of payments could only come from further growth and improved export performance. While Mexico's imports dropped by two-thirds between 1981 and 1983, a development that contributed to our own growing trade deficit, its exports grew by less than 11% during this period.

This disparate performance reflects the fact that Mexico was plagued by economic and structural problems rooted in its past. Having followed a policy of import substitution since the 1940's, Mexico had not by the early 1980's sufficiently diversified its export base and thus its capacity to expand non-oil exports quickly during this period was limited.

In 1985, Mexico suffered an 11% decline in oil receipts that was exacerbated by declines in non-oil exports due in part to an overvalued exchange rate for much of the year. In an effort to sustain economic growth, the government adopted expansionary fiscal and monetary policies despite the lower oil revenues. While growth was maintained at about the 1984 pace, inflation accelerated as the government monetized a substantial portion of the government deficit.

The Mexican Economy Today

Mexico's attempt to maintain economic growth in the face of declining oil revenues made it particularly vulnerable to the 50% drop in world oil prices that took place in the short space of six-weeks in early 1986. Since approximately half of Mexico's government revenues are based on oil exports, the drop in prices translated into a 25% real decline in government revenues.

Coming as it did after four years of economic adjustment, this traumatic contraction was not only economically painful, but politically demoralizing.

The problem now facing Mexico is how to undertake additional substantial adjustment within a very short time frame. This is necessary to stabilize the balance of payments, reduce the fiscal deficit and contain inflation so as to preserve confidence in the peso. To its credit, the de la Madrid administration has taken several steps to contain the fiscal deficit. These include:

-- the continued divestiture of state enterprises, including the closing of a large but inefficient steel mill involving the loss of 5,000 jobs;

-- reduction in direct subsidies to parastatals, a problem that has plagued Mexico's economy for many years.

-- reduction in government subsidies for basic goods and services;

-- encouraging increased foreign investment and a reduction of the debt burden through the use of debt/equity swaps; and

-- implementing a tight credit policy, which in the first four months of 1986 reversed capital flows into Mexico.

The Mexican authorities estimate that in 1986 they will lose about $6 billion in oil export earnings. They also estimate that total external financial requirements are on the order of $5-6 billion. This is not much greater than the amount estimated before the drop in oil prices. The reason for this is that the Mexicans themselves expect to absorb the bulk of the loss in oil revenues. In fact, economic activity in 1986 is anticipated to decline by 3-5%.

As I have noted, large public sector deficits are a major source of inflation in Mexico. Like most other developing countries, Mexico has limited domestic private savings and underdeveloped capital markets. As a result, Mexico is often forced to monetize as much as half of its fiscal deficit. Foreign borrowing can be used to help finance the deficit, but it may not always be available in sufficient quantity. Thus, Mexico has not been able to avoid some of the most undesirable aspects of deficit financing, as indicated by the rise of inflation. At present, inflation is running at about 85% on an annual basis, compared to 64% in 1985 and 28% in 1981.

<u>The Investment and Trade Climate</u>

Foreign investment capital could play a more significant role in Mexico's development at a time when additional bank lending is both difficult and unattractive. However, the foreign investment law adopted in 1973 and subsequent government decrees affecting autos, pharmaceuticals, and other sectors have adversely affected Mexico's investment climate.

The de la Madrid administration announced this past March that it would administer the foreign investment law more flexibly. The increase in the number of applications approved since then seems to indicate a change in attitude. The decision last year to allow a major U.S. multinational to set up a 100% wholly owned subsidiary in Mexico was another indication of a more open attitude toward foreign direct investment by the de la Madrid administration.

The de la Madrid administration is also trying innovative approaches to attract foreign direct investment. Recently, it has been promoting debt/equity swaps which have the benefit of reducing the foreign debt while potentially increasing equity capital inflows. Mexico agreed to a provision in its 1985 debt rescheduling agreement with commercial banks to allow for the use of debt/equity swaps. We believe, and the Mexicans agree, that debt/equity swaps can play an expanding role not only in direct investment by foreigners, but also in the possible reflow of capital held abroad by Mexican nationals.

Mexico is also making considerable progress in rationalizing its trading system through replacement of most import licenses with tariffs. This eliminates unnecessary red tape and represents a first step in opening up the Mexican economy to foreign competition. To help this process along, Mexico is negotiating a large Trade Liberalization Loan with the World Bank.

Mexico and the Program for Sustained Growth

Mexico is one of the major debtor countries expected to benefit from the Program for Sustained Growth. It is presently involved in intensive negotiations with the World Bank on a number of fast-disbursing policy-based loans, including the Trade Liberalization Loan already mentioned. These loans are expected to increase World Bank lending to Mexico in 1986 to about $1 billion net, which is significantly higher than previous levels.

In addition, the Mexican authorities are engaged in continuing negotiations with the IMF on a new stand-by arrangement. Not surprisingly, we understand that the size of the fiscal deficit and the accompanying inflation rate are the major issues under discussion. We hope that the two sides can soon come to an agreement so that Mexico can begin negotiations with the commercial banks on a new money package. If Mexico can successfully implement a new IMF program and important economic reforms in connection with this program and with its World Bank loans, there is every reason to believe that private credit markets will respond.

CONCLUSION

Mr. Chairman, I have briefly reviewed Mexico's economic situation. I have attempted to be candid in my comments in the hope that, by airing these issues fully, we can better appreciate Mexico's economic problems.

Mexico is an important trade and investment partner. We have been working closely with Mexican authorities and they have kept us fully informed of their situation. In our experience, Mexico's economic team has demonstrated competence and a strong commitment to improve their country's economic performance.

The development of the Mexican economy is in the interest of both Mexico and its creditors. Patience, objectivity and sound judgment are of the utmost importance at this juncture.

The task ahead is not easy. But with our support, Mexico's own efforts to grapple with its difficult economic problems, and with the assistance of the international financial institutions and private banks, we are confident that Mexico can stabilize its situation and return to sustainable economic growth.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M. June 10, 1986

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $14,800 million, to be issued June 19, 1986. This offering will result in a paydown for the Treasury of about $4,650 million, as the maturing bills total $19,458 million (including the 15-day cash management bills issued June 4, 1986, in the amount of $5,000 million). Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, June 16, 1986. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,400 million, representing an additional amount of bills dated March 20, 1986, and to mature September 18, 1986 (CUSIP No. 912794 LD 4), currently outstanding in the amount of $6,840 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,400 million, to be dated June 19, 1986, and to mature December 18, 1986 (CUSIP No. 912794 LP 7).

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing June 19, 1986. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold $1,587 million as agents for foreign and international monetary authorities, and $3,777 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series).

B-618

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-2041

Text As Prepared
For Release Upon Delivery
Expected at 7:00 PM EDT

Remarks for the Secretary of Treasury
James A. Baker, III
At the National Foreign Trade Council Dinner
in New York City
Wednesday, June 11, 1986

I am pleased to be with you. I appreciate having the opportunity to come before this distinguished group and discuss Administration policy. For 72 years, the National Foreign Trade Council has been a powerful voice for free trade and a competitive America.

There is undoubtedly a great deal of accumulated wisdom in a Council that has observed the ebb and flow of trade for so long. You have much to teach those of us involved in trade policy in Washington.

You could recount, for example, how in the 1920s a few ripples of protectionism coalesced into a swell in the form of the Fordney-McCumber tariff. This swell gathered momentum and ultimately became a tidal wave called Smoot-Hawley that smashed the world trading system in the 1930s. After the wave broke, the waters became still under the calming influence of the General Agreement on Tariffs and Trade. The ships of free trade sailed swiftly over these smooth waters, carrying prosperity to all parts of the world.

But now, in recent years, the waters have grown choppy and rough again. Subtle and tricky currents, never before seen, pose unexpected dangers. Trade barriers loom like icebergs, and below the surface lurk more subtle barriers. A wave of protectionism may be gathering once more. Those who remember the lessons of history, and cherish the blessings of free trade, must unite to resist this wave.

B-619

But in so doing, we must not panic and run for quick-fix solutions. We must look to comprehensive solutions that address fundamental causes. Rough waters often reflect broad climatic changes or massive seismographic shifts in the earth below the sea. Trade problems often result from movements in the general economy. The Fordney-McCumber tariff in 1922 aimed to protect certain infant industries. The Smoot-Hawley bill came as the depression spread.

Today, our trade deficit reflects such obvious factors as foreign trade barriers, but also less publicized but very powerful factors as differing growth rates among the U.S. and its trading partners, currency values, less developed country debt, and difficulties in certain sectors of our economy.

These factors are more influential and complex than fifty years ago. Each country is now more vulnerable to developments in other nations. In the United States, one of every eight jobs is related to exports, as is two out of every five acres devoted to agricultural production. In some countries, trade is equal to as much as 50 percent of their Gross National Product.

The existence of these factors means that the trade deficit can't be papered over with protectionist legislation. The underlying movements will inevitably shred the paper cover -- dashing false hopes and exposing the policy as inadequate.

President Reagan, therefore, has designed an international economic strategy that takes these factors into account. As he laid out this strategy last September, it has four parts: strengthening the functioning of the international monetary system through closer economic cooperation; promoting stronger and more balanced growth among the major industrial nations; improving growth in developing nations with a heavy debt burden; and last, but not least, promoting free and fair trade.

We believe these elements are the best way to reduce the U.S. trade deficit and the dangerous protectionist pressures associated with it. The policy has already brought significant progress toward establishing the fundamental conditions necessary to achieve and maintain a sound and growing world economy, more balanced trade positions, and greater exchange rate flexibility.

A key contributor to this progress was the Plaza Accord reached here in New York City last September among the "G-5" nations -- Japan, Great Britain, France, Germany and the United States. Since the Accord, exchange rates have moved considerably, and this should play an important role in reducing external imbalances.

At the same time, experience has shown that exchange rate changes alone should not be relied upon to achieve the full magnitude of the adjustments required in external positions. This is one reason why we place such importance on strong, sustained and better balanced growth among the industrial countries. Without greater growth abroad, increased reliance will need to be placed on exchange rates in the adjustment of payments imbalances.

At the recent Tokyo Summit, therefore, we built on the success of the Plaza Accord. We established a process for closer policy coordination.

Under the system, the participating countries will regularly review economic objectives and forecasts with their peers and the managing director of the International Monetary Fund. They will take into account a broad range of indicators such as those spelled out in the Tokyo Summit communique. The internal and external consistency of these projections will then be assessed with a view to necessary adjustments. If significant deviations from an intended course emerge, the participants have pledged to exert best efforts to adopt remedial action.

The Tokyo arrangements do not involve any ceding of sovereignty, nor should they. But if the system is to work, the participants will of their own volition -- to be sure -- under the watchful eye of their peers -- have to take external considerations into account in formulating their domestic economic policies. For the United States this only reflects the reality that the time is long past when the U.S. could, in setting domestic policies, relegate external considerations to an insignificant order of importance.

The major implications for U.S. policy at the present are fairly clear. We must follow through on our program to reduce our budget deficit. The Congress has to complete action on tax reform. Monetary policy must continue to be directed toward sustained, noninflationary growth. And we must avoid the pitfalls of protectionism (more on that in a minute).

The system will only be viable, however, if other nations are prepared to accept similar responsibilities. If U.S. economic policies are to be adjusted to take into account international concerns, others too must be willing to adjust policies. Countries such as Germany and Japan with large trade surpluses must recognize the global need for stronger domestic demand to facilitate the adjustment of external imbalances.

I've described two parts of the President's international economic strategy -- improving the monetary system and encouraging industrial country growth. Let me turn to a third.

The global community has a strong stake in economic stability and growth in the debtor nations, and the successful management of their debt problems. Debt service problems affect all of us, in terms of reduced exports, lower growth, and a less stable international financial system.

Recent progress in this area is heartening, and provides a sound basis for future progress. There is now broad agreement (when not too long ago there wasn't) among both creditors and debtors that improved growth in the debtor nations is essential to the resolution of their debt problems, and that growth-oriented reforms are needed to achieve this goal.

And, centered on that growth theme, we have an agreed basis on which to proceed. The debt initiative outlined by the United States in Seoul last fall has received the strong support of the international community. It is now being carried out through individual debtor's discussions with the IMF and the World Bank.

Moreover, recent improvements in the international economy are providing significant and timely relief for the debtor nations. Stronger growth in the industrial nations this year will add about $2 billion to the major debtors' exports. The sharp decline in interest rates since 1984 will save them $12 billion a year, and lower oil prices will save the oil-importing members some $2 billion annually.

These growth and interest rate changes if sustained, could be more important to a resolution of the debt problem than the amount of new financing by the commercial banks or the much-touted World Bank general capital increase. But to attain stronger growth, debtor nations must adopt growth-oriented policies.

Such changes will not be easy. Commercial bank support for these reform efforts is crucial. Once reforms have been agreed upon, commercial banks must be ready to lend without delay. Coordination among banks -- large and small, U.S. and foreign -- will be a vital part of this process.

And I would hope that the banks are using effectively the time they have now -- in advance of agreement on specific reforms -- to put mechanisms in place which will assure that financing packages can be assembled quickly when called upon.

Recently, much attention has been given to Mexico's efforts to cope with its debt problems. We are actively working on this issue, and are confident that Mexico can stabilize its situation.

I've described so far some of the more basic factors that underlie the choppy surface of the ocean of trade -- less developed country debt, the growth rates among nations, and exchange rates. If these issues are resolved in a coordinated fashion, then trade will flow more smoothly, without so much "pitching to and fro" and turbulence and seasickness and ill tempers.

At the same time, we must address directly these problems on the surface -- the fourth part of the President's strategy -- promoting free and fair trade. Open markets promote growth worldwide and aid our efforts to adjust trade imbalances among industrial nations.

In keeping with the ideal of international cooperation, our efforts to open markets begin at the multilateral level. We are pleased that preparations are well advanced for launching the new round of trade negotiations under the auspices of the General Agreement on Tariffs and Trade. The GATT has served the world well for nearly forty years, but has not completely kept up with the rapid proliferation of trade and trade barriers. The GATT needs to be modernized, streamlined and expanded.

Our Summit partners agreed in Tokyo to the U.S. proposal that the new round of negotiations should include services and trade related aspects of intellectual property rights and foreign direct investment. Agricultural issues are a priority for the United States, and they will also be included in the new round.

While we get ready for multilateral negotiations, we are also carrying on bilateral discussions to open up markets. Last year, for example, we successfully conducted the so-called MOSS talks involving four sectors of Japan's economy. This year talks will focus on additional sectors, including auto parts.

Moreover, we have been pursuing an aggressive program against unfair trade practices. Over the past ten months, the Administration has taken nearly two dozen actions to allow American goods and services to compete on equal footing with foreign competitors.

President Reagan is the first President to self-initiate Section 301 cases against unfair trade practices. Section 301 is a powerful weapon for opening markets, but previously, industry had to go to all the time and expense to start a case.

There already has been considerable success. We have settled disputes involving the European Community's subsidies for canned fruit, Japan's footwear and leather import quotas, Taiwan's import monopoly for liquor and tobacco, and Korea's restrictions on foreign motion pictures.

The answer to our trading problems is a strategy that addresses international issues in cooperation with other nations. The answer most certainly is not a resort to unilateral, self-defeating trade barriers. We want to open foreign markets, not close ours. As President Reagan emphasized last week, he will veto "kamikaze" legislation that could trigger a trade war and send our economy into a nose dive.

It is appropriate to recall here that fifty-six years ago, this very week, the House and the Senate passed the Smoot-Hawley tariff. The bill raised the average levy on imports to 60 percent -- the highest in the twentieth century. It was designed to cure all sorts of economic problems in the United States.

Like today's protectionist legislation, Smoot-Hawley was propelled by extravagant rhetoric. "If this bill is passed," predicted a leading member of the Senate on behalf of Smoot-Hawley, "this nation will be on the upgrade, financially, economically, and commercially within thirty days, and within a year from this date we shall have regained the peak of prosperity."

Not unlike what's going on today, Members of Congress vied with each other to demonstrate how "tough" Smoot-Hawley would be on our trading partners. One Member was loudly applauded by his colleagues when he suggested that the tariff wall be built so high that foreigners would break their legs trying to climb over it.

Within 30 days, instead of instant prosperity for the United States, an economic and political disaster began to spread. Nations retaliated almost instantly. Spain, Italy, Switzerland, France, Britain, Canada and numerous other nations raised tariffs, boycotted American goods, and installed exchange controls. The London Morning Post called on "all men of British blood, wherever they may be, to unite against this peril as they united against the Germans in 1914."

U.S. merchandise exports sank 60 percent from 1929 to 1932. Scholars agree that the loss of trade significantly deepened the Great Depression. The only winners of the bitter tariff battle were dictators who profited from the economic misery it created.

Today, a trade war would create nothing but misery also -- perhaps more so. The House of Representatives has just passed an omnibus bill that could touch off an enormous trade conflict. The bill would force other countries to cut their trade with us, no ifs, ands, or buts. We would be sucked into all sorts of disputes. The flexibility a President needs to administer trade would be sharply restricted. Finding a middle ground in sensitive trade negotiations would be impossible.

Once the button was pressed, the protectionist missiles could not be recalled. American exporters, consumers, and manufacturers would be held hostage. The consequences of such actions would be incalculable in terms of inflation, inefficiency, and unemployment.

And the repercussions would not be merely economic. A trade war would involve primarily our friends and allies. Vital foreign policy and national security goals would be jeopardized if we alienate our trading partners. Our ideals of cooperation and international harmony would be crushed by any retreat to protectionism.

A trade conflict is vastly different than a struggle against terrorism or communism. In the latter, we defend freedom. A trade war, on the other hand, destroys freedom -- such as the freedom of American consumers and manufacturers to buy products they can afford, the freedom of our farmers to sell their products abroad, and the freedom gained from prosperity in general.

In the struggle against tyranny, we stand with our friends. In a trade war, we stand alone.

Protectionism poses a particular challenge to the business community and all organizations that support free trade. It is sometimes supposed that a dramatic shift in public opinion is behind the protectionist movement in Washington in recent years. But polling data, as compiled by public opinion analyst William Schneider, seem to indicate that the level of protectionist sentiment in the general public has not changed very much over the last ten or so years.

The shift in opinion, Schneider observes, has come among business executives. Increasing percentages of these elites believe that trade barriers are necessary, and this sentiment encourages protectionist proposals.

A special responsibility therefore rests with those of you in the business community to work for free trade. Your opinions are respected. Your influence on the course of events can be considerable. The cry for protectionism today is clear and forceful. The voice of free trade must also be fully heard.

This is the responsibility of the United States to the world as well. Since our noble experiment began in the wilderness centuries ago, we have set ideals that sophisticated skeptics of the old world said never could be reached. We may not have attained all of these ideals yet, but in pursuing them, we have achieved a measure of greatness. And we have inspired the world to follow in our footsteps.

But should the United States abandon its free trade principles and launch large-scale protectionism, what kind of example would we set for the world? And what sort of model would we be for our idealistic youth, whom we have raised to believe in a dynamic United States and its heritage of freedom? The bottom line is if the U.S. goes protectionist -- we will lose the world's free trading system.

The results of a trade war would be manifold, but perhaps the most enduring would be disillusionment. The hopes for a better world would be dimmed. As D.H. Lawrence wrote of World War I, "all the great words were canceled out for that generation." After a trade war, the words we use today, like "freedom, growth, opportunity" would lose their meaning as well. And without words to live by, achievement is not possible.

But I am confident that, if we commit ourselves to the task, and follow our strategy, we can build on the progress we have made in recent months. We can create a brighter future, and set a good example for all, in our service to the country that Lincoln called the "last, best hope of earth."

Thank you.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE UPON DELIVERY
June 10, 1986

Statement by
Robert A. Cornell
Deputy Assistant Secretary
for Trade and Investment Policy
Department of the Treasury

Before
Subcommittee on Financial Institutions Supervision,
Regulation, and Insurance
Committee on Banking
House of Representatives

June 10, 1986

Chairman and Members of the Subcommittee:

I appreciate the opportunity to present the Treasury Department's views on H.R. 4868 and to comment on the sanctions contained therein. The Administration, like the Congress, seeks the end of apartheid and establishment of a system of government in South Africa in which all South Africans can participate.

We think that measures such as those proposed in H.R. 4868, aimed at the entire South African economy, will not realize their goal, even though they may be sincerely intended to do so. We hold this view for several reasons:

-- We remain strongly opposed to punitive economic sanctions.

B-620

-- Reducing the U.S. economic presence in South Africa and attempting to damage severely the South African economy will not provide the incentives for genuine change that we seek. U.S. firms in South Africa are challenging the apartheid system.

-- The proposed measures would harm the majority, non-white population of South Africa more than they would help it. Some recent polls in South Africa indicate that seven out of ten black South Africans oppose sanctions.

-- The measures would harm United States banks, investors, and business firms.

-- Imposition of sanctions will strengthen the extremes and weaken the middle of the political spectrum in all communities.

I shall focus my remarks initially on certain effects of the President's September 1985 economic measures and subsequently on H.R. 4868's proposals to prohibit U.S. citizens from making deposits in banks in South Africa and in U.S. branches of South African banks, to ban new U.S. investment in South Africa and new South African investment in the United States banking sector, to force divestiture of established investments, to prohibit certain imports and further restrict exports and technology transfers.

President's Executive Order on Bank Loans

Last September, the President imposed a ban on most types of U.S. bank loans to the South African Government, including public sector entities such as power companies and the agricultural marketing boards. Among other things, the ban prohibits U.S. export financing where the importing entities are in the governmental sector. Treasury's Office of Foreign Assets Control has promulgated regulations to carry out this ban, and has received no indication that this measure has been evaded.

Total U.S. bank claims on South Africa as of December 1985 were $3.2 billion compared to $4.7 billion at the end of 1984. But only a small portion of these claims, about five percent or $180 million, represented direct lending to South African public sector entities. The amount is small because over a period of several years U.S. banks of their own accord had greatly reduced their claims on the public sector of South Africa.

Prior to September 1985, U.S. banks already had independently froze and then reduced their credit lines to South Africa, mostly affecting the private sector. The U.S. banks' actions were taken in late July and August of last year partially as a result of President Botha's declaration of a state of emergency. The banks' decisions to freeze and reduce their credit lines and the further erosion of international confidence in South Africa and its currency led to a declaration by the South African Government in early September of a moratorium on repayments of principal on much of the country's foreign debt owed to banks. U.S. bank claims on South Africa's private sector have in effect been frozen as a result of this action, and will decline if debt is repaid without the benefit of new loans. Therefore, the overall effect of the U.S. ban coupled with independent actions of U.S. banks and the South African Government itself are likely to result in a continued decrease in U.S. bank claims on South Africa.

H.R. 4868 Proposals on Banking

Let me now turn to the sanctions approach found in H.R. 4868. The bill bans all new investments in South Africa, other than the reinvestment in an existing business enterprise of earnings derived from that enterprise. It also bans deposits in banks in South Africa. If certain very fundamental political changes are not made in South Africa within twelve months after the passage of the bill, then all computer-related investment in South Africa must be divested. Also, if such changes are not made by mid-1988, the President must recommend to the Congress whether there should be divestment of all U.S. investment in South Africa.

The bill also prohibits certain types of investment activity outside South Africa. No deposits may be made in banks organized under South African law or owned or controlled by South African nationals. Banks organized under South African law or owned or controlled by South African nationals may not establish or operate branches or agencies in the United States. Air carriers owned by the Government of South Africa or by South African nationals will be prhobited from having landing rights in the United States.

Disinvestment and Ban on New Investment

As you know, Mr. Chairman, this Administration has a long-standing policy not to restrict market oriented investment flows. In the case of South Africa, this goal and our mutual concerns for the economic and social well-being of the majority of South African citizens are best served by not requiring disinvestment and not banning new investment. I should note, however, that owing to market forces and exchange rate changes, there was a $500 million net decline in the outstanding amount of U.S. direct investment in South Africa at the end of 1984, the latest year for which we have data.

The Impact on the Majority Community. A ban on new investments in South Africa and/or a requirement that U.S. firms disinvest would have some impact on the employment of non-whites in South Africa and on the exemplary labor policies practiced by U.S. firms with operations in South Africa. U.S. firms operating in South Africa are important employers of blacks and a major source of pressure for change in South Africa's policies. Limiting the ability of these firms to bring in new capital, to grow or to adjust to market conditions, or requiring that they leave South Africa, could reduce job opportunities for blacks. The level of unemployment among blacks is already extremely high--about 25 percent overall and up to 60 percent in the Port Elizabeth area, according to some observers. Any reduction in foreign investment would retard the South African economy's growth rate and its ability to absorb new non-white entrants into the job market.

Replacement by Other Investors. Foreign investment is a small percentage of total domestic and foreign investment in South Africa, about 14 percent for all foreign investors. Although the United States is the third largest source of foreign direct investment in South Africa, an ending of new U.S. investment flows or the sale of existing capital assets is not likely by itself to create a long-term danger for the South African economy. Other countries (Japan, the United Kingdom, West Germany) have major commercial interests in South Africa, and their firms, which also compete with us in world markets, or South African firms, would fill gaps left by departing U.S. firms. South Africa also has demonstrated its ability to develop efficient indigenous production in the face of international sanctions, such as in its arms industry.

Adverse Impact on U.S. Investors. U.S. firms would also be placed in a precarious position by a ban on new investment or a requirement to disinvest. A large portion of U.S. investment in South Africa is in those sectors where there are numerous competitors--automotive vehicles, pharmaceuticals, petrochemicals and computers. A ban on new investments and on technology transfers to South African subsidiaries of U.S. energy companies would limit established U.S. firms' capacity to adjust to the dynamics of the market and, without the ability to make new investments, ultimately could force many firms to withdraw. This could be extremely costly to the firm. Firms would likely be forced to sell their assets at a price well below market value. The likely buyers--white South Africans and non-U.S. foreigners--would reap windfall gains from the forced sale of U.S. firms. In addition, the buyers would likely have less interest in maintaining and encouraging non-discriminatory practices in the workplaces than U.S. firms do. It is hard to see the point of a policy that would: a) confer windfall capital gains on white South African investors and perhaps our worldwide competitors at American expense, and b) weaken our companies' stance against discriminatory practices in the workplace and their courageous action in promoting civil disobedience to challenge apartheid.

Blocked Transfers. If faced with disinvestment, the South African Government could effectively block the transfer of the proceeds of the divested assets from South African rands into dollars. In this situation, U.S. investors would hold inconvertible South African rands, which for all intents and purposes would be worthless. Even if transfers were not blocked, the U.S. investor would be paid in "financial" rands, which, under South Africa's present system, can only be converted into foreign exchange by selling to another foreign investor. With U.S. investors in effect ultimately forced to divest in the banking, computer and energy sectors and possibly more generally, under the proposed legislation, the resulting downward pressure on the financial rand would reduce even further the dollar value of the realized assets.

Trade Ban

Finally, the Treasury Department firmly opposes the measure proposed in H.R. 4868 to prohibit certain imports into the United States from South Africa. A ban against importation of these goods from South Africa would require switching of sourcing which would result in higher costs for our industry.

We also oppose the ban on U.S. energy technology exports and the possible exports of computer related items. You are aware, Mr. Chairman, that the United States Government currently has in place comprehensive controls on exports to South Africa covering military and dual-use items, computers, and nuclear technology. All these controls focus pressure on the South African Government, its defense agencies, and those agencies which enforce the policies of apartheid.

A ban on certain exports to the South African private sector would adversely affect our export sector; in fact U.S. exports to South Africa declined by $1 billion last year. It would also have an adverse impact on the South African people and its economy, denying them goods and services necessary for a healthy economy. We believe it would be wrong to target the South African people. The President's Executive Order was aimed at the South African Government and its enforcement of apartheid.

Conclusion

In summary, Mr. Chairman, we recognize the pressures to respond strongly to South Africa's policies, and the Congress's genuine attempts to develop a sound approach. In fact, the financial markets have already recognized the increased risks of doing business with South Africa. Nevertheless, Treasury's examination of the types of measures proposed in legislation such as those contained in H.R. 4868, in terms of their potential for promoting change and their effects on U.S. interests and the interests of non-whites in South Africa, leads to the conclusion that the proposed measures would be very damaging. We believe the proposed sanctions in H.R. 4868 would not produce the changes we all seek, but would damage interests we would like to promote and defend. Such sanctions would further disadvantage the black population in South Africa, and would have adverse, perhaps significant and long-standing, effects on U.S. Government and private economic interests and on our ability to influence events in a positive fashion.

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TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M. June 11, 1986

TREASURY TO AUCTION $9,750 MILLION OF 2-YEAR NOTES

The Department of the Treasury will auction $9,750 million of 2-year notes to be issued June 30, 1986. This issue will provide about $725 million new cash, as the maturing 2-year notes held by the public amount to $9,033 million, including $801 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

In addition to the maturing 2-year notes, there are $4,346 million of maturing 4-year notes held by the public. The disposition of this latter amount will be announced next week. Federal Reserve Banks as agents for foreign and international monetary authorities currently hold $1,426 million, and Government accounts and Federal Reserve Banks for their own accounts hold $1,313 million of maturing 2-year and 4-year notes.

The $9,750 million is being offered to the public, and any amounts tendered by Federal Reserve Banks for their own accounts, or as agents for foreign and international monetary authorities, will be added to that amount. Tenders for such accounts will be accepted at the average price of accepted competitive tenders.

Details about the new security are given in the attached highlights of the offering and in the official offering circular.

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Attachment

B-621

HIGHLIGHTS OF TREASURY OFFERING TO THE PUBLIC OF 2-YEAR NOTES TO BE ISSUED JUNE 30, 1986

June 11, 1986

Amount Offered:	
To the public	$9,750 million
Description of Security:	
Term and type of security	2-year notes
Series and CUSIP designation	AB-1988 (CUSIP No. 912827 TT 9)
Maturity Date	June 30, 1988
Call date	No provision
Interest Rate	To be determined based on the average of accepted bids
Investment yield	To be determined at auction
Premium or discount	To be determined after auction
Interest payment dates	December 31 and June 30
Minimum denomination available ..	$5,000
Terms of Sale:	
Method of sale	Yield auction
Competitive tenders	Must be expressed as an annual yield, with two decimals, e.g., 7.10%
Noncompetitive tenders	Accepted in full at the average price up to $1,000,000
Accrued interest payable by investor	None
Payment by non-institutional investors	Full payment to be submitted with tender
Payment through Treasury Tax and Loan (TT&L) Note Accounts ...	Acceptable for TT&L Note Option Depositaries
Deposit guarantee by designated institutions	Acceptable
Key Dates:	
Receipt of tenders	Wednesday, June 18, 1986, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions)	
a) cash or Federal funds	Monday, June 30, 1986
b) readily-collectible check ..	Thursday, June 26, 1986

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

STATEMENT OF THE HONORABLE
FRANCIS A. KEATING, II
ASSISTANT SECRETARY OF THE TREASURY (ENFORCEMENT)
BEFORE THE COMMITTEE ON GOVERNMENTAL AFFAIRS,
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
UNITED STATES SENATE

June 12, 1986

I appreciate the opportunity to testify before the Committee today on the subject of Bank Secrecy Act enforcement. We welcome the continued interest of this Committee in this complex subject and the analysis of the General Accounting Office of our programs.

At the outset, let me express to this Committee my commitment and determination to continue to improve the utilization of the Bank Secrecy Act as a major weapon against drug trafficking and all other forms of organized crime. I want to highlight to the Committee the initiatives that Treasury has taken over the last year to improve Bank Secrecy Act enforcement. I believe that much progress has been made towards our shared goal of efficient and effective Bank Secrecy Act enforcement. We are proud of our efforts, but we also recognize that improvements can be made.

Of course, I am not in a position today to respond to the specific criticisms in the GAO report. However, I want to assure the Committee that we will thoroughly evaluate all the recommendations in the GAO report and take appropriate remedial steps where necessary. I would be happy to appear again before the Committee or to respond in writing after we have had time to evaluate the report. In the future, I also would be pleased to discuss the steps we have taken to implement the recommendations of the report.

The enforcement initiatives that I will discuss today fall into four general categories:

1. Improved coordination with and supervision of the agencies to which Treasury has delegated Bank Secrecy Act enforcement authority. This includes issuance of standardized Bank Secrecy Act examination procedures and establishment of the Treasury Bank Secrecy Act Enforcement Advisory Board and Working Group.

2. Revision of the Bank Secrecy Act regulations and promotion of legislative improvements to the Act.

B-622

3. Additions to and reorganization of Treasury resources dedicated to Bank Secrecy Act compliance. Treasury has established the Office of Financial Enforcement to develop enforcement policy and supervise the enforcement of the Bank Secrecy Act. The Internal Revenue Service has established a separate, greatly enlarged unit at the Detroit Data Center to conduct Bank Secrecy Act operations, including the processing of Currency Transaction Reports (CTRs). IRS has succeeded recently in eliminating the backlog in CTR processing.

4. Assessment of civil penalties against financial institutions for past Bank Secrecy Act non-compliance.

1. <u>Improved Supervision and Coordination with the Bank Secrecy Act Enforcement Agencies</u>

First, I would like to mention the measures Treasury has taken to improve its supervision of and coordination with the agencies to which it has delegated Bank Secrecy Act responsibilities. A primary initiative in this area was standardization of the examination procedures used by the various agencies, including the Internal Revenue Service, the Securities Exchange Commission and the bank supervisory agencies, for compliance examinations.

As many of the civil penalty cases which we have dealt with and the <u>Bank of Boston</u> case have demonstrated, the procedures used by the examiners in the past were not sufficient to ensure that violations of the Act would be detected. These procedures needed to be improved, and a number of other issues also had to be considered in order to make compliance examinations more effective. These issues include the maintenance of detailed workpapers, the sharing of information among bank supervisory agencies, and the uniform application of the examination procedures. To address these matters, we held a series of meetings with the Federal bank supervisory agencies and others who have an interest in improving the procedures used by examiners for checking the compliance of financial institutions with the Bank Secrecy Act. As a result of these consultations, we issued final instructions on examination procedures to the supervisory agencies in April of this year. It is axiomatic that improved and aggressive examination will foster improved compliance.

Our experience in the improvement and standardization of examination procedures made clear to me the need for an ongoing interchange of ideas between Treasury and the agencies to which Treasury has delegated enforcement responsibility. Therefore, I convened a permanent Treasury Bank Secrecy Act Enforcement Advisory Group, consisting of supervisory level representatives of Treasury, Customs, IRS, the SEC, and the bank supervisory agencies. This group is chaired by the Deputy Assistant Secretary (Law Enforcement). The group had its first meeting in May and will meet monthly as needed. We will use this forum to address mutual enforcement problems and to discuss Treasury policy initiatives. The Advisory Group has established a Bank Secrecy Act Working Group under its auspices to work on specific tasks assigned by the Advisory Group.

One of the first tasks assigned to this Working Group is to revise the standard procedures for referral of penalty cases to Treasury. A second task is to work with the Office of Financial Enforcement to develop a pamphlet for distribution to all bank financial institutions on procedures for exempting customers from the reporting requirements of the Bank Secrecy Act. The first draft of this pamphlet is due June 18th.

As you are aware, under Treasury regulations, banks may exempt certain customers from the reporting requirements and may request special exemptions from Treasury on others. Treasury does not require banks to exempt any customers. In an abundance of caution in the last year, many banks have greatly reduced the number of exemptions. This has resulted in a large volume of Currency Transaction Reports being filed on customers eligible for exemptions. Filing on exemptible transactions is expensive to the banks and Treasury, and produces information of little or no utility. We hope that the information in this pamphlet will enhance banks' understanding of the exemption process and encourage the judicious granting of exemptions to our mutual advantage.

In the future, among the tasks of the Working Group will be to develop guidelines for more comprehensive, standard periodic reports to Treasury on the agencies' Bank Secrecy Act enforcement. In this way, Treasury will be better advised of the strengths and weaknesses of the agencies' programs and will be able to direct remedial measures. The group also will develop a formal published ruling system for dissemination of interpretations of the Bank Secrecy Act and the Bank Secrecy Act regulations.

2. Regulatory and Legislative Initiatives

Since last year, we have strengthened the Treasury Bank Secrecy Act regulations in several respects and currently have under discussion internally a major regulatory revision package. On May 7, 1985, regulations became effective that designated casinos as financial institutions subject to Bank Secrecy Act reporting and recordkeeping requirements. As evidenced in hearings by the President's Commission on Organized Crime last summer, money laundering through casinos may have been even more widespread than once thought. We believe that the new regulations have reduced the attractiveness of the use of casinos for money laundering.

A regulatory amendment pertaining to international transactions was published as a final rule last summer. Under the regulations, Treasury is able to require a financial institution or a selected group of financial institutions to report specified international transactions, including wire transfers, for a defined period of time. We envision that this will require reporting of transactions with financial institutions in designated foreign locations that would produce information especially useful in identifying individuals and companies involved in money laundering and tax evasion. The Internal Revenue Service's Criminal Investigation Division has sent to my office for approval a pilot program for the initial use of this regulatory authority. This plan is currently under review.

In February, Treasury circulated a major regulatory revision package to the bureaus within Treasury with Bank Secrecy Act responsibility - Customs, IRS, the Office of the Comptroller of the Currency - and to the Justice Department. This package is complex and comprehensive and has undergone much revision and scrutiny. Treasury has tried to strike the proper balance between law enforcement needs and the need to avoid excessive burdens to financial institutions. We anticipate that these regulations will be published as a proposed rule within the next month or so.

Among the highlights of the proposed regulatory revisions are the following:

° Treasury proposes to expand the types of businesses that banks can unilaterally exempt from currency reporting without a special exemption request to Treasury. The new types of businesses are public utility companies, regularly scheduled transportation companies and organizations that have been granted § 501(c)(3) status by the IRS.

° For the first time, the regulations will specifically include the instruction on the Currency Transaction Report that a financial institution must, for reporting purposes, aggregate all currency transactions of which it is aware that occur in a single day.

° There will be a proposed new reporting requirement to address the well-known problem of smurfing, whereby individuals take cash from illegal sources in amounts less than the $10,000 reporting threshold to various banks and purchase a number of cashier's checks. The checks are then deposited to an account and often wired abroad. We will propose a requirement that banks maintain records of each cash purchase of a monetary instrument, e.g. a travelers check, bank or cashier's check, in excess of a specified amount.

° We propose to require customers to certify on a Treasury form the accuracy of the information on which a bank is basing an exemption of the customer's transactions from currency reporting. The information includes the nature of the customer's business and the type, frequency and dollar amount of regular cash transactions.

With respect to legislative initiatives, Treasury worked with the Department of Justice to develop S. 1335, the "Money Laundering and Related Crimes Act". Besides a substantive criminal offense for money laundering, the bill contains a number of critical revisions to the Bank Secrecy Act.

Under S. 1335 the Secretary for the first time would be given summons authority both for financial institution witnesses and documents in connection with Bank Secrecy Act violations. This authority was among the legislative recommendations in the October, 1984 report money laundering to the President's Commission on Organized Crime.

Under the proposal, the Secretary would be able to summon a financial institution officer, or an employee, former officer, former employee or custodian of records, who may have knowledge relating to a violation of a recordkeeping or reporting violation of the Act and require production of relevant documents. This authority is essential both to investigate violations and to assess the appropriate level of civil penalties once a violation is discovered.

This authority is especially needed with respect to miscellaneous non-bank financial institutions, such as casinos and certain companies which transfer funds domestically and internationally. These institutions number in excess of 3,000. The responsibility for compliance review of these institutions has been delegated to the Internal Revenue Service. Currently, however, the IRS summons authority is restricted to Title 26 purposes. Therefore, in examining these institutions, IRS must rely on voluntary cooperation. The cooperating financial institutions frequently request a summons as a means of protecting themselves from suits by their customers.

In addition to the Administration's money laundering bill, there is another legislative initiative on which we have urged early and favorable action. This bill is S. 2306 (H.R. 4753), introduced by Senator D'Amato and in the House by Congressmen Pickle and Schulze.

This bill would prohibit structuring of currency transactions to avoid the $10,000 currency transaction reporting requirement. Recent decisions in three Federal Circuits have made it clear that the current law is inadequate to sustain consistent prosecutions for structuring. The proposal would subject to the criminal and civil sanctions of the Bank Secrecy Act any person who structures transactions to avoid the currency reporting requirements, or who causes a financial institution not to file a required report.

The bill also provides seizure and forfeiture authority for currency related to a domestic (CTR) reporting violation or interest in property traceable to the currency. Currently, there is forfeiture authority only for cash and monetary instruments involved in violations of the reporting requirements for internationally transported monetary instruments.

Mr. Chairman, the Bank Secrecy Act has proven beyond all doubt its effectiveness as a law enforcement tool against drug trafficking, organized crime, and the illicit financial activity that supports it. The investigations that the Departments of Justice and Treasury have conducted, particularly those under the President's Organized Crime Drug Enforcement Task Force program, have relied upon the Bank Secrecy Act data and the analyses of these data that Treasury has prepared. In approximately three years of full operation, these Task Forces have initiated 1,350 cases and resulted in the indictments of 8,649 individual, 3,678 of which have been convicted.

While our progress has been substantial, we are under no illusions concerning the extent of the drug and organized crime problem that continues to plague our society. In my view, the amendments to the Bank Secrecy Act which I have described are critically needed, so that we can strike a more effective blow against these forms of criminal activity.

3. <u>Commitment and Reorganization of Treasury Resources</u>

In July, 1985, the Treasury Department established the Office of Financial Enforcement as the unit primarily responsible within my office for administering the Bank Secrecy Act. The establishment of this office provided a focal point for Bank Secrecy Act related activity within the Treasury Department and acknowledged the increasing importance of the Act in Treasury's law enforcement efforts. The office has broad responsibilities for the compliance activities of all agencies that have been delegated responsibilities under the Act, and there has been an increased commitment of staff resources to the office.

In April, Robert J. Stankey, Jr., who had been acting as Director of the Office of Financial Enforcement, retired. Mr. Stankey was a familiar figure to this Committee and more than any other person was responsible for the development of the Bank Secrecy Act into an effective law enforcement tool.

We have been interviewing many well-qualified replacements for Mr. Stankey and hope to have a new permanent Director of the Office of Financial Enforcement in the near future. One of the first tasks I will assign to that person is to take all appropriate measures to follow up on the GAO report.

Another significant development has been a very large commitment of resources by IRS, particularly with respect to the processing of Currency Transaction Reports. As you know, following the publicity surrounding the Bank of Boston case there was a dramatic upsurge in the filing of Currency Transaction Reports. As you can see from the attached charts, at the present rate, there will be an estimated 3 million CTR's filed this year. This compares with approximately 1.8 million filed in 1985 and 700,000 in 1984. Unfortunately, the unexpected upsurge created a processing backlog for a number of months.

The backlog is now eliminated. All CTRs received through April 1986 have been processed. Data from over 2.4 million CTRs has been sent to the TECS database this fiscal year. The Detroit Data Center has utilized a combination of both permanent and temporary employees and contract transcription support to process these forms. CTRs received in May 1986 are currently being processed on schedule. The backlog of unprocessed CTRs has been eliminated.

The function of granting special exemptions to bank customers from the reporting requirement was also delegated to IRS by my office late last year. All exemptions were previously granted by the Office of Financial Enforcement and its predecessor office. This function is also being carried out by the Detroit Data Center. Presently seven persons have been assigned responsibility for review of exemptions.

4. Civil Penalty Assessment

I also would like to discuss Treasury's imposition of civil penalties against financial institutions for past non-compliance. In the wake of the publicity surrounding the Bank of Boston case, and in good measure as a response to Congressional hearings, including those held by this Committee, over sixty banks and bank holding companies have come forward to Treasury with past violations of the Bank Secrecy Act. Some have come forward as a result of bank regulatory examinations, particularly those of the Comptroller of the Currency. To date, eighteen civil penalties have been assessed under 31 U.S.C. § 5321, ranging from $75,000 to $4.75 million in the case of Bank of America.

Other cases are under review, and we anticipate that additional penalties will be assessed shortly. In many instances, the cases are taking several months to conclude because of the time required for banks to conduct an examination of past compliance and to reconstruct past unreported transactions for late-filing of Currency Transaction Reports.

We continue to encourage financial institutions to come forward to disclose past violations. Non-volunteer banks will be dealt with more severely. Banks that become aware of past non-compliance and make no effort to contact Treasury are running a serious risk. We are now working to uncover these non-volunteers. This effort will ultimately depend heavily on the support of the bank supervisory agencies.

We believe that Treasury's rigorous enforcement of the Bank Secrecy Act, including the imposition of publicly announced, substantial civil penalties, where appropriate, has contributed to enhanced awareness of the requirements of the Bank Secrecy Act. As a consequence, and as confirmed in our dealings with many banks and the increased volume of Currency Transaction Reports, we believe that overall compliance has improved and that compliance has become a high priority with many major financial institutions.

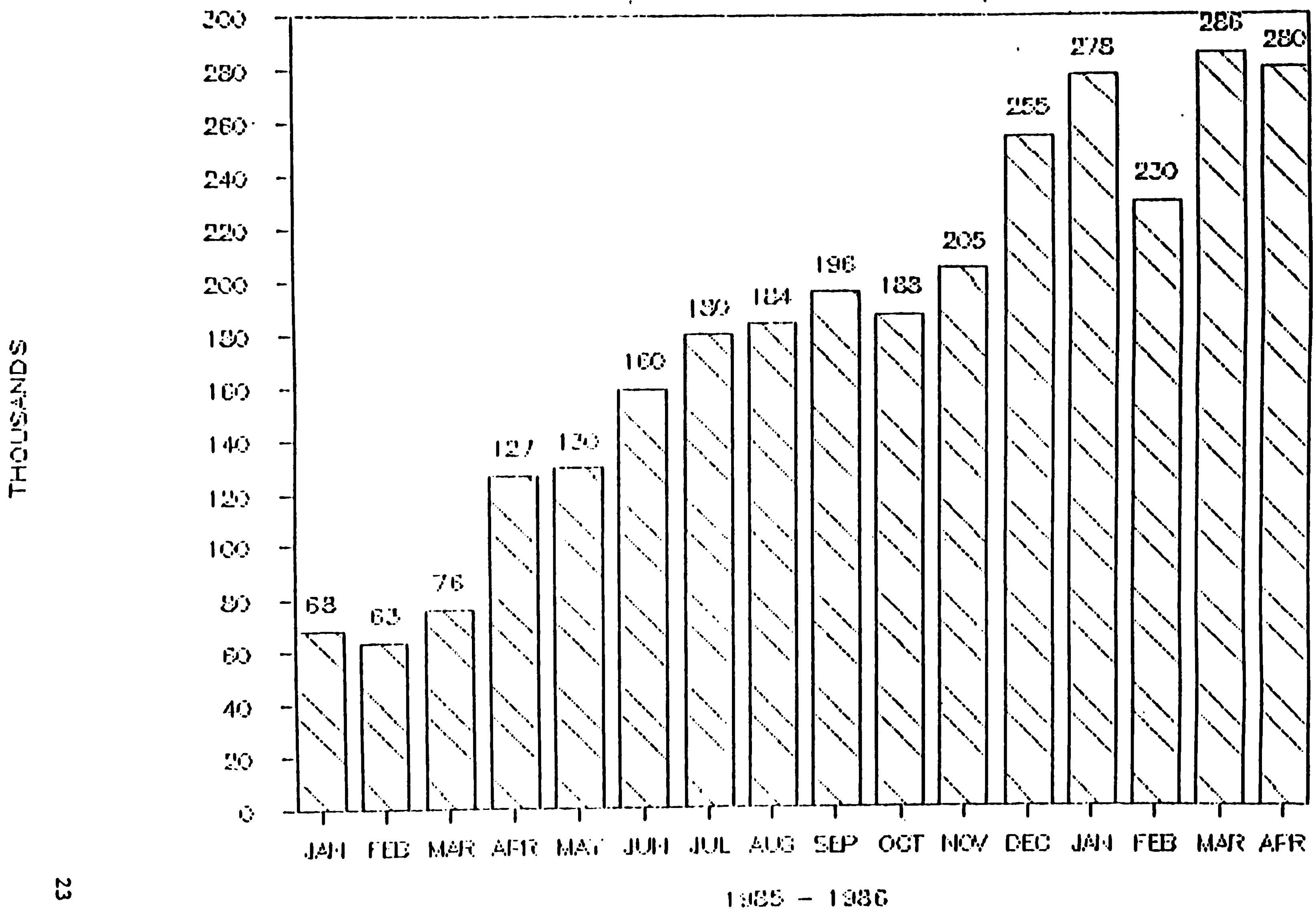
In closing, I want to emphasize that this is a time of activity and innovation in Treasury's Bank Secrecy Act program. I am pleased to have GAO's input into this ongoing process. I am firmly committed to an aggressive enforcement policy that ensures that all information required under the Bank Secrecy Act is retained or reported. At the same time, I am also committed to the efficient and effective use of that information.

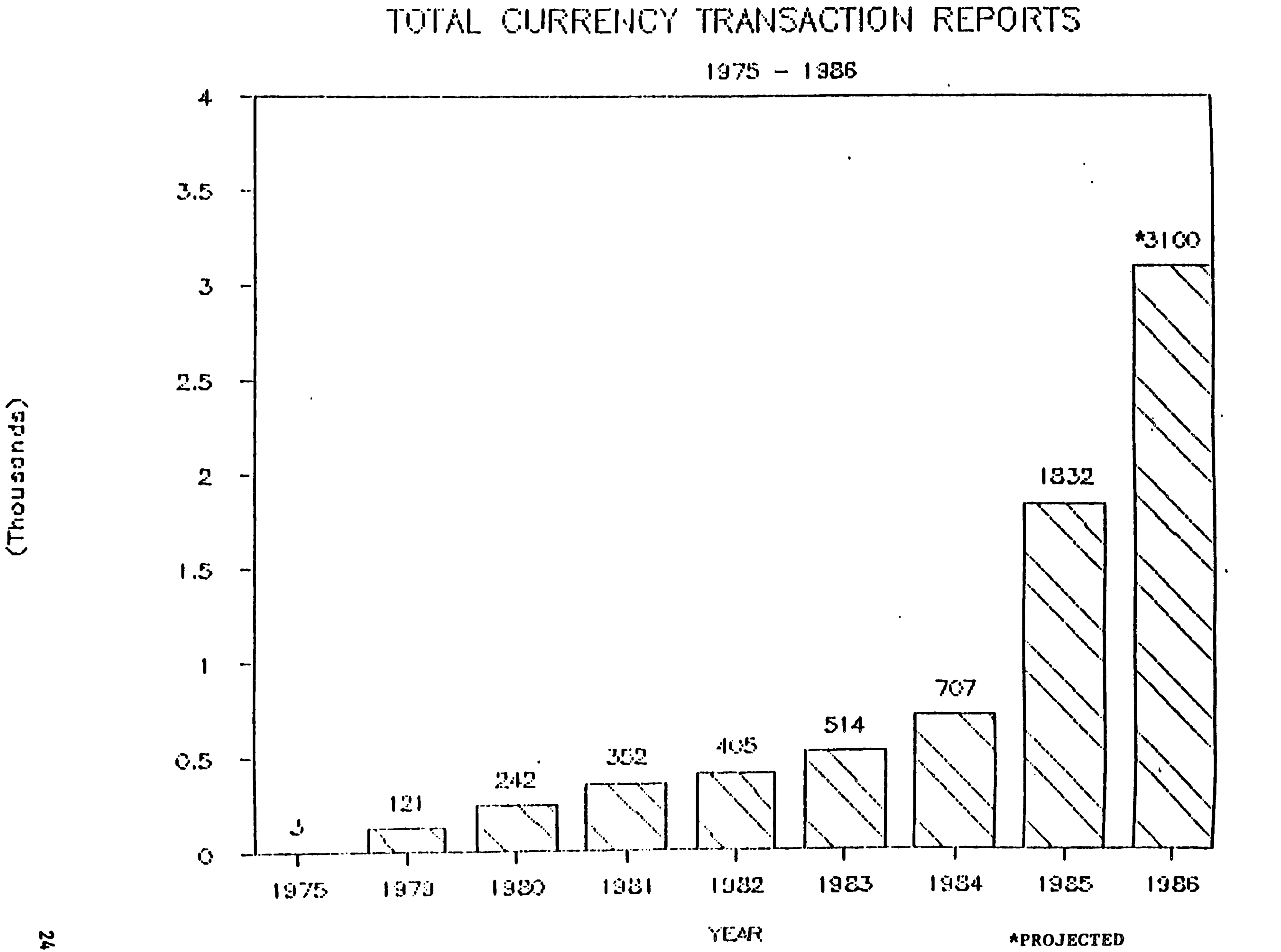
Mr. Chairman, I would like to acknowledge the substantial contribution that this Committee has made to our progress in improving the administration and enforcement of the Bank Secrecy Act. I look forward to continuing to work with you and the other members of this Committee as we seek to further our progress.

This concludes my prepared remarks. I would be happy to address any questions the Committee may have.

CURRENCY TRANSACTION REPORTS

(THOUSANDS OF FORMS 4789)




TOTAL CURRENCY TRANSACTION REPORTS
1975 - 1986
(Thousands)
4
3.5
3
2.5
2
1.5
1
0.5
0
3
121
242
352
405
514
707
1832
*3100
1975
1979
1980
1981
1982
1983
1984
1985
1986
YEAR
*PROJECTED

TREASURY NEWS

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Text As Prepared
For Release Upon Delivery
Expected at 2:30 p.m. EDT

Remarks by Secretary of Treasury
James A. Baker, III
To the National Convention of
The League of Women Voters
Washington, D.C.
Monday, June 16, 1986

It is a privilege for me to address an organization that is such a highly regarded feature on our country's electoral landscape. The League of Women Voters is well known, not just for its sponsorship of Presidential debates (on which I've had the pleasure of working closely with the League), but also for its valuable service in voter education and registration. And you can all take great pride in your involvement in America's political process. Your participation helps strengthen our democratic fabric.

Today, you, like I, are focusing on the future of tax reform, and I am looking forward to responding to your questions on this subject during the Q&A session to follow these remarks. But in recognition of your contribution to our political process I want to take this opportunity to discuss another, more enduring element of governance -- the institution of the American Presidency.

I have been privileged to serve two Presidents and to be involved in the last three campaigns for that office. So I have been able to observe the modern American Presidency at close range -- and to develop some opinions about that office -- the factors that shape a strong Presidency, and why its strength is important to the nation.

One of the keenest observers of the Presidency was Teddy White who died recently and whom I know we will all miss. In The Making of the President 1960, the first of five books on America's presidential electoral process, White's concluding chapter reflects on an interview with the new young President about the unique requirements of that office. "The essence of leadership," wrote White, is whether the President "is moved by other people and other forces or [whether he] moves them." He added: "A President governing the United States can move events only if he can first persuade."

B-625

The inauguration of John F. Kennedy seemed to initiate a new era for the American Presidency -- and the nation. He emerged on the national scene determined to provide vigorous national leadership to confront our problems. At the same time another force that would have a profound effect on the institution of the Presidency also came on the political stage. In fact it would come more and more to shape the script and actors of governance, and that was television.

Television played a key role in the advent of 20th century mass democracy by broadcasting the presidential debates. With their phenomenally high ratings these contests (it can be fairly said) gave the more skillful communicator, Kennedy, a boost that carried him to victory a few weeks later.

Once in office he mastered the new medium by being the first President to allow his press conferences to be televised live, satisfying the thirst of the new medium for drama on the national scene. His performances seemed to cement Americans' impression of him as the President who would lead and offer movement to a nation with seemingly unbridled prospects for growth and prosperity. Regrettably, events overtook our optimism.

By 1968 White commented in his third book on the presidential election process that President Johnson had "left behind a tradition of distrust in leadership, a repudiation of the presidential capacity unmatched, emotionally, since the repudiation of Herbert Hoover."

At the risk of oversimplifying, a credibility gap had taken hold of the Johnson Presidency engulfing his domestic and foreign initiatives. His vision for a harmonious "Great Society" was cracked by discordant riots in our cities and a new dissent on our campuses. His pronouncements that the Vietnam War was going well were repudiated by the reality of an escalating conflict.

And reflecting all of this was television, which had become, White wrote, the primary vehicle "for the new court of high criticism" of the Presidency. Many tests faced the next President, social unrest and the war, but White thought Richard Nixon's real challenge would be to restore "the confidence of millions of Americans who no longer trust any government of the United States." This would only happen, White predicted, if the new president could convey his vision of conciliation to the nation.

But none of Nixon's accomplishments at home or abroad could offset the verdict of two summers' congressional hearings televised daily and nightly into America's homes. The office of the President had reached its lowest ebb. From a time when we once revered the image of Camelot at the White House, "imperial" had become a pejorative when used to describe our highest elective office. President Ford restored confidence and trust in the chief executive's post, but in the aftermath of Watergate, instead of turning to a strong Presidency in the next election, we looked to a different kind of Presidency.

In the wake of the previous decade the early Carter Presidency was a time of national catharsis. Instead of choosing the customary limousine, he walked with his family to the White House after his inauguration. When he greeted his first official audience at the White House, the ceremonial ruffles and flourishes was not played. Initially, the press applauded President Carter for "denobilizing" the presidency, stripping it of its pomp. The Carter Administration made the White House and the Presidency more ordinary and less mystifying, and removed any sense of awe and majesty from the Oval Office.

All of this, it seems, reflected the distaste for leadership that Americans had developed in the aftermath of Watergate and Vietnam. Accompanying (and perhaps feeding) this syndrome, was an increasingly popular tendency to denigrate the Presidency. It would reach its zenith in the Carter years.

Professor Henry Graff of Columbia University has noted how Lyndon Johnson, "the ablest congressional politician of this century, was somehow changed perceptually into a riverboat gambler unworthy of his high place," how Gerald Ford, "the best athlete ever to sit in the Oval Office, became a caricaturist's delight as an oafish stumblebum," and how Jimmy Carter, having been elected as "the outsider brought in to straighten out the mess, became a failure because he was not an insider."

The Presidency is an office held to high expectations. Yet the framers of the Constitution were determined that the President should not command Congress. Our chief of state has fairly modest and much-checked formal powers but, as presidential scholar Richard Neustadt has observed, great resources for leadership by "persuasion." He must use those resources skillfully in order to secure the broad approval of the public and support from the political community -- especially Congress -- or he will be ineffective.

Now admitting my own bias and prejudice, I think that the perceived failure of the Carter Presidency, and conversely the success of Ronald Reagan's, center on their different attitudes towards governance.

President Carter's well-intentioned first hundred days certainly rivaled FDR's in number of initiatives. He sent a massive and far-reaching collection of complex legislation to Capitol Hill, including a tax cut bill, a major budget revision, executive reorganization authority, establishment of the new Energy Department, and packages for welfare, labor and social security reform, among others. Yet with the possible exception of the energy plan, there was no focal point for his Presidency to rally around, no vision of what his priorities were.

The failure to establish an agenda was a strategic mistake on President Carter's part, but there were tactical ones as well. Much has been written about his perceived inability to negotiate effectively with Congress. Some said he handled the Congress with the same detached coolness that he accorded the Georgia State Legislature. Other observers have noted that he was less than a forceful communicator.

But perhaps the most fundamental flaw in the Carter Presidency was the philosophical premise that the task of governing can be achieved with a technocratic approach to problem solving. This is the idea that every public policy issue can be resolved with a specific plan or program, and that the activist President is the technocratic manager of a complex set of interrelated policies. Whatever appeal this may have to social scientists, it is of little help in the practical aspects of governing.

As opposed to being seen as a leader with a vision and effective capacity, President Carter was diminished by his approach to governance. He himself correctly lamented the problem towards the end of his term in the famous "malaise" speech: What you see in Washington he said: "is a system of governance incapable of action.... Often you see paralysis and drift...."

The elements of this crisis can be seen in the contradiction between the objectives of President Carter's government by technocratic management and the forces that accompanied his rise to power. The powers of the Presidency had been so degraded by the time he took office, that Carter did not command the respect and deference normally accorded a President.

And the reform impulse in Congress, the diffusion of power with the proliferation of subcommittees and the weakening of the congressional leadership expanded the opportunities for interest groups with inimical goals to influence the lawmakers.

As Teddy White observed: "President Carter... insisted on keeping all his promises at once, which left him exposed to all those with leverage in the offices of congressmen elected to represent their interests."

In response to this situation, a consensus among our elites began to develop that the structural design of government was inadequate to meet the tasks of governing. It was said that the President's personal and political resources were insufficient to overcome the fragmentation and disarray inherent in the American separation of powers.

President Carter's White House Counsel argued while his chief was still in office that the formal institutional resources for executive leadership were so insufficient that the Carter Presidency could not succeed. "In parliamentary terms, one might say that under the U.S. Constitution it is not now feasible to "form a government," he wrote in Foreign Affairs magazine.

Unfortunately, he said, no recent President had been able to get his programs through Congress in anything approaching coherent form. The United States, he suggested, needed to go to a parliamentary type of government to end this executive-legislative deadlock.

This was not the first time that structural reform was advised for the Presidency. Limiting the President to a single six-year term was discussed at the Constitutional Convention and proposed to Congress as a constitutional amendment as early as 1826! Proponents have reintroduced this measure into Congress more than 100 times since then, arguing that the President should be released from the constraints of seeking re-election.

More recently we've heard that our problems are too big for partisan control of the executive branch and that some form of coalition government should be considered.

I think we should question such proposals. When political institutions, like the Presidency, maintain relatively popular support for nearly 200 years, we should assume that they are doing something right! The existing constitutional definition of the Presidency retains the support of the American public.

Notwithstanding my own bias, I think that by successfully completing two successive terms, Ronald Reagan will have not only redefined the role of the President but reinvigorated the institution of the Presidency as well. This will be, I think, one of his most important legacies to the nation. He has reversed the commentary that Presidents were incapable of leading the nation.

The Presidency is still what Theodore Roosevelt once called a "bully pulpit." Much has been said and written of Ronald Reagan's ability to gain support for his programs by his skill as an educator, as a mobilizer of public opinion. The President has been able to use his skills as a communicator to take maximum advantage of the powers of persuasion Neustadt has written about.

When President Reagan came into office the conventional wisdom was that it was very difficult for a President to maintain his power through television, and -- over time -- it would help destroy him. But now that view is subject to some revision I think. In his first term, by carefully marshaling his appearances before key congressional votes the President was able to maximize his leverage over the congressional agenda. And with each victory, the President enhanced his reputation as a strong and successful leader.

Perhaps most importantly, the President has been able to convey a vision for the future of the country. This is critical to effective Presidential leadership. Many people do not agree with particular aspects of his vision, but by focusing the national agenda, President Reagan has given much-needed direction to our public policy debates.

But having observed President Reagan interact with members of the House and Senate, I would place equal emphasis for his success upon what Neustadt called "the residual impressions of tenacity and skill" that the President conveys to the Congress and the rest of the Washington community. A President's high approval in public opinion polls is no guarantee that he will be able to lead effectively if the elite opinion of his abilities is low.

The political skills needed to persuade the Washington community are not always the ones a President uses to move public opinion. Strength, steady resolution, the ability to fight hard for one's policies without personalizing disagreements, and knowing when and how to compromise to achieve the most of one's objectives have all been critical to President Reagan's success.

By revitalizing the Presidency, Ronald Reagan has increased the likelihood of cooperation between Capitol Hill and the White House on public policy. The contest between the two branches of government is not a zero-sum game. The President's gain is not Congress's loss. In fact, polling data suggest that the President's popularity and success are positively influencing public attitudes toward other branches and levels of government, including Congress.

I have seen this cooperation work first hand. The Social Security compromise in 1983 was sensible legislation and defused perhaps the most sensitive political issue between Democrats and Republicans. And although it may be just a footnote now to the protracted turmoil in Lebanon, I think historians will favorably record the successful negotiations between the Congress and the President over the first use of the War Powers Act to deploy U.S. military forces. Fundamental tax reform -- which many sophisticates said couldn't be accomplished -- now appears likely to become another product of this cooperation.

As we approach the 200th year of our Constitution we should remember that America's government at its best is based on the strength of her institutions. Calling forth our best is not only for Presidents and lawmakers, but for Americans of all walks of life. Twenty-five years ago that was the message of a dynamic young President.

In this city we are constantly reminded that the founding fathers were men who dared to build a nation upon confidence and cooperation, not fear and disunity. And the memorials to America's sons and daughters who have fallen in battle for their country kindles the honorable flame of duty and service in all of us.

At the conclusion of his memoirs (<u>In Search of History</u>) White wondered whether "the old ideas that have made America a nation could stretch far enough to keep it one." I am confident that he believed they would. I agree. And as we continue with the challenges we face in the years ahead, I ~~am~~ sure that our leaders and institutions will prove equal to the tasks.

Thank you very much.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE June 16, 1986

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,400 million of 13-week bills and for $7,406 million of 26-week bills, both to be issued on June 19, 1986, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing September 18, 1986			26-week bills maturing December 18, 1986		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	6.07%	6.25%	98.466	6.17%a/	6.46%	96.881
High	6.12%	6.30%	98.453	6.20%	6.49%	96.866
Average	6.11%	6.29%	98.456	6.18%	6.47%	96.876

a/ Excepting 2 tenders totaling $100,200,000.

Tenders at the high discount rate for the 13-week bills were allotted 27%.
Tenders at the high discount rate for the 26-week bills were allotted 04%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 40,585	$ 40,585	$ 27,630	$ 27,630
New York	21,529,265	6,407,475	20,600,970	6,208,170
Philadelphia	24,925	24,925	16,660	16,660
Cleveland	48,865	48,865	23,355	23,355
Richmond	46,480	46,480	41,370	31,770
Atlanta	41,360	41,360	26,265	26,265
Chicago	1,732,800	193,150	1,939,830	437,230
St. Louis	69,570	49,570	63,635	43,635
Minneapolis	29,355	15,705	29,170	19,570
Kansas City	49,690	49,690	43,260	43,260
Dallas	43,200	43,200	15,020	15,020
San Francisco	1,120,840	131,610	916,725	291,765
Treasury	307,670	307,670	221,360	221,360
TOTALS	$25,084,605	$7,400,285	$23,965,250	$7,405,690
Type				
Competitive	$21,602,175	$3,917,855	$20,476,805	$3,917,245
Noncompetitive	1,075,275	1,075,275	673,245	673,245
Subtotal, Public	$22,677,450	$4,993,130	$21,150,050	$4,590,490
Federal Reserve	1,954,355	1,954,355	1,900,000	1,900,000
Foreign Official Institutions	452,800	452,800	915,200	915,200
TOTALS	$25,084,605	$7,400,285	$23,965,250	$7,405,690

1/ Equivalent coupon-issue yield.

B-624

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery
Expected at 10:00 a.m. EDT
June 17, 1986

STATEMENT OF
DON FULLERTON
DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON COAST GUARD AND NAVIGATION
COMMITTEE ON MERCHANT MARINE AND FISHERIES

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the findings of the Treasury Department's study of the excise taxes attributable to fuel used in recreational motorboats. The study was mandated by the Recreational Boating Safety and Facilities Improvement Act of 1980. The principal findings of the report, which was released on June 16, 1986, are the following:

(1) For 1985, approximately $98 million of gasoline excise tax revenues were attributable to fuel used in recreational motorboats. This amount equals 1.08 percent of total gasoline excise tax revenues.

(2) Although gasoline excise tax revenues have been allocated to the trust fund using the fixed allocation percentage (0.75), the methodology developed in the report provides estimates of motorboat fuel consumption that can be updated annually when new Coast Guard data become available. Use of the report's methodology would ensure that gasoline excise tax revenues attributable to motorboats capture the relative growth in motorboat use. The methodology also could incorporate new state studies on the use of fuel by size of motorboat.

B-625

My testimony is divided into three sections. The first section describes the background for the current percentage used to attribute revenues to excise taxes on motor fuels. The second section describes the methodology developed in the Treasury Department's study for estimating excise tax revenues attributable to fuel used by recreational motorboats. The third section discusses the report's findings and conclusions.

Background

The revenues from excise taxes on motor fuels are paid into the Highway Trust Fund. The fund finances the Federal-aid highway program using revenues from excise taxes imposed on those who benefit from the resulting expenditures, i.e., users of public highways. When these excise taxes were enacted under the Highway Revenue Act of 1956, certain exemptions were provided for nonhighway use of motor fuels so that taxes collected on motor fuels not used on the highways would not be used to fund the Federal-aid highway program, and they are not.

In the Land and Water Conservation Fund Act of 1965, Congress directed that revenue from the excise tax on fuels used in recreational motorboats be transferred to the Land and Water Conservation Fund for the acquisition and development of public land and water areas for recreational purposes. The tax on motorboat use of motor fuels was intended to benefit boaters. This legislation provided that the Secretary of the Treasury estimate the amounts of the excise tax revenue that derives from fuels used in motorboats, in consultation with the Secretary of Commerce. These amounts would then be transferred from the Highway Trust Fund to the Land and Water Conservation Fund.

Although the Highway Revenue Act had provided that the Internal Revenue Service (IRS) refund fuel excise taxes for fuel used in recreational motorboats, there were relatively few requests for such refunds. As a consequence, IRS data were not available to estimate fuel use by recreational motorboats.

Estimates were available from only two states in the late 1960's. A study done by the state of California in 1964 estimated that 0.58 percent of the total motor fuel sold in the state was consumed by boaters. A study by the state of Washington in 1966 estimated that sales of gasoline for use in boats was 0.83 percent of total taxable gasoline sales in the state.

In fiscal year 1969, the Secretary of the Treasury concurred with a recommendation by the Secretary of Commerce to set the amount of total fuel excise tax revenue attributable to motorboats at 0.75 percent, and the rate has not changed since then. The recommendation by the Department of Commerce was based on the estimates from the states of California and Washington, which were thought to be representative of boating activities nationally.

The Recreational Boating Safety and Facilities Improvement Act of 1980 established the National Recreational Boating Safety and Facilities Improvement Fund (Boating Safety Fund) to finance recreational boat safety and facilities improvement projects. Under the Act, excise taxes on motor fuel used in motorboats were transferred to the Boating Safety Fund. The 1980 Act mandated the Treasury study because of concern over the prevailing rate used to estimate the revenue allocation. Some of this concern was generated after additional studies by individual states were completed.

Although the Deficit Reduction Act of 1984 repealed the provisions of the 1980 Act which established the Boating Safety Fund, it established instead the Aquatic Resources Trust Fund. The 0.75 percent allocation percentage currently is used to determine amounts of excise tax revenue on motor fuels to be transferred to the Land and Water Conservation Fund and the Aquatic Resources Trust Fund.

Fourteen states have conducted surveys during the past twenty years to estimate fuel use by recreational motorboats, with disparate results. Estimates of annual fuel consumption per boat ranged from 41 gallons to 386 gallons. Motorboat fuel consumption as a percent of total state fuel consumption ranged from 0.21 percent to 1.74 percent. Most state surveys have been based on respondent recall of the amount of fuel used. This type of study methodology is problematic for several reasons, including difficulty of recall, gamesmanship by respondents, and different survey designs.

The United States Coast Guard conducted two studies in 1973 and in 1976 that included estimates of fuel consumption by recreational motorboats. For 1973, the average number of gallons of fuel used per boat was estimated to be 330 gallons. For 1976, the comparable estimate was 351 gallons. Use of the 1976 Coast Guard estimate would have resulted in a finding that 2.45 percent of total gasoline excise tax revenue was attributable to use in recreational motorboats. This estimate exceeded estimates from all the state studies.

Unlike most state surveys, the Coast Guard Survey did not ask respondents directly about the amount of fuel used. A possible source of upward bias of the Coast Guard estimates may have been confusion about two of the survey questions. The first question asked about the "number of different months" in which the boat was used. A second question asked how may times per month, on the average, the boat was used during "the boating season." Respondents may have considered the "boating season," a period of relatively intensive boat use, to be a period shorter than the "number of different months" the boat was used. The consumption estimate, however, multiplied the answers to these two questions, and then multiplied by the answer to a third question on the average gallons of fuel used on a typical outing.

Methodology for Estimating Excise Tax Revenues Attributable to Fuel Used by Recreational Motorboats

The Treasury Department's study developed a methodology which used available data for estimating the excise tax revenue attributable to fuel used in motorboats. Unlike the use of a single fixed proportion of total fuel excise tax revenues, the Treasury Department's methodology could be used to update the estimates annually to reflect changes in the number and size of motorboats. Further, the estimates could reflect new data, as it became available, on the average fuel consumption of motorboats.

The methodology is quite simple. The average annual fuel consumption per motorboat in each of three boat-size classes was calculated from state studies and then was multiplied by the number of motorboats in those classes (available from the U.S. Coast Guard). The fuel consumption in each size class was then added together to obtain an estimate of total fuel consumption attributable to all motorboats in the United States. Finally, total motorboat fuel consumption was then multiplied by the prevailing Federal excise tax rate per gallon of gasoline to obtain an estimate of total gasoline excise tax revenues attributable to motorboat fuel consumption in the United States.

This estimate was based on data which the Coast Guard publishes annually on the number of motorboats under 16 feet in length, 16 to 26 feet, and over 26 feet. The size distribution of motorboats has changed since 1964, with fewer small motorboats and proportionally more medium-size boats. This methodology would capture that change in future years.

As noted earlier, the average annual fuel consumption per motorboat has not been collected reliably on a national basis. A number of states, however, have asked boaters to estimate the amount of fuel used during the year. After contacting all fifty states plus the District of Columbia, seven state studies were identified that estimated fuel consumption by size of boat. The state studies used to estimate the U.S. average for fuel consumption by size of boat are from Arizona, California, Hawaii, Nevada, New York, Pennsylvania, and Wisconsin. These states accounted for 1.6 million registered motorboats and 18 percent of all motorboats in the United States in 1985.

The methodology involves two important assumptions. First, the average fuel consumption estimates by size of motorboat from the seven state studies were assumed to be representative of recreational boating and boat use nationally. A statistical test was performed that compared three factors affecting recreational boating use in these seven states and all states: heating degree days, inland water density, and coastline density. The results of the statistical test supported the assumption that these factors in the seven states are similar to those in all states.

Second, the average fuel consumption in each size class was assumed to be unchanged from the time that the state studies were completed. Part of any change in the relative intensity of motorboat use would be reflected in changes in the size distribution of motorboats, which could be updated annually with Coast Guard data. Although the average horsepower of motors used in a particular size class could change, so could the efficiency of motors and the amount of time the motors were used. The methodology could incorporate new estimates of average fuel consumption by boat size as it became available.

Findings and Conclusions

The Treasury Department's study estimates that approximately $97.9 million of motor fuel excise tax revenues were attributable to fuel used in recreational motorboats in 1985. This represents 1.08 percent of the $9,062.4 million of total gasoline tax revenues in 1985. Total revenues attributable to fuel used in recreational motorboats were calculated by multiplying the 9 cents per gallon excise tax rate on gasoline by an estimate of 1.08 billion gallons of fuel consumed in the United States by recreational motorboats in 1985.

The data used in estimating gasoline excise tax revenues attributable to fuel used in motorboats for 1985 are shown in Table 1. The first row shows the number of motorboats in each size class as reported by the United States Coast Guard. The second row shows the average annual fuel consumption per boat, by size of boat. These consumption estimates are based on the seven state surveys, weighted by 1985 boat registration data. Total fuel consumed per size class (line 3)is obtained by multiplying the first two rows. Total motorboat fuel consumption for the United States of $1,087.7 million gallons (line 4) is the sum of the amounts shown on line 3. The amount of gasoline excise tax revenue attributable to recreational motorboats, $97.9 million, is calculated by multiplying the current gasoline excise tax rate of 9 cents per gallon by the total gallons consumed (line 4).

Because the methodology estimates the actual gallons of fuel consumed by all motorboats, the amount of annual excise tax revenue is derived directly by simply applying the prevailing tax rate. This methodology enables the estimate to be updated annually, thereby ensuring that the allocation reflects changes in the number and size distribution of boats. The estimate of motor fuel tax revenue attributable to motorboats would then depend upon the relative growth of boating use. The methodology also could incorporate new state studies on the use of fuel by size of motorboat.

Table 1

Estimation of Gasoline Excise Tax Revenues
Attributable to Use by Recreational Motorboats
and Supporting Data: 1985

	Motorboat Size		
	Less than 16 feet	16 to 26 feet	Greater than 26 feet
1. Number of Boats in the U.S. (millions)	5.19	3.34	0.35
2. Average Annual Fuel Consumption Per Boat, gallons	55.01	192.86	451.55
3. Total Gallons of Motorboat Fuel Consumed (millions)	285.5	644.2	158.0

4. Total Motorboat Fuel Consumed: 1,087.7 million gallons.

5. Current Gasoline Excise Tax Rate: $0.09 per gallon.

6. Gasoline Excise Tax Attributable to Recreational Motorboats:
(1,087.7 million gallons) x ($0.09) = $97.9 million.

Department of the Treasury
Office of Tax Analysis

June 1986

TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Immediate Release
June 16, 1986

Contact: Charles Powers
Phone: (202) 566-8773

TREASURY RELEASES REPORT ON GASOLINE EXCISE TAX REVENUES ATTRIBUTABLE TO FUEL USED IN RECREATIONAL MOTORBOATS

The Treasury Department today released its Report on the Gasoline Excise Tax Attributable to Fuel Used in Recreational Motorboats. The report was mandated by the Recreational Boating Safety and Facilities Improvement Act of 1980 (P.L. 96-451) which requires the Secretary of the Treasury to conduct a study to determine the portion of taxes imposed on motor fuels that are attributable to fuel used in recreational motorboats. The Act established a separate fund, entitled the Recreational Boating Safety and Facilities Improvement Fund, and directed the Secretary of the Treasury to pay into the fund excise tax revenues attributable to fuel used in recreational motorboats.

The principal conclusions of the report are:

(1) For 1985, approximately $98 million of gasoline excise tax revenues were attributable to fuel used in recreational motorboats. This amount equals 1.08 percent of total gasoline excise tax revenues. Currently, 0.75 percent of gasoline excise tax revenues are attributed to fuel used in recreational motorboats and are transferred from the Highway Trust Fund to the Land and Water Conservation Fund and the Aquatic Resources Trust Fund.

(2) Although gasoline excise tax revenues have been allocated to the trust fund using the fixed allocation percentage (0.75), the methodology developed in the report provides estimates of motorboat fuel consumption that can be updated annually when new Coast Guard data become available. Use of the report's methodology would ensure that gasoline excise tax revenues attributable to motorboats reflect the relative growth in motorboat use. The methodology also could incorporate new state studies on the use of fuel by size of motorboat.

B-626

TREASURY NEWS

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TEXT AS PREPARED
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Expected at 8:00 p.m. EDT

Remarks by Secretary of Treasury
James A. Baker, III
To the New York Financial Writers' Association
Sheraton Centre Hotel
New York City
Tuesday, June 17, 1986

It's a great pleasure to be here tonight. I always look forward to discussing current economic issues with members of the press. Really, we have much in common. Like myself, you must constantly be alert to twists and trends in the markets, always scanning the latest indicators for what they may portend for the economy's future.

Being in the international financial capital of the world I thought it would be appropriate to take this opportunity to be a little reflective and focus my remarks on a topic that I'm sure many of you are familiar with, and that is international economic policy cooperation and coordination.

Looking back over the 20th century we see that international cooperation on economic problems is not a new impulse. The goal of economic coordination inspired the formation of such modern-day institutions as the International Monetary Fund and the International Bank for Reconstruction and Development which were outgrowths of the Bretton Woods Conference held during World War II. At that time the allies recognized that the post-war world would need to be reassured that the economic ravages of the 1930s, which gave rise to totalitarianism, would not be repeated.

The mistakes that plagued the world's interwar financial relationships are worth remembering. In response to the Great Depression our own country resorted to protectionism with the Smoot-Hawley Tariff. We thought that this would restore domestic prosperity. Instead, our trading partners retaliated in kind, U.S. exports sank dramatically, and economic misery spread.

The depression unraveled the economic ties among nations. Governments sought to shelter domestic economies from the global collapse through competitive currency devaluations. Facing rising domestic unemployment, countries unilaterally depreciated their currencies to stimulate exports and discourage imports.

B-627

But the result of these uncoordinated actions was a global exchange rate crisis which further disrupted international monetary relations. This beggar-thy-neighbor cycle of devaluations did nothing to restore business or political confidence and, in fact, did little to improve the devaluing nation's competitive position. The only winners in this vicious cycle were dictators who profited from the economic disruption it created.

The Bretton Woods arrangements sought to prevent a recurrence of these problems. These arrangements aimed at avoiding uncoordinated national actions, especially trade controls and competitive depreciations. And indeed, under the new rules of Bretton Woods, a great liberalization of the international economy occurred and world trade and output flourished.

The economic pressures today are not those the industrial world faced in the '30s. Quite the contrary, the primary nemesis of the international economy in the 1970s, inflation, has been cut sharply and is expected to stay low. The recent substantial reductions in interest rates have been facilitated by the easing of inflationary pressures. And this year, growth in the industrial countries has been predicted to average three-and-a-half percent.

But serious problems remain. Postwar efforts at coordination have not been totally successful. Large external imbalances persist which can lead governments to adapt protectionist policies. And when their constituents demand it, governments often are tempted to follow economic policies aimed at strictly domestic goals. We must avoid risking a return to the economic nationalism that destroyed the world economy in the 1930s.

In recent years efforts have been made at various economic summits to improve coordination. And we took an important step forward with the Plaza Agreement here in New York city last September. The impact of the Plaza Agreement on exchange rates was dramatic. They have moved considerably since then and this should improve prospects for reducing our trade deficit.

At the same time, experience has shown that exchange rate changes alone should not be relied upon to achieve the full magnitude of the adjustments required in external positions. This is one reason why we place such importance on strong, sustained and better balanced growth among the industrial countries. Without greater growth abroad, increased reliance will need to be placed on exchange rates in the adjustment of payments imbalances.

At the recent Tokyo Summit we built on the success of the Plaza Agreement. We established a system for closer policy coordination. Under this system management responsibilities extend across a broad range of economic policies and performance. The system is designed to promote consistent domestic policies and compatible policies among countries, all the time focusing on achieving favorable fundamentals.

The Summit partners established a process for coordination and committed themselves to make that process work. The participating countries will review economic objectives and forecasts with their peers and the managing director of the IMF. They will take into account a broad range of indicators such as those spelled out in the Tokyo Summit communique. The internal and external consistency of these projections will then be assessed with a view to necessary adjustments. If significant deviations from an intended course emerge, the participants have pledged to exert best efforts to adopt remedial action.

"Best efforts" and peer pressure may not seem like a prescription for fundamentally altering the economic course of nations. But with such efforts there is a better chance for more external discipline than under normal practices. If nothing else, one could reasonably expect that the political process would lead countries to formulate and adapt economic policies with more awareness, at least, of international considerations.

The coordination of economic policies will not be easy. To specify, and then reconcile, national objectives and forecasts, taking into account a broad range of indicators, will raise a host of technical and political problems. There will be deviations from intended courses, and there will be difficulties in determining which are significant and should have priority.

Nevertheless, we believe that the end result will be a greater likelihood that remedial actions will be taken when necessary. In addition to the high level commitment, other factors give us greater hope as we work out the details of the Tokyo arrangements.

For example, the success of the Plaza Agreement last September is a good omen. The public agreement of the G-5 to implement important policy intentions and modify exchange rates was not easily nor lightly reached. In addition, subsequent coordination of interest rate decisions was not easily achieved. But in the end, actions were taken in a coordinated fashion. These achievements encouraged us to seek approval at the Tokyo Summit of the better mechanism for policy coordination.

The process of economic policy coordination can also be improved by a focus on exchange rates and current account positions to assess incompatibilities among nations. Countries may not always be able or willing to agree on the specific level for their currencies. But they can tell when currency values need to change and the appropriate direction of change. The Plaza Agreement demonstrates that the major industrial countries could go this far. The Tokyo arrangements institutionalize the practice of discussing exchange rates on a regular basis. One result should be greater stability of exchange rate expectations.

The Tokyo arrangements do not involve any ceding of sovereignty, nor should they. But if the system is to work, participants will of their own volition -- to be sure, under the watchful eye of their peers -- have to take external considerations more heavily into account in formulating their domestic economic policies. For the United States this only reflects the reality that the time is long past when the U.S. could, in setting domestic policies, relegate external considerations to an insignificant order of importance.

The major implications for U.S. policy at present are fairly clear. We must follow through on our program to reduce our budget deficit. The Congress has to complete action on tax reform. Monetary policy must continue to be directed toward sustained non-inflationary growth. And, we must avoid the folly of protectionism.

The system will only be viable, however, if other nations are prepared to accept similar responsibilities. If U.S. economic policies are to be adjusted to take into account international concerns, others too must be willing to adjust policies. Countries such as Germany and Japan with large trade surpluses must recognize the global need for stronger domestic demand to facilitate the adjustment of external imbalances.

The global community also has a strong stake in economic stability and growth in the debtor nations, and the successful management of their debt problems. Debt service difficulties affect all of us, in terms of reduced exports, lower growth, and a less stable international financial system. Cooperative efforts to deal with the debt problem therefore have a high priority on our policy agenda.

Recent progress in this area is somewhat heartening, and provides a basis for future improvements:

First, there is broad agreement among both creditors and debtors that improved growth in the debtor nations is essential to the resolution of their debt problems, and that growth oriented policy reforms in the debtor nations are central to achieving this objective.

Second, centered on that growth theme, we have an agreed basis on which to proceed. The debt initiative which we outlined last fall in Seoul has received the strong support of the international community -- including the key international financial institutions and the commercial banking groups in all major creditor nations. This strengthened debt strategy is now being actively implemented through individual debtor's discussions with the IMF and the World Bank.

<u>Third</u>, recent improvements in the global economy are providing significant and timely relief for the debtor nations. For example, stronger growth in the industrial nations this year will add approximately $2 billion to the major debtors' exports. The sharp decline in interest rates -- more than four percentage points since early 1984 -- will save them $12 billion annually in debt service payments. Lower oil prices will also save the oil-importing members of this group some $2 billion annually.

I recognize that the debt situation for the net oil exporting debtors will be exacerbated by the loss in oil export earnings, and that this may necessitate additional adjustment measures to meet the new external realities. But lower interest rates and stronger world growth will help to temper these added demands upon their economies.

Indeed, on an aggregate basis, these growth and interest rate changes if sustained, could be more important to a resolution of the debt problem than the provision of marginal amounts of financing by the banks or any World Bank general capital increase. Calls for interest rate relief or debt forgiveness seemingly ignore this dramatic change in the global economic environment.

Such "solutions" to the debt problem may appear to offer short-term panaceas to ease the debt service burden, but in reality pose a very serious risk of shutting off future access to financial markets which is crucial to developing nations' trade and future growth.

Continued cooperative efforts among the key industrial nations will be important to sustain this positive global environment. But the adoption of growth-oriented policies by the debtor nations will remain crucial to providing the domestic stimulus to stronger growth. Measures which will increase savings and investment, improve economic efficiency, and encourage a return of flight capital, together with sound fiscal and monetary policies, will enhance the debtors' ability to take advantage of favorable external circumstances, while providing a sound basis for long term growth.

A number of debtor nations are already moving in this direction, adopting more market-oriented policies, reducing inflation, and privatizing public enterprises. We should not harbor any illusions that such policy changes will be easy to implement, or that they can be accomplished overnight.

They will take time. And while the IMF and the World Bank can assist in this process -- and are doing so -- the reforms which are adopted must be developed at the initiative and with the support of the debtor governments themselves. Ultimately, they are responsible for the international financial markets' perception of their creditworthiness.

I recognize that there has been some concern about how the three elements of this process will come together. Let me review briefly how we see this process working.

The World Bank, in close consultation with the IMF, is helping a number of the major debtor nations to develop proposals for medium-term adjustment programs. They will focus in particular on efforts to increase growth and export capabilities, mobilize domestic savings, encourage increased investment, and liberalize trade. The privatization of public enterprises and domestic tax reforms may be important elements of this approach.

As these medium term approaches are being developed, the IMF and World Bank are also working closely with the debtor nations on immediate policy steps to be supported by new IMF arrangements and World Bank sector or structural adjustment loans. The IMF, for example, has existing or pending arrangements with 11 of the 15 major debtor nations, while the World Bank has structural or sector loan negotiations underway with 13 of these nations and has recently extended loans to Ecuador, Argentina, Colombia and the Ivory Coast to support adjustment efforts in some of their key sectors.

Commercial bank support for these policy changes, however, is crucial. Once reforms have been agreed upon, commercial banks must be ready to lend without delay. For those debtors which have successfully implemented IMF programs and have adopted additional structural adjustment measures in concert with World Bank loans, the commercial banks should be responsive to requests for new lending.

We do not intend to twist the arms of U.S. banks or to support special government or World Bank guarantees in order to secure new lending. I am confident that the banks will lend if they perceive it to be in their interest to do so. Nevertheless, it is important for all of us to be able to plan ahead, and to count on the timely support of the commercial banks, as pledged, as one of the key elements of the debt initiative, and one which is vital to its success.

We are all, in fact, engaged in a process of exploring new horizons in seeking to resolve the international debt problem. All of us have a stake in this process: the industrial nations, to provide a sound world economic environment within which individual debtor's problems can be effectively managed; the debtors, to undertake the policy reforms needed to enhance their growth prospects; the international financial institutions and the commercial banks to support this process with enhanced financing to assure a smooth transition to stronger growth in the debtor nations. Working together, I am confident that we can accomplish that task.

I began my remarks tonight with a reference to the Bretton Woods Conference. One of my predecessors at Treasury, Henry Morgenthau, opened that Conference 43 years ago by telling the delegates that the problems in the international economy were "beyond the capacity of any one country, or of any two or three countries." They were, he said, multilateral problems which required multilateral cooperation.

Morgenthau urged the assembled nations to work together in a cooperative spirit so that exchange disruptions of the interwar period could be avoided and the balanced growth of international trade restored. If negotiations were conducted with good will and statesmanship, he predicted that the delegates could construct "a dynamic world economy in which the people of every nation will be able to realize their potential in peace."

Our challenges are surely no greater than those posed to the post-war generation. They too can be dealt with if we perceive the wisdom of strengthening international cooperation and coordination. Now the task of statesmanship is to implement these goals so the potential of our countries today remains undiminished in the future.

Thank you very much.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M. June 17, 1986

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $14,800 million, to be issued June 26, 1986. This offering will provide about $350 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $14,451 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, June 23, 1986. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,400 million, representing an additional amount of bills dated March 27, 1986, and to mature September 25, 1986 (CUSIP No. 912794 LE 2), currently outstanding in the amount of $6,842 million, the additional and original bills to be freely interchangeable.

183-day bills (to maturity date) for approximately $7,400 million, representing an additional amount of bills dated December 26, 1985, and to mature December 26, 1986 (CUSIP No. 912794 KU 7), currently outstanding in the amount of $9,281 million, the additional and original bills to be freely interchangeable.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing June 26, 1986. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold $1,588 million as agents for foreign and international monetary authorities, and $3,014 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series).

B-628

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M. June 17, 1986

TREASURY TO AUCTION 4-YEAR AND 7-YEAR NOTES
TOTALING $14,000 MILLION

The Treasury will raise about $9,650 million of new cash by issuing $7,250 million of 4-year notes and $6,750 million of 7-year notes. This offering will also refund $4,346 million of 4-year notes maturing June 30, 1986. The $4,346 million of maturing 4-year notes are those held by the public, including $625 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

In addition to the maturing 4-year notes, there are $9,033 million of maturing 2-year notes held by the public. The disposition of this latter amount was announced last week. Federal Reserve Banks, as agents for foreign and international monetary authorities, currently hold $1,426 million, and Government accounts and Federal Reserve Banks for their own accounts hold $1,313 million of maturing 2-year and 4-year notes. The maturing securities held by Federal Reserve Banks for their own account may be refunded by issuing additional amounts of the new 2-year and 4-year notes at the average prices of accepted competitive tenders.

The $14,000 million is being offered to the public, and any amounts tendered by Federal Reserve Banks as agents for foreign and international monetary authorities will be added to that amount. Tenders for such accounts will be accepted at the average prices of accepted competitive tenders.

Details about each of the new securities are given in the attached highlights of the offerings and in the official offering circulars.

oOo

Attachment

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC
OF 4-YEAR AND 7-YEAR NOTES

June 17, 1986

Amount Offered to the Public....	$7,250 million	$6,750 million
Description of Security:		
Term and type of security.......	4-year notes	7-year notes
Series and CUSIP designation....	Series P-1990 (CUSIP No. 912827 TU 6)	Series G-1993 (CUSIP No. 912827 TV 4)
Issue date......................	June 30, 1986	July 7, 1986
Maturity date...................	June 30, 1990	July 15, 1993
Call date.......................	No provision	No provision
Interest Rate...................	To be determined based on the average of accepted bids	To be determined based on the average of accepted bids
Investment yield................	To be determined at auction	To be determined at auction
Premium or discount.............	To be determined after auction	To be determined after auction
Interest payment dates..........	December 31 and June 30	January 15 and July 15 (first payment on January 15, 1987)
Minimum denomination available..	$1,000	$1,000
Terms of Sale:		
Method of sale..................	Yield auction	Yield auction
Competitive tenders.............	Must be expressed as an annual yield, with two decimals, e.g., 7.10%	Must be expressed as an annual yield, with two decimals, e.g., 7.10%
Noncompetitive tenders..........	Accepted in full at the average price up to $1,000,000	Accepted in full at the average price up to $1,000,000
Accrued interest payable by investor....................	None	None
Payment through Treasury Tax and Loan (TT&L) Note Accounts...	Acceptable for TT&L Note Option Depositaries	Acceptable for TT&L Note Option Depositaries
Payment by non-institutional investors......................	Full payment to be submitted with tender	Full payment to be submitted with tender
Deposit guarantee by designated institutions.........	Acceptable	Acceptable
Key Dates:		
Receipt of tenders..............	Tuesday, June 24, 1986, prior to 1:00 p.m., EDST	Wednesday, June 25, 1986, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):		
a) cash or Federal funds........	Monday, June 30, 1986	Monday, July 7, 1986
b) readily-collectible check....	Thursday, June 26, 1986	Wednesday, July 2, 1986

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
EXPECTED AT 9:30 A.M.
WEDNESDAY, JUNE 18, 1986

Statement of
Robert A. Cornell
Deputy Assistant Secretary of the Treasury
for International Trade and Investment Policy
Before the
Economic Stabilization Subcommittee
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives

Mr. Chairman and Members of the Subcommittee:

I am pleased to be able to testify today on the Treasury's role in the offset report required by Section 309 of the Defense Production Act, and on our view of the final product.

Since Treasury representatives testified on offsets before this committee in 1981 and again in 1984, you are aware that we have long been concerned about the effects of offsets on the U.S. economy. However, there had been no consensus within the Executive Branch on whether the net economic effects of offsets are positive or negative, still less on whether the United States should discourage them as a matter of policy.

In the spring of 1984, the Treasury suggested to the Interagency Group on International Economic Policy (IG/IEP) that the Administration conduct a study of the economic effects of offsets. We hoped to assemble a body of facts and analysis which might form the basis for a policy consensus. At about the same time, Congress renewed the Defense Production Act and included Section 309, which was intended to accomplish the same objective and preempted our initiative in the IG.

My testimony will deal first with the procedures followed by the interagency coordinating committee which produced the report, and then with the substance of the report itself.

<u>Data Collection</u>

The first major issue addressed by the coordinating committee was whether a survey of industry was necessary. Agencies believed that it was, since there was no comprehensive

B-630

economic information available on offsets and without a survey we would not be able to develop a comprehensive data base.

We then learned that the International Trade Commission was preparing a survey of its own on nonmilitary countertrade, and wondered whether it might be combined with the offset report to minimize the reporting burden on industry. In the summer of 1984, working-level staff members of the ITC and of the Departments of Commerce, Treasury, Labor and Defense met in the Treasury to discuss whether there was an overlap in subject matter and methodology between the two such that it would make sense to combine them in the interest of efficiency. The group concluded that there was very little overlap, and that combining them would make both surveys more difficult to conduct with little or no reduction in the respondents' paperwork burden to show for it.

The two projects proceeded on separate tracks until, at a meeting in November 1984, the committee was informed by OMB that the two survey questionnaires would be combined into one at the direction of OIRA. We were informed that the ITC was to have responsibility for collecting the data and passing it in its entirety to the 309 committee. Treasury agreed to handling the data in this way. When the offsets questionnaire was mailed out in January, 1985, the instruction sheet included the following statement: "The information supplied in connection with this survey will be made available <u>in aggregated form</u> to appropriate Executive agencies as designated by the Office of Management and Budget ..." (emphasis added).

Given my experience with the USITC, I recognized this as its standard practice, which we do not criticize. We thought that the USITC was prepared to make an exception in this case, but there apparently was a misunderstanding or a communication failure. In any event, the result was a probably unintended compromise of the survey process that in Treasury's view caused fundamental problems which it was too late to cure.

Let me outline the problems as Treasury saw them. The Treasury has maintained from the outset of this project that the drafting agencies must have access to individual survey responses to do an adequate job of economic analysis. Survey responses, especially on a subject as complex and uncharted as this one, inevitably contain ambiguities and omissions. These must be clarified if the margin of error in the final report is to be kept within reasonable bounds. The normal, and only possible, means of clarification is by follow-up telephone calls to the respondents, and without access to the individual responses no follow-up is possible (although we understand the ITC did some limited follow-up).

The underlying assumption of a survey such as this is that a body of aggregated data will be built up from the individual responses, and conclusions at the aggregate level will be based on close screening of the data at a microeconomic level. The researcher will not only know the degree of confidence he can place in his data, he also will be able to make comparisons and cross-tabulations among the responses to spot trends or trace the consequences of particular events (such as a given sale). When access to the individual responses was denied us, these normal elements of economic analysis were foreclosed.

The result was that the report included errors and ambiguities which would have been reduced if normal survey research procedure had been followed. The GAO Report of April 1986 confirms on pages 7, 8, and 9 that there were ambiguities in the responses as well as errors in transcribing the data; it was precisely to deal with such problems that we sought access to the responses. It made no sense for those charged with preparing the report to have no access to their prime sources, while the raw data were available only to an agency which had no role at all in the analysis.

The drafting agencies did have access to a matrix which included "all" the data "except" the names of firms, programs, and competitors. But we believed these omissions, far from being minor, imposed significant limits on our ability to produce a credible analysis. As one example, it makes a substantial difference to our discussion of trade effects whether a competitor for a contract is American or foreign.

The Questionnaire and Analytical Strategy

Once a work plan was established, with Defense, Commerce, Labor and Treasury in charge of drafting the four main sections of the report, the next step was to design a questionnaire. An office in the Commerce Department made the first attempt at this very difficult task. The resulting draft was comprehensive, but, understandably, so long and complicated that it was thought likely to discourage response. Assuming that we would get better results by cooperating with industry rather than confronting it, a working group including Commerce, Defense, Labor, Treasury and OMB undertook to simplify the questionnaire with input from interested industrial groups.

Section 309 requires a report on the effects of offsets "on the defense preparedness, industrial competitiveness, employment, and trade of the United States." The working group observed that the one variable underlying all four of these topics is U.S. production.

As a consequence, the analytical strategy adopted by the Commerce, Treasury and Labor Departments for their portions of the report was to focus on production effects, especially in Commerce's discussion of competitiveness. The competitiveness section, in turn, would be the heart of the report. These agencies' input to the questionnaire was designed to elicit information as concisely as possible on sales and offsets in order to determine the effects on U.S. production.

Since, in the view of Treasury and others, changes in employment and trade are a result of changes in competitiveness, the employment and trade sections of the report would flow from the Commerce Department's analysis. The Treasury did not think it useful to ask questions specifically on trade, since any one firm could provide answers only on its own trade but not on total U.S. trade. Even if we had included direct questions on trade and aggregated the answers, the conclusions would not have taken into account the effect on the foreign trade of other U.S. firms not involved in the survey.

While it was never intended that the defense preparedness section be based on the competitiveness analysis in the same way as the trade and employment sections, it obviously was likely that some of Commerce's conclusions would be relevant to the question of defense preparedness.

After considerable delay, the aggregated data (without company, program, or competitor names) were released to the committee by the ITC in late July 1985. But an essential element of the analytical approach had been changed. The Coordinating Committee did not have access to individual survey responses. Without that access, a strategy of analyzing the effects of offset transactions on U.S. production was ruled out. Commerce was obliged to rely more heavily than intended on anecdotal evidence, rather than doing a quantitative analysis as planned.

Without being able to build on the Commerce portion of the report, we in the Treasury concluded that we could not do a credible analysis of trade effects. We would have been confined to limited analysis based on the available data, which would not have told us much more than we learned from our 1983 report on offsets. Early in the fall of 1985, therefore, we notified OMB we could not write the trade section.

The Mailing List

I should address here the issue raised by the GAO about the selection of firms asked to participate in the survey.

The working group preparing the mailing list began with the Defense Department's list of one hundred largest defense contractors. After deleting firms supplying food and petroleum to U.S. military bases, this gave us a ready-made roster of large manufacturers of defense articles -- the firms most often asked to provide offsets.

Identifying a representative group of subcontractors was much harder. We began with DOD's list of its five hundred largest R&D contractors, focusing on smaller firms toward the bottom of that list as a proxy for the universe of subcontractors. We deleted the "beltway bandits" who concentrate solely on research, in an attempt to isolate manufacturers. When in doubt, we telephoned many of these companies to confirm that they produce hardware or engineering services which might be subjected to offset requirements.

To these we added firms named in Aviation Week's annual inventory of U.S. aerospace firms which were known to be significant producers but were not already on our list. We also canvassed knowledgeable personnel in our agencies for ideas. We well knew this procedure was not ideal, but considered it to be the most practical way of proceeding, since the alternative would have been to canvass hundreds or even thousands of firms.

The problem of isolating the effect of offsets on subcontractors was one of the most difficult we addressed in the entire survey. Obviously, despite the best efforts of all concerned, we have not solved it yet.

The Report

I have tried in this presentation to stress to the Subcommittee the unfortunate consequences of what turned out, in our view, to be a breakdown in the survey process. In the following discussion of the Report itself, I provide a catalog of the consequences of that procedural problem. It should be interpreted in that light rather than as simply a critique of the Report or of any of the Agencies which prepared it.

The drafting agencies were instructed in early summer, 1984, to start preparing their contributions to the report even before the survey was conducted. We were to identify gaps in our information to be addressed in the survey. But without data, the Treasury believed this approach would lead only to repetition of established agency positions without moving us any closer to understanding the costs and benefits of offsets.

As a result, several sections of the report, particularly in the Executive Summary and Introduction, could be interpreted as supporting current offset practices without focussing on the effects of those practices. We need more analysis of a cost-benefit type to permit definitive conclusions on this point.

Several of the "findings" on pages ix through xi of the Executive Summary do not flow from the data. The first and fourth ones on page ix, for example, are *a priori* judgments on which we see a need for more analysis. The fourth one asserts that a sale with offsets is better than no sale at all, without considering whether the costs of the offsets exceed the benefits of the sale. Another example appears on page 22, where it is asserted that without offsets, importing countries would be willing to spend less on foreign-designed defense goods. Such may not be the case.

At the bottom of page ix, it is stated that production costs "may be lowered by an increased number of producers both here and abroad," apparently on the assumption that more producers will lead to fiercer competition and lower prices. In fact, it is at least as likely that an increase in the number of producers will lead to *higher* costs for each of them, absent an increase in the size of the market.

The trade section treats offsets as the economic equivalent of normal imports, ignoring the role of governments in requiring offsets. Foreign government monopsony power of this sort requires much deeper study, we think. This section also asserts that any imbalances in military trade will be counterbalanced by capital flows; in other words, because of the truism that the balance of payments is always in balance, it is of no consequence to the national interest whether U.S. firms lose business due to the actions of other governments.

The report, except for the Employment section, makes little use of the data that are available. While a large number of tables is appended, there is little connection between most of them and the text. This probably is due in part to the lack of access to the survey responses, which precluded deeper analysis.

Conclusion

Treasury believes that additional analysis of the offset phenomenon would be warranted. We continue to believe that the Administration and the Congress should have better information and, we would hope, a better understanding of the economic consequences of offsets. We are convinced that the only way to achieve this understanding is by detailed analysis of individual offset transactions.

We believe there are various ways by which this might be done while taking account of the legal constraints on the ITC, such as by temporarily assigning researchers from an Executive Branch agency to the ITC to perform the analysis. Alternatively, we could ask the firms to submit copies of their previous responses to this agency. In any case, the Treasury continues to believe that the Executive Branch must have detailed data in order to have an adequate understanding of this issue. Economic and cost-benefit analysis of offsets are possible.

Thank you.

TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-2041

June 18, 1986

J. MICHAEL HUDSON
ASSISTANT SECRETARY FOR LEGISLATIVE AFFAIRS

J. Michael Hudson was confirmed as Assistant Secretary of the Treasury for Legislative Affairs on May 8, 1986. He succeeds Bruce E. Thompson, Jr.

Since 1984 Mr. Hudson has been serving at the White House as Special Assistant to the President for Legislative Affairs. Previously, he was Assistant to the Director for Legislative Affairs, Office of Management and Budget, in 1982-84, and was Deputy Assistant to the Director for Legislative Affairs, Office of Management and Budget in 1981-82.

From 1979 to 1981, Mr. Hudson held the positions of Legislative Assistant and Press Secretary to U.S. Representative Tom Loeffler (R-Texas). He was Speechwriter and Legislative Aide to U.S. Senator John Tower (R-Texas) in 1977-1979.

Mr. Hudson graduated from the University of Texas (B.A.,1971) and American University (M.A.,1975). He was born February 27, 1948 in Hollis, Oklahoma and now resides in Washington, D.C.

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B-631

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE June 18, 1986

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $9,751 million of $26,720 million of tenders received from the public for the 2-year notes, Series AB-1988, auctioned today. The notes will be issued June 30, 1986, and mature June 30, 1988.

The interest rate on the notes will be 7%. The range of accepted competitive bids, and the corresponding prices at the 7% interest rate are as follows:

	Yield	Price
Low	7.00%	100.000
High	7.05%	99.908
Average	7.04%	99.927

Tenders at the high yield were allotted 52%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 79,470	$ 48,470
New York	23,266,130	8,296,890
Philadelphia	28,960	28,960
Cleveland	111,150	106,350
Richmond	62,025	53,585
Atlanta	34,315	32,835
Chicago	1,401,405	438,285
St. Louis	110,065	94,065
Minneapolis	32,965	32,815
Kansas City	109,755	109,755
Dallas	18,020	18,020
San Francisco	1,458,990	483,910
Treasury	6,880	6,880
Totals	$26,720,130	$9,750,820

The $9,751 million of accepted tenders includes $735 million of noncompetitive tenders and $9,016 million of competitive tenders from the public.

In addition to the $9,751 million of tenders accepted in the auction process, $565 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $1,000 million of tenders was also accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities.

B-~~672~~

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE June 18, 1986

RESULTS OF AUCTION OF 2-YEAR NOTES

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B-632

IN ADVANCE OF
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DEPARTMENT OF THE TREASURY
Office of Foreign Assets Control
31 C.F.R. Part 550
Libyan Sanctions Regulations

AGENCY: Office of Foreign Assets Control, Department of the Treasury

ACTION: Final Rule

SUMMARY: The Treasury Department is amending § 550.409 of the Libyan Sanctions Regulations ("the Regulations") to alter the interpretation of the scope of the prohibition on exports from the United States to Libya in § 550.202 of the Regulations. Exports of goods to third countries are prohibited where the exporter knows, or has reason to know, that exported goods are intended specifically for substantial transformation or incorporation abroad into manufactured products to be used in the Libyan petroleum or petrochemical industry. Similarly, exports of technology to third countries are prohibited where the exporter knows, or has reason to know, that exported technology is intended specifically for use abroad to manufacture, or for incorporation into, products to be used in the Libyan petroleum or petrochemical industry. Other aspects of the interpretation in § 550.409 are generally unchanged. The Treasury Department is also amending the Regulations to reflect approval by the Office of Management and Budget of the information collection provisions contained in §§ 550.601 and 550.602 of the Regulations.

6-19

Received in the Office
of the Federal Register

EFFECTIVE DATE: [14 days from date of publication in the Federal Register for § 550.409; publication date for § 550.901.]

FOR FURTHER INFORMATION: Contact Marilyn L. Muench, Chief Counsel, Office of Foreign Assets Control, Department of the Treasury, Washington, D.C. 20220, Tel. (202) 376-0408.

SUPPLEMENTARY INFORMATION: The Libyan Sanctions Regulations, 31 C.F.R. Part 550 (51 FR 1354, January 10, 1986; 51 FR 2462, January 16, 1986; and 51 FR 19751, June 2, 1986) were issued by the Treasury Department in implementation of Executive Order 12543 of January 7, 1986 (51 FR 865, January 9, 1986) and Executive Order 12544 of January 8, 1986 (51 FR 1235, January 10, 1986). As originally published, § 550.409 of the Regulations exempted from the prohibition on exports to Libya exports of goods to third countries if, among other things, the goods were to be incorporated abroad into manufactured products or substantially transformed abroad prior to shipment to Libya. The amendment adopted in this notice makes the exemption in § 550.409 unavailable for such exports to third countries where the exporter knows, or has reason to know, that the third-country product produced using the U.S. exports is intended specifically for use in the Libyan petroleum or petrochemical industry. The amendment also extends the interpretation of § 550.409 expressly to cover exports of technology as well as goods.

Since the Regulations involve a foreign affairs function, the provisions of the Administrative Procedure Act, 5 U.S.C. 553, requiring notice of proposed rulemaking, opportunity for public participation, and delay in effective date, are inapplicable. Because no notice of proposed rulemaking is required for this rule, the Regulatory Flexibility Act, 5 U.S.C. 601 et seq., does not apply. Because the Regulations are issued with respect to a foreign affairs function of the United States, they are not subject to Executive Order 12291 of February 17, 1981, dealing with Federal regulations.

List of Subjects in 31 C.F.R. Part 550: Libya, Exports, Reporting and recordkeeping requirements.

PART 550--LIBYAN SANCTIONS REGULATIONS

31 CFR Chapter V, Part 550, is amended as set forth below:

1. The "Authority" citation for Part 550 continues to read as follows:

Authority: 50 U.S.C. 1701 et seq.; E.O. 12543, 51 FR 875, January 9, 1986; E.O. 12544, 51 FR 1235, January 10, 1986.

2. The table of contents of Part 550 is amended by adding an entry for § 550.901 to previously reserved Subpart I as follows:

* * * * *

Subpart I-Miscellaneous

* * * * *

Sec.

550.901 Paperwork Reduction Act Notice.

Subpart D--Interpretations

3. Section 550.409 is revised to read as follows:

§ 550.409 Exports to third countries; transshipment.

(a) Exports of goods or technology (including technical data and other information) from the United States to third countries are prohibited if the exporter knows, or has reason to know, that:

(1) the goods or technology are intended for transshipment to Libya (including passage through, or storage in, intermediate destinations) without coming to rest in a third country and without being substantially transformed or incorporated into manufactured products in a third country, or

(2) the exported goods are intended specifically for substantial transformation or incorporation in a third country into products to be used in Libya in the petroleum or petrochemical industry, or

(3) the exported technology is intended specifically for use in a third country in the manufacture of, or for incorporation into, products to be used in Libya in the petroleum or

petrochemical industry.

(b) For the purposes of paragraph (a) of this section:

(1) the scope of activities encompassed by the petroleum and petrochemical industries shall include, but not be limited to, the following activities: oil, natural gas, natural gas liquids, or other hydrocarbon exploration (including geophysical and geological assessment activity), extraction, production, refining, distillation, cracking, coking, blending, manufacturing, and transportation; petrochemical production, processing, manufacturing, and transportation;

(2) exports subject to the prohibition in paragraph (a) include not only goods and technology for use in third-country products uniquely suited for use in the petroleum or petrochemical industry, such as oilfield services equipment, but also goods and technology for use in products, such as computers, office equipment, construction equipment, or building materials, which are suitable for use in other industries, but which are intended specifically for use in the petroleum or petrochemical industry; and

(3) goods and technology are intended specifically for a third-country product to be used in Libya if the particular product is being specifically manufactured to fill a Libyan order or if the manufacturer's sales of the particular product are predominantly to Libya.

(c) Specific licenses may be issued to authorize exports to third countries otherwise prohibited by paragraph (a)(2) of this section in appropriate cases, such as those involving extreme hardship or where the resulting third-country products will have insubstantial U.S. content.

(d) Exports of goods or technology from the United States to third countries are not prohibited where the exporter has reasonable cause to believe that:

(1) except as otherwise provided in paragraph (a) of this section, the goods will be substantially transformed or incorporated into manufactured products before export to Libya, or

(2) the goods will come to rest in a third country for purposes other than reexport to Libya, *e.g.*, for purposes of restocking the inventory of a distributor whose sales of the particular goods are not predominantly to Libya, or

(3) the technology will come to rest in a third country for purposes other than reexport to Libya.

(e) Note: Exports or reexports of goods and technical data, or of the direct products of technical data (regardless of U.S. content), not prohibited by this part may require authorization from the U.S. Department of Commerce pursuant to the Export Administration Act of 1979, as amended, 50 U.S.C. App. § 2401 *et seq.*, and the Export Administration Regulations implementing that Act, 15 C.F.R. Parts 368-399.

Subpart I-Miscellaneous

4. New § 550.901 is added to read as follows:

§ 550.901 Paperwork Reduction Act Notice.

The information collection requirements in §§ 550.601 and 550.602 have been approved by the Office of Management and Budget and assigned control number 1505-0092.

Dated: June 16, 1986

Dennis M. O'Connell

Dennis M. O'Connell
Director
Office of Foreign Assets Control

Approved: June 16, 1986

Francis A. Keating, II
Assistant Secretary
(Enforcement)

Filed: June 19, 1986
Publication Date: June 23, 1986

federal financing bank NEWS
WASHINGTON, D.C. 20220
Press 566-2041
FFB 566-2468

FOR IMMEDIATE RELEASE June 23, 1986

FEDERAL FINANCING BANK ACTIVITY

Francis X. Cavanaugh, Secretary, Federal Financing Bank (FFB), announced the following activity for the month of April 1986.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $153.5 billion on April 30, 1986, posting an increase of less than $0.1 billion from the level on March 31, 1986. This net change was the result of a decrease in holdings of agency debt of $0.5 billion and increases of under $0.3 billion each in agency assets and in holdings of agency-guaranteed debt. FFB made 341 disbursements during April.

Attached to this release are tables presenting FFB April loan activity, commitments entered during April, and FFB holdings as of April 30, 1986.

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B-633

FEDERAL FINANCING BANK

APRIL 1986 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
AGENCY DEBT					
TENNESSEE VALLEY AUTHORITY					
Advance #593	4/3	$ 179,000,000.00	4/10/86	6.655%	
Advance #594	4/7	250,000,000.00	4/14/86	6.535%	
Advance #595	4/7	119,000,000.00	4/17/86	6.535%	
Advance #596	4/10	28,000,000.00	4/15/86	6.315%	
Advance #597	4/10	146,000,000.00	4/17/86	6.315%	
Advance #598	4/14	262,000,000.00	4/21/86	6.255%	
Advance #599	4/17	250,000,000.00	4/21/86	6.065%	
Advance #600	4/17	13,000,000.00	4/23/86	6.065%	
Advance #601	4/21	5,000,000.00	4/25/86	6.165%	
Power Bond Series 1986 B	4/21	600,000,000.00	4/30/16	7.285%	
NATIONAL CREDIT UNION ADMINISTRATION					
Central Liquidity Facility					
+Note #391	4/1	11,225,000.00	7/3/86	6.655%	
+Note #392	4/2	5,000,000.00	7/3/86	6.645%	
+Note #393	4/7	3,000,000.00	7/8/86	6.545%	
+Note #394	4/14	37,925,000.00	7/15/86	6.265%	
+Note #395	4/29	5,000,000.00	7/29/86	6.415%	
AGENCY ASSETS					
FARMERS HOME ADMINISTRATION					
Certificates of Beneficial Ownership					
	4/1	25,000,000.00	4/1/01	7.565%	7.708% ann.
	4/1	100,000,000.00	4/1/06	7.585%	7.729% ann.
	4/14	200,000,000.00	4/14/96	7.415%	7.552% ann.
	4/30	40,000,000.00	4/30/96	7.505%	7.646% ann.
GOVERNMENT - GUARANTEED LOANS					
DEPARTMENT OF DEFENSE					
Foreign Military Sales					
Cameroon 7	4/1	4,000,000.00	3/26/91	7.180%	
Colombia 5	4/1	231,789.00	12/15/88	7.125%	
Colombia 6	4/1	4,996,145.81	6/30/91	7.176%	
Egypt 7	4/1	482,788.14	7/31/14	7.565%	
Greece 14	4/1	174,897.60	4/30/11	7.575%	
Portugal 2	4/1	7,740,078.50	9/10/95	7.427%	
Turkey 17	4/1	838,590.75	11/30/13	7.565%	
Egypt 7	4/2	592,551.12	7/31/14	7.595%	
Colombia 7	4/3	1,952,715.00	9/5/91	7.185%	
Jordan 11	4/3	125,700.46	11/15/92	7.365%	
Jordan 12	4/3	2,515,051.00	2/5/95	7.421%	
Philippines 10	4/3	151,214.00	7/15/92	7.355%	
Turkey 17	4/4	23,054.58	11/30/13	7.615%	
Egypt 7	4/7	398,067.07	7/13/14	7.665%	
Peru 9	4/7	45,126.64	9/15/95	7.495%	
Turkey 17	4/7	953,922.80	11/30/13	7.695%	
Philippines 10	4/7	22,385.48	7/15/92	7.405%	
Spain 8	4/8	47,100,000.00	3/25/96	7.215%	
Zaire 4	4/8	99,855.59	9/14/95	7.245%	
Philippines 10	4/10	19,816.66	7/15/92	7.155%	

+rollover

FEDERAL FINANCING BANK

APRIL 1986 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual	INTEREST RATE (other than semi-annual)
Foreign Military Sales (Cont'd)					
Greece 15	4/10	$ 1,536,275.05	6/15/12	7.502%	
Jordan 12	4/10	181,190.00	2/5/95	7.335%	
Greece 14	4/10	1,448,020.08	4/30/11	7.525%	
Egypt 7	4/11	286,104.51	7/31/14	7.455%	
Indonesia 11	4/11	329,828.00	8/12/93	6.375%	
Morocco 13	4/17	16,725.47	5/31/96	6.845%	
Turkey 17	4/17	9,175,360.75	11/30/13	7.298%	
Jordan 12	4/21	98,126.70	2/5/95	7.145%	
Jordan 11	4/22	40,713.00	11/15/92	6.975%	
Greece 15	4/22	669,221.23	6/15/12	7.318%	
Philippines 10	4/22	529,872.33	7/15/92	6.925%	
Ecuador 8	4/23	521,580.00	7/31/96	7.012%	
Tunisia 17	4/23	649,564.00	9/15/96	7.271%	
Greece 14	4/25	15,452,684.11	4/30/11	7.797%	
Greece 15	4/25	15,196,411.89	6/15/12	7.787%	
Kenya 10	4/30	1,244,429.71	5/5/94	7.392%	
Portugal 2	4/30	422,030.00	9/10/95	7.475%	
DEPARTMENT OF HOUSING & URBAN DEVELOPMENT					
Community Development					
Provo, UT	4/1	942,583.00	8/1/86	6.665%	
Newport News, VA	4/1	254,000.00	2/17/87	6.815%	6.915% ann.
St. Louis, MO	4/3	400,000.00	2/17/87	6.795%	6.894% ann.
Springfield, MA	4/3	608,932.00	8/1/86	6.695%	
Santa Ana, CA	4/7	220,099.94	8/15/86	6.585%	
Louisville, KY	4/10	102,000.00	2/2/87	6.435%	6.515% ann.
Biloxi, MI	4/11	160,536.00	5/1/87	6.455%	6.559% ann.
Mayaguez, PR	4/14	15,000.00	8/3/87	6.555%	6.662% ann.
Newport News, VA	4/14	103,000.00	2/17/87	6.445%	6.529% ann.
Hialeah, FL	4/21	187,598.01	12/1/86	6.245%	6.281% ann.
Albany, NY	4/22	250,000.00	7/1/03	7.209%	7.339% ann.
Mayaguez, PR	4/22	281,397.68	8/3/87	6.425%	6.528% ann.
Massillon, OH	4/28	175,000.00	9/15/86	6.565%	
Newport News, VA	4/28	69,000.00	2/17/87	6.725%	6.810% ann.
DEPARTMENT OF THE NAVY					
Ship Lease Financing					
+Bobo	4/15	118,839,782.17	7/15/86	6.215%	
+Bobo Container	4/15	2,200,359.00	7/15/86	6.215%	
+Williams	4/15	116,422,407.03	7/15/86	6.215%	
+Williams Container	4/15	2,200,359.00	7/15/86	6.215%	
+Lopez	4/15	113,852,682.12	7/15/86	6.215%	
+Lopez Container	4/15	2,200,359.00	7/15/86	6.215%	
+Lummus	4/15	116,787,637.44	7/15/86	6.215%	
+Lummus Container	4/15	2,200,359.00	7/15/86	6.215%	
+Buck	4/15	47,642,729.54	7/15/86	6.215%	
+Darnell	4/15	44,561,684.08	7/15/86	6.215%	
+Cobb	4/15	43,316,650.34	7/15/86	6.215%	
+Matthiesen	4/15	43,583,218.74	7/15/86	6.215%	
+Kocak	4/15	104,788,142.81	7/15/86	6.215%	
+Obregon	4/15	107,879,688.62	7/15/86	6.215%	
+Pless	4/15	105,919,489.26	7/15/86	6.215%	
+Pless Container	4/15	2,330,000.00	7/15/86	6.215%	
+Hauge	4/15	126,322,576.50	7/15/86	6.215%	
+Baugh	4/15	122,312,472.03	7/15/86	6.215%	
+Anderson	4/15	120,680,366.76	7/15/86	6.215%	
+Fisher	4/15	117,268,592.12	7/15/86	6.215%	
+Fisher Container	4/15	1,584,418.71	7/15/86	6.215%	
+Bonnyman	4/15	124,086,023.84	7/15/86	6.215%	
+Bonnyman Container	4/15	1,584,382.08	7/15/86	6.215%	
Gianella	4/22	46,101,422.15	7/15/86	6.165%	

+rollover

FEDERAL FINANCING BANK

APRIL 1986 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
Defense Production Act					
Gila River Indian Community	4/21	$ 179,598.69	10/1/92	6.829%	6.772% qtr.
RURAL ELECTRIFICATION ADMINISTRATION					
Corn Belt Power #292	4/2	637,000.00	1/2/18	7.586%	7.515% qtr.
*Wabash Valley Power #206	4/2	12,107,000.00	4/4/88	7.015%	6.955% qtr.
*Wabash Valley Power #206	4/2	365,000.00	4/4/88	7.015%	6.955% qtr.
*South Mississippi Electric #90	4/2	495,000.00	12/31/12	7.542%	7.472% qtr.
*Wolverine Power #100	4/2	1,409,000.00	12/31/12	7.562%	7.492% qtr.
*Wolverine Power #101	4/2	1,822,000.00	12/31/12	7.562%	7.492% qtr.
*Wolverine Power #182	4/2	4,870,000.00	1/3/17	7.587%	7.516% qtr.
*Wolverine Power #191	4/2	5,878,000.00	1/3/17	7.587%	7.516% qtr.
*Sunflower Electric #174	4/2	17,100,000.00	1/3/17	7.587%	7.516% qtr.
*Allegheny Electric #93	4/2	2,670,000.00	12/31/13	7.545%	7.475% qtr.
*Allegheny Electric #175	4/2	4,933,000.00	12/31/15	7.550%	7.480% qtr.
*Allegheny Electric #175	4/2	9,024,000.00	12/31/15	7.550%	7.480% qtr.
*United Power #86	4/2	2,456,000.00	12/31/13	7.545%	7.475% qtr.
*Saluda River Electric #186	4/2	7,042,000.00	1/3/17	7.587%	7.516% qtr.
*United Power #122	4/2	678,000.00	1/3/17	7.587%	7.516% qtr.
*United Power #212	4/2	1,160,000.00	1/3/17	7.587%	7.516% qtr.
*Western Illinois Power #225	4/2	5,367,000.00	12/31/18	7.591%	7.520% qtr.
*New Hampshire Electric #192	4/2	1,575,000.00	12/31/18	7.591%	7.520% qtr.
*Kansas Electric #216	4/2	2,960,000.00	12/31/18	7.591%	7.520% qtr.
*Kansas Electric #216	4/2	1,134,000.00	12/31/18	7.591%	7.520% qtr.
*Kansas Electric #216	4/2	1,104,000.00	12/31/18	7.591%	7.520% qtr.
*Kansas Electric #216	4/2	1,234,000.00	12/31/18	7.591%	7.520% qtr.
*Deseret G&T #211	4/3	4,772,000.00	12/31/20	7.566%	7.496% qtr.
*Deseret G&T #315	4/3	33,357,000.00	12/31/16	7.563%	7.493% qtr.
*Colorado Ute Electric #276	4/3	2,155,000.00	6/30/88	7.072%	7.011% qtr.
*Colorado Ute Electric #297	4/3	2,803,000.00	6/30/88	7.072%	7.011% qtr.
*Plains Electric G&T #300	4/3	1,023,000.00	12/31/16	7.535%	7.465% qtr.
*Basin Electric #87	4/7	1,515,000.00	12/31/12	7.717%	7.644% qtr.
*Basin Electric #87	4/7	10,000.00	12/31/12	7.717%	7.644% qtr.
*Basin Electric #87	4/7	20,000,000.00	12/31/12	7.717%	7.644% qtr.
*Basin Electric #87	4/7	205,951.46	12/31/12	7.717%	7.644% qtr.
*Basin Electric #87	4/7	374,000.00	12/31/12	7.717%	7.644% qtr.
*Basin Electric #87	4/7	295,000.00	12/31/12	7.717%	7.644% qtr.
*Basin Electric #87	4/7	254,000.00	12/31/12	7.717%	7.644% qtr.
*Basin Electric #87	4/7	25,000,000.00	12/31/12	7.717%	7.644% qtr.
*Basin Electric #137	4/7	9,853,000.00	1/3/17	7.702%	7.629% qtr.
*Basin Electric #137	4/7	25,000,000.00	1/3/17	7.702%	7.629% qtr.
*Basin Electric #137	4/7	30,000,000.00	1/3/17	7.702%	7.629% qtr.
*Basin Electric #137	4/7	20,000,000.00	1/3/17	7.702%	7.629% qtr.
*Basin Electric #137	4/7	20,000,000.00	1/3/17	7.702%	7.629% qtr.
*Basin Electric #137	4/7	15,000,000.00	12/31/18	7.697%	7.624% qtr.
*Basin Electric #137	4/7	30,000,000.00	12/31/13	7.713%	7.640% qtr.
*Basin Electric #272	4/7	600,900.82	12/31/15	7.703%	7.630% qtr.
*Basin Electric #272	4/7	163,256.20	12/31/15	7.703%	7.630% qtr.
*Basin Electric #272	4/7	6,884.30	12/31/15	7.703%	7.630% qtr.
Sho-Me Power #164	4/7	1,600,000.00	12/31/20	7.691%	7.618% qtr.
*Tex-La Electric #208	4/7	3,222,000.00	12/31/18	7.696%	7.623% qtr.
*Basin Electric #232	4/7	121,000.00	12/31/18	7.696%	7.623% qtr.
*United Power #129	4/8	1,946,000.00	1/2/18	7.675%	7.603% qtr.
*United Power #159	4/8	619,000.00	12/31/20	7.704%	7.631% qtr.
*United Power #212	4/8	61,000.00	12/31/20	7.704%	7.631% qtr.
*New Hampshire Electric #192	4/9	1,098,000.00	1/3/17	7.547%	7.477% qtr.
*New Hampshire Electric #192	4/9	1,340,000.00	1/3/17	7.547%	7.477% qtr.
*New Hampshire Electric #192	4/9	1,091,000.00	1/3/17	7.547%	7.477% qtr.
*New Hampshire Electric #192	4/9	1,065,000.00	1/3/17	7.547%	7.477% qtr.
*Brazos Electric #108	4/9	1,101,000.00	1/3/17	7.547%	7.477% qtr.
*Brazos Electric #144	4/9	1,541,000.00	1/3/17	7.547%	7.477% qtr.
*Associated Electric #132	4/9	10,945,000.00	12/31/19	7.543%	7.473% qtr.

*maturity extension

FEDERAL FINANCING BANK

APRIL 1986 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
RURAL ELECTRIFICATION ADMINISTRATION (Cont'd)					
Oglethorpe Power #246	4/10	$ 30,268,000.00	12/31/20	7.480%	7.411% qtr.
Oglethorpe Power #299	4/10	4,898,000.00	12/31/21	7.471%	7.403% qtr.
*Wabash Valley Power #104	4/10	3,606,000.00	12/31/14	7.488%	7.419% qtr.
*Wabash Valley Power #206	4/10	223,000.00	4/11/88	6.705%	6.650% qtr.
*Mid-Georgia Telephone #229	4/10	2,312,000.00	12/31/20	7.466%	7.398% qtr.
*Wolverine Power #100	4/10	2,158,000.00	12/31/12	7.475%	7.406% qtr.
*Wolverine Power #101	4/10	2,757,000.00	12/31/12	7.475%	7.406% qtr.
*Allegheny Electric #93	4/10	2,643,000.00	12/31/13	7.448%	7.380% qtr.
*Sunflower Electric #151	4/11	542,000.00	12/31/14	7.475%	7.406% qtr.
*Mid-Georgia Telephone #229	4/11	2,312,000.00	12/31/20	7.466%	7.398% qtr.
*Oglethorpe Power #74	4/14	15,289,000.00	1/3/17	7.521%	7.452% qtr.
*Oglethorpe Power #74	4/14	18,470,411.17	1/3/17	7.521%	7.452% qtr.
*Oglethorpe Power #74	4/14	25,429,000.00	12/31/15	7.523%	7.454% qtr.
*Oglethorpe Power #150	4/14	760,000.00	1/3/17	7.521%	7.452% qtr.
*Oglethorpe Power #150	4/14	9,394,000.00	1/3/17	7.521%	7.452% qtr.
*Oglethorpe Power #150	4/14	7,041,000.00	12/31/14	7.523%	7.454% qtr.
*Oglethorpe Power #150	4/14	26,772,000.00	12/31/15	7.523%	7.454% qtr.
*New Hampshire Electric #192	4/14	1,100,000.00	12/31/18	7.520%	7.451% qtr.
*Wabash Valley Power #104	4/14	6,237,000.00	4/14/88	6.775%	6.719% qtr.
*Wabash Valley Power #206	4/14	1,973,000.00	4/14/88	6.775%	6.719% qtr.
*Wolverine Power #101	4/14	1,057,000.00	12/31/12	7.475%	7.406% qtr.
*Wolverine Power #182	4/14	2,917,000.00	1/3/17	7.521%	7.452% qtr.
*Wolverine Power #183	4/14	1,594,000.00	1/3/17	7.521%	7.452% qtr.
*Wolverine Power #191	4/14	941,000.00	1/3/17	7.521%	7.452% qtr.
*Alabama Electric #244	4/14	3,354,000.00	12/31/20	7.519%	7.450% qtr.
*East Kentucky Power #140	4/16	188,000.00	12/31/20	7.486%	7.417% qtr.
*East Kentucky Power #291	4/16	706,000.00	12/31/15	7.482%	7.413% qtr.
*Western Illinois Power #99	4/16	3,603,000.00	12/31/14	7.484%	7.415% qtr.
*Corn Belt Power #94	4/16	361,000.00	12/31/18	7.484%	7.415% qtr.
*Soyland Power #226	4/16	31,142,000.00	12/31/18	7.484%	7.415% qtr.
*Colorado Ute Electric #203	4/16	1,376,000.00	4/18/88	6.655%	6.601% qtr.
*South Texas Electric #200	4/16	704,000.00	1/3/17	7.484%	7.415% qtr.
*Cajun Electric #180	4/16	46,500,000.00	1/3/17	7.484%	7.415% qtr.
*Central Electric #131	4/16	425,000.00	1/3/17	7.484%	7.415% qtr.
*Seminole Electric #141	4/17	2,037,000.00	12/31/14	7.286%	7.221% qtr.
*Seminole Electric #141	4/17	36,562,000.00	1/2/18	7.287%	7.222% qtr.
*Seminole Electric #141	4/17	21,106,000.00	1/2/18	7.287%	7.222% qtr.
*Seminole Electric #141	4/17	8,765,000.00	12/31/15	7.287%	7.222% qtr.
*Old Dominion Electric #267	4/18	47,979,798.00	12/31/13	7.287%	7.222% qtr.
*Sugar Land Telephone #69	4/18	1,200,000.00	12/31/14	7.311%	7.245% qtr.
*Sugar Land Telephone #69	4/18	1,411,000.00	1/3/17	7.310%	7.244% qtr.
*Sugar Land Telephone #69	4/18	1,000,000.00	12/31/14	7.312%	7.246% qtr.
*Sugar Land Telephone #69	4/18	1,771,000.00	1/3/17	7.311%	7.245% qtr.
*Sugar Land Telephone #210	4/18	688,000.00	12/31/13	7.310%	7.244% qtr.
Brazos Electric #230	4/21	986,000.00	12/31/20	7.346%	7.280% qtr.
*South Mississippi Electric #90	4/21	1,170,000.00	12/31/12	7.304%	7.239% qtr.
*Corn Belt Power #94	4/21	600,000.00	1/3/17	7.351%	7.285% qtr.
*United Power #145	4/21	1,650,000.00	1/3/17	7.351%	7.285% qtr.
*Southern Illinois Power #98	4/21	800,000.00	12/31/18	7.348%	7.282% qtr.
*Western Farmers Electric #133	4/21	1,705,000.00	12/31/18	7.348%	7.282% qtr.
*Western Farmers Electric #200	4/21	2,600,000.00	12/31/18	7.348%	7.282% qtr.
*Colorado Ute Electric #78	4/23	414,000.00	6/30/88	6.738%	6.682% qtr.
*Cajun Electric #147	4/23	35,500,000.00	12/31/14	7.488%	7.419% qtr.
*Cont. Tel. of Kentucky #254	4/23	3,500,000.00	12/31/20	7.459%	7.391% qtr.
*Central Electric #278	4/24	714,000.00	12/31/16	7.630%	7.559% qtr.
*Colorado Ute Electric #168	4/28	1,027,695.00	4/28/88	7.035%	6.974% qtr.
*French Broad Electric #245	4/28	650,000.00	12/31/18	7.792%	7.718% qtr.
*Cajun Electric #249	4/28	10,000,000.00	12/31/18	7.792%	7.718% qtr.
*S. Mississippi Electric #3	4/29	138,028.85	1/3/11	7.669%	7.597% qtr.
*S. Mississippi Electric #3	4/29	107,650.48	1/3/11	7.669%	7.597% qtr.
*S. Mississippi Electric #3	4/29	557,575.44	1/3/11	7.669%	7.597% qtr.
*S. Mississippi Electric #4	4/29	1,101,127.27	12/31/12	7.674%	7.602% qtr.
*S. Mississippi Electric #4	4/29	1,100,154.54	12/31/12	7.674%	7.602% qtr.

*maturity extension

FEDERAL FINANCING BANK

APRIL 1986 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
RURAL ELECTRIFICATION ADMINISTRATION (Cont'd)					
*S. Mississippi Electric #90	4/29	$ 382,000.00	12/31/12	7.716%	7.643% qtr.
*S. Mississippi Electric #90	4/29	599,016.39	12/31/12	7.715%	7.642% qtr.
*S. Mississippi Electric #90	4/29	485,917.44	12/31/12	7.674%	7.602% qtr.
*S. Mississippi Electric #90	4/29	264,185.82	12/31/12	7.674%	7.602% qtr.
*S. Mississippi Electric #90	4/29	867,779.82	12/31/12	7.674%	7.602% qtr.
*S. Mississippi Electric #90	4/29	3,837,409.08	12/31/12	7.674%	7.602% qtr.
*S. Mississippi Electric #171	4/29	4,688,000.00	1/31/17	7.704%	7.631% qtr.
*S. Mississippi Electric #171	4/29	2,250,000.00	1/2/18	7.700%	7.627% qtr.
*S. Mississippi Electric #171	4/29	2,375,000.00	1/2/18	7.701%	7.628% qtr.
*S. Mississippi Electric #171	4/29	1,800,000.00	1/2/18	7.701%	7.628% qtr.
*S. Mississippi Electric #171	4/29	2,891,000.00	12/31/15	7.707%	7.634% qtr.
*S. Mississippi Electric #171	4/29	1,639,000.00	12/31/15	7.707%	7.634% qtr.
*S. Mississippi Electric #171	4/29	2,500,000.00	12/31/15	7.708%	7.635% qtr.
*S. Mississippi Electric #289	4/29	1,026,500.00	12/31/18	7.699%	7.626% qtr.
*North Carolina Electric #268	4/29	1,157,000.00	1/2/18	7.698%	7.625% qtr.
*Kamo Electric #266	4/30	4,239,000.00	12/31/15	7.579%	7.509% qtr.
*New Hampshire Electric #270	4/30	978,000.00	12/31/17	7.610%	7.539% qtr.
*Allegheny Electric #175	4/30	4,421,000.00	12/31/15	7.580%	7.510% qtr.
Allegheny Electric #304	4/30	306,000.00	12/31/18	7.587%	7.516% qtr.
*Tex-La Electric #208	4/30	788,000.00	12/31/18	7.608%	7.537% qtr.
*Basin Electric #137	4/30	9,545,000.00	12/31/16	7.612%	7.541% qtr.
*Basin Electric #232	4/30	69,000.00	12/31/18	7.608%	7.537% qtr.
*Corn Belt Power #138	4/30	162,000.00	12/31/18	7.608%	7.537% qtr.
*Northwest Electric #176	4/30	915,000.00	5/2/88	6.975%	6.915% qtr.
SMALL BUSINESS ADMINISTRATION					
State & Local Development Company Debentures					
Deep East Texas Reg. CDl Co.	4/9	88,000.00	4/1/01	7.548%	
North Georgia CDC	4/9	102,000.00	4/1/01	7.548%	
Virginia Economic Dev. Corp.	4/9	105,000.00	4/1/01	7.548%	
North Texas Reg. Dev. Corp.	4/9	151,000.00	4/1/01	7.548%	
Empire State CDC	4/9	174,000.00	4/1/01	7.548%	
San Diego County LDC	4/9	176,000.00	4/1/01	7.548%	
Cumberland-Allegheny C.I.F.	4/9	202,000.00	4/1/01	7.548%	
Arrowhead Reg. Dev. Corp.	4/9	214,000.00	4/1/01	7.548%	
Iowa Business Growth Co.	4/9	244,000.00	4/1/01	7.548%	
Southeast LDC	4/9	385,000.00	4/1/01	7.548%	
Brenham Indus. Foundation, Inc.	4/9	420,000.00	4/1/01	7.548%	
Michigan CDC	4/9	420,000.00	4/1/01	7.548%	
Iowa Bus. Growth Co.	4/9	500,000.00	4/1/01	7.548%	
Wilmington Indus. Dev., Inc.	4/9	44,000.00	4/1/06	7.670%	
Birmingham City Wide LDC	4/9	56,000.00	4/1/06	7.670%	
Areawide Dev. Corp.	4/9	60,000.00	4/1/06	7.670%	
Texas CDC, Inc.	4/9	64,000.00	4/1/06	7.670%	
South Georgia Area Dev. Corp.	4/9	75,000.00	4/1/06	7.670%	
Coon Rapids Dev. Co.	4/9	76,000.00	4/1/06	7.670%	
St. Louis LDC	4/9	79,000.00	4/1/06	7.670%	
Jacksonville LDC, Inc.	4/9	81,000.00	4/1/06	7.670%	
Opportunities Minnesota Inc.	4/9	82,000.00	4/1/06	7.670%	
Columbus Countywide Dev. Corp.	4/9	83,000.00	4/1/06	7.670%	
Columbus Countywide Dev. Corp.	4/9	88,000.00	4/1/06	7.670%	
Michigan CDC	4/9	89,000.00	4/1/06	7.670%	
Historic 25th Street Dev. Co.	4/9	90,000.00	4/1/06	7.670%	
St. Louis County LDC	4/9	97,000.00	4/1/06	7.670%	
Arizona Enterprise Dev. Corp.	4/9	102,000.00	4/1/06	7.670%	
Oakland County LDC	4/9	105,000.00	4/1/06	7.670%	
Opportunities Minnesota, Inc.	4/9	105,000.00	4/1/06	7.670%	
Texas Panhandle Reg. Dev. Corp.	4/9	109,000.00	4/1/06	7.670%	
Indiana Statewide CDC	4/9	121,000.00	4/1/06	7.670%	
St. Louis County LDC	4/9	122,000.00	4/1/06	7.670%	
Milwaukee Economic Dev. Corp.	4/9	125,000.00	4/1/06	7.670%	
Toledo Econ. Plan. Council, Inc	4/9	126,000.00	4/1/06	7.670%	

*maturity extension

FEDERAL FINANCING BANK

APRIL 1986 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
State & Local Development Company Debentures (Cont'd)					
Evergreen Community Dev. Assoc.	4/9	$ 131,000.00	4/1/06	7.670%	
Detroit Economic Growth Corp.	4/9	134,000.00	4/1/06	7.670%	
Bristol County Chamber LDC	4/9	137,000.00	4/1/06	7.670%	
Oakland County LDC	4/9	142,000.00	4/1/06	7.670%	
St. Petersburg CDC, Inc.	4/9	145,000.00	4/1/06	7.670%	
Mahoning Valley Ec. Dev. Corp.	4/9	149,000.00	4/1/06	7.670%	
Oakland County LDC	4/9	150,000.00	4/1/06	7.670%	
Clay County Dev. Corp.	4/9	169,000.00	4/1/06	7.670%	
Coon Rapids Dev. Co.	4/9	174,000.00	4/1/06	7.670%	
East Texas Reg. Dev. Co.	4/9	182,000.00	4/1/06	7.670%	
Opportunities Minnesota Inc.	4/9	189,000.00	4/1/06	7.670%	
Tulare County Ec. Dev. Corp.	4/9	206,000.00	4/1/06	7.670%	
East Cen. Michigan Dev. Corp.	4/9	208,000.00	4/1/06	7.670%	
Granite State Ec. Dev. Corp.	4/9	208,000.00	4/1/06	7.670%	
Empire State CDC	4/9	218,000.00	4/1/06	7.670%	
Metro. Growth & Dev. Corp.	4/9	234,000.00	4/1/06	7.670%	
Nevada State Dev. Corp.	4/9	246,000.00	4/1/06	7.670%	
Houston-Galveston Area LDC	4/9	272,000.00	4/1/06	7.670%	
Greater Southwest Kansas CDC	4/9	291,000.00	4/1/06	7.670%	
East Cen. Michigan Dev. Corp.	4/9	347,000.00	4/1/06	7.670%	
Hamilton County Dev. Co., Inc.	4/9	348,000.00	4/1/06	7.670%	
Wilmington Indus. Dev., Inc.	4/9	351,000.00	4/1/06	7.670%	
Georgia Mountains Reg. EDC	4/9	375,000.00	4/1/06	7.670%	
C.D.C. of Warren County, Inc.	4/9	379,000.00	4/1/06	7.670%	
Los Medanos Fund, Inc.	4/9	420,000.00	4/1/06	7.670%	
Wisconsin Bus. Dev. Fin. Corp.	4/9	500,000.00	4/1/06	7.670%	
San Diego County LDC	4/9	500,000.00	4/1/06	7.670%	
Big Country Dev. Corp.	4/9	500,000.00	4/1/06	7.670%	
San Diego County LDC	4/9	500,000.00	4/1/06	7.670%	
Wisconsin Bus. Dev. Fin. Corp.	4/9	500,000.00	4/1/06	7.670%	
Centralina Dev. Corp., Inc.	4/9	500,000.00	4/1/06	7.670%	
Wisconsin Bus. Dev. Fin. Corp.	4/9	500,000.00	4/1/06	7.670%	
MSP 503 Dev. Corp.	4/9	53,000.00	4/1/11	7.724%	
Warren Redev. & Planning Corp.	4/9	78,000.00	4/1/11	7.724%	
Dev. Corp. of Middle Georgia	4/9	83,000.00	4/1/11	7.724%	
Johnstown Area Reg. Indus. CDC	4/9	83,000.00	4/1/11	7.724%	
Montgomery County B.D.C.	4/9	87,000.00	4/1/11	7.724%	
River East Progress, Inc.	4/9	97,000.00	4/1/11	7.724%	
Region Eight Dev. Corp.	4/9	99,000.00	4/1/11	7.724%	
E.D.F. of Sacramento, Inc.	4/9	106,000.00	4/1/11	7.724%	
Gold Country CDC	4/9	119,000.00	4/1/11	7.724%	
Lake County Sm. Bus. 503 Corp.	4/9	138,000.00	4/1/11	7.724%	
Wilmington Indus. Dev., Inc.	4/9	147,000.00	4/1/11	7.724%	
Opportunities Minnesota, Inc.	4/9	156,000.00	4/1/11	7.724%	
Gold Country CDC	4/9	158,000.00	4/1/11	7.724%	
Bay Colony Dev. Corp.	4/9	158,000.00	4/1/11	7.724%	
Columbus Countywide Dev. Corp.	4/9	181,000.00	4/1/11	7.724%	
New Haven Com. Invest. Corp.	4/9	202,000.00	4/1/11	7.724%	
Housatonic Indus. Dev. Corp.	4/9	231,000.00	4/1/11	7.724%	
E.D.F. of Sacramento, Inc.	4/9	241,000.00	4/1/11	7.724%	
Business Dev. Corp. of Nebraska	4/9	265,000.00	4/1/11	7.724%	
Wisconsin Bus. Dev. Fin. Corp.	4/9	268,000.00	4/1/11	7.724%	
Kisatchie-Delta RP&D Dis., Inc.	4/9	273,000.00	4/1/11	7.724%	
St. Louis County LDC	4/9	282,000.00	4/1/11	7.724%	
Massachusetts CDC	4/9	283,000.00	4/1/11	7.724%	
N. Virginia LDC, Inc.	4/9	301,000.00	4/1/11	7.724%	
Bay Area Employment Dev. Co.	4/9	342,000.00	4/1/11	7.724%	
W. Mass. Sm. Bus. Assist., Inc.	4/9	343,000.00	4/1/11	7.724%	
Railbelt Community Dev. Corp.	4/9	363,000.00	4/1/11	7.724%	
Scioto Ec. Dev. Corp.	4/9	387,000.00	4/1/11	7.724%	
Bay Area Bus. Dev. Co.	4/9	390,000.00	4/1/11	7.724%	
HEDCO LDC	4/9	441,000.00	4/1/11	7.724%	
Evergreen Community Dev. Assoc.	4/9	498,000.00	4/1/11	7.724%	
Bay Area Bus. Dev. Co.	4/9	500,000.00	4/1/11	7.724%	
Delaware Dev. Corp.	4/9	500,000.00	4/1/11	7.724%	

FEDERAL FINANCING BANK

APRIL 1986 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
+Note A-86-07	4/30	501,360,919.15	7/31/86	6.415%	

+rollover

FEDERAL FINANCING BANK
APRIL 1986 Commitments

BORROWER	GUARANTOR	AMOUNT	COMMITMENT EXPIRES	MATURITY
Alhambra, CA	HUD	$ 1,370,285.00	8/15/87	8/15/93
Bellflower, CA	HUD	1,725,000.00	6/1/87	6/1/93
Harrisburg, PA	HUD	150,000.00	12/1/86	12/1/92
Harrisburg, PA	HUD	650,000.00	12/1/86	12/1/92
Hialeah, FL	HUD	276,140.68	12/1/86	12/1/90
Kansas City, MO	HUD	1,500,000.00	6/15/87	6/15/92
Pascagoula, MS	HUD	1,173,000.00	6/1/87	6/1/93

FEDERAL FINANCING BANK HOLDINGS
(in millions)

Program	April 30, 1986	March 31, 1986	Net Change 4/1/86-4/30/86	Net Change--FY 1986 10/1/85-4/30/86
Agency Debt				
Export-Import Bank	$ 15,250.1	$ 15,250.1	$ -0-	$ -159.0
NCUA-Central Liquidity Facility	146.5	223.0	-76.5	-75.7
Tennessee Valley Authority	14,250.0	14,649.0	-399.0	-131.0
U.S. Postal Service	1,690.0	1,690.0	-0-	-0-
U.S. Railway Association	73.8	73.8	-0-	-0-
Agency Assets				
Farmers Home Administration	63,829.0	63,464.0	365.0	-340.0
DHHS-Health Maintenance Org.	105.9	105.9	-0-	-3.3
DHHS-Medical Facilities	122.1	122.1	-0-	-0.7
Overseas Private Investment Corp.	3.4	3.4	-0-	-2.7
Rural Electrification Admin.-CBO	4,071.2	4,171.7	-100.5	346.9
Small Business Administration	28.9	29.4	-0.5	-4.0
Government-Guaranteed Lending				
DOD-Foreign Military Sales	18,686.8	18,584.3	102.5	598.3
DEd.-Student Loan Marketing Assn.	5,000.0	5,000.0	-0-	-0-
DHUD-Community Dev. Block Grant	287.4	297.1	-9.7	-2.0
DHUD-New Communities	32.2	32.2	-0-	-1.3
DHUD-Public Housing Notes	2,111.4	2,111.4	-0-	-34.7
General Services Administration	405.3	405.3	-0-	-3.1
DOI-Guam Power Authority	34.7	34.7	-0-	-0.5
DOI-Virgin Islands	27.8	27.8	-0-	-0.4
NASA-Space Communications Co.	887.6	887.6	-0-	-0-
DON-Ship Lease Financing	1,634.7	1,588.6	46.1	321.6
DON-Defense Production Act	7.6	7.5	0.2	1.8
Oregon Veteran's Housing	-0-	-0-	-0-	-60.0
Rural Electrification Admin.	21,060.5	20,958.8	101.7	-615.0
SBA-Small Business Investment Cos.	1,041.4	1,051.0	-9.6	17.5
SBA-State/Local Development Cos.	723.9	703.6	20.3	128.2
TVA-Seven States Energy Corp.	1,754.7	1,742.3	12.4	103.3
DOT-Section 511	63.7	63.7	-0-	-89.9
DOT-WMATA	177.0	177.0	-0-	-0-
TOTALS*	$ 153,507.6	$ 153,455.3	$ 52.4	$ -5.6

*figures may not total due to rounding

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE June 23, 1986

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,408 million of 13-week bills and for $7,409 million of 26-week bills, both to be issued on June 26, 1986, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing September 25, 1986			26-week bills maturing December 26, 1986		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	6.07%	6.25%	98.466	6.11%	6.39%	96.894
High	6.10%	6.28%	98.458	6.14%	6.43%	96.879
Average	6.09%	6.27%	98.461	6.13%	6.41%	96.884

Tenders at the high discount rate for the 13-week bills were allotted 18%.
Tenders at the high discount rate for the 26-week bills were allotted 42%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 34,175	$ 34,175	$ 19,305	$ 19,305
New York	22,319,160	6,337,560	21,664,510	6,417,310
Philadelphia	21,245	21,245	10,355	10,355
Cleveland	127,565	107,065	45,115	30,615
Richmond	40,260	39,795	55,320	47,420
Atlanta	37,900	36,150	22,640	21,640
Chicago	1,679,270	223,950	1,731,510	452,610
St. Louis	84,640	48,120	74,165	39,845
Minneapolis	26,420	12,320	23,395	23,395
Kansas City	44,905	44,905	39,175	39,175
Dallas	36,735	32,635	18,490	15,590
San Francisco	2,122,150	193,410	1,303,080	107,500
Treasury	276,460	276,460	184,285	184,285
TOTALS	$26,850,885	$7,407,790	$25,191,345	$7,409,045
Type				
Competitive	$24,142,550	$4,699,455	$21,807,130	$4,024,830
Noncompetitive	954,760	954,760	585,740	585,740
Subtotal, Public	$25,097,310	$5,654,215	$22,392,870	$4,610,570
Federal Reserve	1,524,430	1,524,430	1,500,000	1,500,000
Foreign Official Institutions	229,145	229,145	1,298,475	1,298,475
TOTALS	$26,850,885	$7,407,790	$25,191,345	$7,409,045

An additional $25,255 thousand of 13-week bills and an additional $120,725 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-634

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

June 25, 1986

JAMES A. BAKER, III
SECRETARY OF THE TREASURY

James A. Baker, III became the 67th Secretary of the Treasury on February 3, 1985.

Prior to this Secretary Baker had been appointed by President Reagan as Chief of Staff to the President of the United States, a position which he occupied from January 1981 through January 1985. While at the White House he was a member of the National Security Council and remains a member as Secretary of the Treasury. He is also Chairman of the President's Economic Policy Council.

In 1980, Secretary Baker served as Senior Adviser to the Reagan/Bush general election campaign. From January 1979 to May 1980 he was the Chairman of Vice President Bush's campaign for the 1980 Republican Presidential nomination.

Secretary Baker was the Republican Party's nominee for Attorney General of the state of Texas in 1978. He is a native Houstonian and practiced law there with the firm of Andrews & Kurth from 1957 to 1975.

In August 1975, Secretary Baker was appointed by President Ford to be the Under Secretary of Commerce. Secretary Baker joined President Ford's presidential campaign in May 1976 as Deputy Chairman for Delegate Operations and in August became National Chairman of the President Ford Committee.

Secretary Baker graduated from Princeton University in 1952. After two years of active duty as a Lieutenant in the United States Marine Corps he entered the University of Texas School of Law at Austin. He received his J.D. with honors in 1957.

A member of the American, Texas and Houston Bar Associations, the American Judicature Society, and the Phi Delta Phi honorary legal fraternity, Secretary Baker also serves on the Board of Trustees of the Woodrow Wilson International Center for Scholars at the Smithsonian Institution. He has served on the governing bodies of the Texas Children's Hospital and the M.D. Anderson Hospital and Tumor Institute.

Secretary Baker has been the recipient of the Jefferson Award for distinguished public service from the American Institute for Public Service, an award for Distinguished Public Service from the John F. Kennedy School of Government at Harvard and the Woodrow Wilson Award for distinguished achievement in the nation's service from Princeton University. Secretary Baker was selected in 1986 as a Distinguished Alumnus of the University of Texas. He has received numerous honorary degrees.

Secretary Baker was born April 28, 1930. He and his wife, the former Susan Garrett, reside in Washington, D.C. They have eight children.

B-635

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 4:00 P.M. June 24, 1986

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $14,800 million, to be issued July 3, 1986. This offering will provide about $125 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $14,673 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, June 30, 1986. The two series offered are as follows:

91-day bills (to maturity date) for approximately $7,400 million, representing an additional amount of bills dated October 3, 1985, and to mature October 2, 1986 (CUSIP No. 912794 KR 4), currently outstanding in the amount of $15,447 million, the additional and original bills to be freely interchangeable.

183-day bills for approximately $7,400 million, to be dated July 3, 1986, and to mature January 2, 1987 (CUSIP No. 912794 LQ 5).

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. Both series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing July 3, 1986. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. Federal Reserve Banks currently hold $946 million as agents for foreign and international monetary authorities, and $3,732 million for their own account. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-2 (for 26-week series) or Form PD 4632-3 (for 13-week series).

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE June 24, 1986

RESULTS OF AUCTION OF 4-YEAR NOTES

The Department of the Treasury has accepted $7,389 million of $31,930 million of tenders received from the public for the 4-year notes, Series P-1990, auctioned today. The notes will be issued June 30, 1986, and mature June 30, 1990.

The interest rate on the notes will be 7-1/4%. The range of accepted competitive bids, and the corresponding prices at the 7-1/4% interest rate are as follows:

	Yield	Price
Low	7.26%	99.966
High	7.26%	99.966
Average	7.26%	99.966

Tenders at the high yield were allotted 40%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 27,316	$ 7,316
New York	29,530,850	7,057,390
Philadelphia	11,519	11,519
Cleveland	15,989	15,989
Richmond	32,835	16,835
Atlanta	36,112	13,112
Chicago	1,382,762	118,762
St. Louis	85,331	56,731
Minneapolis	8,098	8,098
Kansas City	45,400	43,400
Dallas	11,006	5,006
San Francisco	741,872	33,672
Treasury	926	926
Totals	$31,930,016	$7,388,756

The $7,389 million of accepted tenders includes $384 million of noncompetitive tenders and $7,005 million of competitive tenders from the public.

In addition to the $7,389 million of tenders accepted in the auction process, $325 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $313 million of tenders was also accepted at the average price from Government accounts and Federal Reserve Banks for their own account in exchange for maturing securities.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE June 25, 1986

RESULTS OF AUCTION OF 7-YEAR NOTES

The Department of the Treasury has accepted $6,758 million of $16,656 million of tenders received from the public for the 7-year notes, Series G-1993, auctioned today. The notes will be issued July 7, 1986, and mature July 15, 1993.

The interest rate on the notes will be 7-1/4%. The range of accepted competitive bids, and the corresponding prices at the 7-1/4% interest rate are as follows:

	Yield	Price
Low	7.26%	99.940
High	7.36%	99.399
Average	7.33%	99.561

Tenders at the high yield were allotted 30%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 1,650	$ 1,650
New York	14,543,090	5,950,590
Philadelphia	1,232	1,232
Cleveland	10,531	8,531
Richmond	6,290	6,290
Atlanta	17,162	17,162
Chicago	1,127,102	285,102
St. Louis	59,008	43,008
Minneapolis	3,973	3,973
Kansas City	19,075	19,075
Dallas	15,707	15,707
San Francisco	851,076	405,076
Treasury	437	437
Totals	$16,656,333	$6,757,833

The $6,758 million of accepted tenders includes $309 million of noncompetitive tenders and $6,449 million of competitive tenders from the public.

B-638

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
June 26, 1986

CONTACT: Susanne Howard
566-2843

TREASURY SECRETARY BAKER ANNOUNCES SELECTION OF DESIGNS FOR UNITED STATES GOLD AND SILVER BULLION COINS

Secretary of the Treasury, James A. Baker III, announced today the designs for the new U. S. gold and silver bullion coins which will be issued this fall marking this country's first entry into the bullion coin market.

All four denominations of gold coins - a Fifty Dollar coin containing one fine ounce of gold, a Twenty-five Dollar coin containing a half ounce, a Ten Dollar coin containing a quarter ounce, and a Five Dollar coin containing one-tenth ounce have the Augustus Saint-Gaudens obverse design of Liberty used on U. S. Twenty Dollar gold pieces from 1907 until 1933. The reverse on each of the four new gold coins features a "family of eagles" - a male eagle carrying an olive branch flying above a nest containing a female eagle and hatchlings - symbolizing the unity and family tradition of America.

The Silver Liberty One Dollar coin has Adolph A. Weinman's Walking Liberty design used on U. S. Half Dollar coins from 1916 until 1947. The reverse design is a rendition of a heraldic eagle with shield holding arrows in one talon and an olive branch in the other.

Public Law 99-185 of December 17, 1985, the Gold Bullion Coin Act of 1985, provides for the Treasury Department to mint and issue gold bullion coins in quantities sufficient to meet public demand. The Act specifies that the obverse design of the Fifty Dollar gold coin shall have a design symbolic of Liberty and a reverse design representing a family of eagles. The Liberty Coin Act of July 9, 1985, provided for the striking and issuance of silver One Dollar coins to meet the demand of the public, and calls for a symbol of Liberty on the obverse side and an eagle on the reverse.

There have been some minor refinements to the Saint-Gaudens double eagle Liberty design which will appear on the gold coins, the most noticeable being the increase in the number of stars around the border to fifty (50). The coin had a border of forty-six (46) stars on the obverse from 1907 to 1911 and forty-eight (48) stars from 1912 to 1933. Roman numerals will be used to designate the year of issue. Augustus Saint-Gaudens' initials appear on the design. Matthew Peloso, a Mint Sculptor and Engraver, executed the model.

Mrs. Miley Busiek, an artist from Dallas, Texas, prepared and furnished to the Department a "family of eagles" design which appears on all four denominations of gold coins. She worked with U. S. Mint Sculptors/Engravers in simplifying and refining her design to be adaptable for use on the bullion coins. Sherl J. Winter, a Mint Sculptor and Engraver, executed the model and his initials will appear on the reverse as well as those of Mrs. Busiek.

On the original Walking Liberty Half Dollars, Adolph A. Weinman's monogram appeared on the reverse of the coin. On the Silver Liberty One Dollar bullion coin his monogram has been added to the obverse design. Edgar Steever, a Mint Sculptor and Engraver, executed the model.

Unlike earlier U. S. Silver Dollars which are 1-1/2 inches in diameter and contain a little over three quarters of an ounce of fine silver, the new U. S. Silver Liberty One Dollar bullion coin is slightly larger in diameter and contains one fine ounce of silver. John Mercanti, a Mint Sculptor and Engraver, prepared the heraldic eagle design and executed the model. His initials will appear on the reverse.

In accordance with the Gold Bullion Coin Act and the Liberty Coin Act, the Department will issue both the gold and silver bullion coins on October 1, 1986.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

For Release Upon Delivery
June 19, 1986 2:00 P.M. EDT

Remarks of
David D. Queen
Deputy Assistant Secretary of Enforcement
Department of the Treasury
before the
House Select Committee on
Narcotics Abuse and Control

and

House Foreign Affairs Committee
Task Force on International
Narcotics Control

Mr. Chairman, the Treasury Department is pleased to have this opportunity to appear before you to address the issue of international drug trafficking, narcotics related money laundering and other activities associated with the illicit narcotics trade.

In the past decade illegal drug trafficking has increased dramatically, with a corresponding increase in crimes associated with it. President Reagan has identified the interdiction of illegal drugs as one of the major priorities of this administration. In support of this commitment the United States has allocated substantial law enforcement and prosecutorial resources to impede the flow of drugs and moneys associated with this illegal activity across our borders. As you may be aware, the Treasury Department and its law enforcement agencies has taken an equally firm stand to put narcotics interdiction squarely at the top of our international law enforcement agenda. We have repeatedly stated in every available forum that drug trafficking is a problem that cannot be solved by any one person, agency or Government. It must be attacked on all fronts and with every tool at our command, including the cooperation and assistance of our allies.

Treasury has primary responsibility for enforcing the "Bank Records and Foreign Transactions Act", commonly referred to as the "Bank Secrecy Act." The Act authorizes the Secretary of the Treasury to require certain reports and records where they are unlikely to have a high degree of usefulness in criminal, tax or regulatory investigations or proceedings. Under the Act, Treasury is responsible for monitoring the flow of currency in and out of the United States through the use of the reporting requirements. In addition, this law permits us to monitor and require the reporting of large cash transactions at domestic financial institutions.

Our experience in this area indicates that illegal drug trafficking, and the money laundering associated with it, requires the use of sophisticated financial arrangements involving the movement of large sums of cash. In many instances the financial institutions and systems that are used for these activities have no knowledge that they are being used to launder money.

Early in 1983, the Treasury Department became aware of an unusual flow of U.S. currency from the Banco Nacional de Panama (National Bank of Panama) to the Federal Reserve Bank offices in New York and Miami. Based on the data we were able to compile, it revealed that from 1980 through 1984 approximately $3.5 billion (primarily small bills) was shipped from Panama to the United States. In contrast the Federal Reserve Banks shipped to Panama $500 million in replacement currency during the same period, showing an immense cash surplus. Although U.S. Government agencies had received information for a number of years indicating that major drug traffickers or money launderers were using Panamanian banks or shell corporations to conceal their financial transactions, we were previously unaware of the magnitude and growth of the transactions being channeled through Panama.

Although our most recent data indicates the currency flow from the Banco Nacional de Panama appears to have decreased, it is still running at a very high level. It is our belief, based on data from the Forms 4789 (Currency Transaction Report - IRS) and 4790 (Currency & Monetary Instruments Report - Customs) filed with us, that much of this money is from illegal activities, mainly drug trafficking.

Panama is particularly vulnerable to money launderers for two reasons: geography and its banking system. Geographically Panama is the crossroad between the two continents, North and South America. With the exception of Mexican marijuana and heroin, which are produced adjacent to its market, Central America and the many islands in the Caribbean provide the bridge traveled by Latin American drugs en route to markets in the United States and Europe.

In the opposite direction a stream of money flows back to reimburse participants at the various stages of the production and trafficking process and to pay for the equipment and protection needed to move the various products to their destinations.

The flow pattern of drug money is motivated by many of the same considerations that govern the disposition of other liquid assets. Like legitimate money, narco-dollars tend to seek the highest rate of return and the lowest rate of taxation consistent with other considerations, such as secrecy and the ease to which narco-dollars may be disguised as legitimate dollars. While Panama is smaller geographically and in population than the State of New Jersey, it has over a 123 banks operating within its borders, and can justifiably proclaim itself the major financial center for Latin America. Approximately 70 of these financial institutions are associated with 26 foreign countries, including: U.S. - 14, Japan - 9, France - 6, Switzerland - 5, Canada - 3, Columbia - 2 etc. The facilities through which narco-dollars may be laundered or disguised as legitimate dollars are abundant.

A common hazard shared by drug traffickers is fluctuation in the relative value of currencies. Since the most likely exchange rate movement is devaluation of nonconvertible currency, traffickers try to hold their funds in hard currency (preferably U.S. dollars) as long as possible. The balboa, the Panamanian unit of currency, is at par with and equivalent to the U.S. dollar. Panama issues no paper currency. The U.S. dollar serves as the circulating medium of paper currency, making it almost impossible to segregate narco-dollars from legitimate dollars.

Drug money movements are susceptible to special problems. Like illicit drugs, narco-dollars are a form of contraband, which places an exceptionally high premium on secrecy of movement. It is no secret that Panama has perhaps the most stringent bank secrecy laws of any country in the region. Indeed, much of its success as a banking center is directly attributable to the strict confidentiality inherent in its bank secrecy laws and numbered accounts which are major ingredients in the system.

While the picture I have painted may appear somewhat dismal, I am pleased to report that we are engaged in discussions aimed at addressing these problems. During my tenure as Deputy Assistant Secretary I have had the opportunity to discuss this problem with my law enforcement colleagues at Justice and State, and our counterparts within the Government of Panama. The Panamanians have built a record of informal cooperation and assistance to the United States in law enforcement matters (e.g. extradition, search and seizure of Panamanian flag-ships, etc.). It is clear that illegal drug trafficking has important implications for the national interests of our respective countries. I believe this concern is shared by civilian officials at the highest level of the Panamanian Government with whom we have dealt. Building on the tradition of informal law enforcement cooperation that Panama has established, I am hopeful that as our discussions continue the United States and Panama will be able to develop a framework through this problem may be addressed.

This concludes my formal remarks, I would be pleased to address any question the Committee may have.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR RELEASE AT 12:00 NOON June 27, 1986

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for approximately $9,500 million of 364-day Treasury bills to be dated July 10, 1986, and to mature July 9, 1987 (CUSIP No. 912794 MT 8). This issue will provide about $975 million of new cash for the Treasury, as the maturing 52-week bill is outstanding in the amount of $8,514 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Tuesday, July 8, 1986.

The bills will be issued on a discount basis under competitive and noncompetitive bidding, and at maturity their par amount will be payable without interest. This series of bills will be issued entirely in book-entry form in a minimum amount of $10,000 and in any higher $5,000 multiple, on the records either of the Federal Reserve Banks and Branches, or of the Department of the Treasury.

The bills will be issued for cash and in exchange for Treasury bills maturing July 10, 1986. In addition to the maturing 52-week bills, there are $14,500 million of maturing bills which were originally issued as 13-week and 26-week bills. The disposition of this latter amount will be announced next week. Federal Reserve Banks currently hold $1,816 million as agents for foreign and international monetary authorities, and $5,388 million for their own account. These amounts represent the combined holdings of such accounts for the three issues of maturing bills. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rate of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold $100 million of the original 52-week issue. Tenders for bills to be maintained on the book-entry records of the Department of the Treasury should be submitted on Form PD 4632-1.

Each tender must state the par amount of bills bid for, which must be a minimum of $10,000. Tenders over $10,000 must be in multiples of $5,000. Competitive tenders must also show the yield desired, expressed on a bank discount rate basis with two decimals, e.g., 7.15%. Fractions may not be used. A single bidder, as defined in Treasury's single bidder guidelines, shall not submit noncompetitive tenders totaling more than $1,000,000.

Banking institutions and dealers who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities may submit tenders for account of customers, if the names of the customers and the amount for each customer are furnished. Others are only permitted to submit tenders for their own account. Each tender must state the amount of any net long position in the bills being offered if such position is in excess of $200 million. This information should reflect positions held as of 12:30 p.m. Eastern time on the day of the auction. Such positions would include bills acquired through "when issued" trading, and futures and forward transactions as well as holdings of outstanding bills with the same maturity date as the new offering, e.g., bills with three months to maturity previously offered as six-month bills. Dealers, who make primary markets in Government securities and report daily to the Federal Reserve Bank of New York their positions in and borrowings on such securities, when submitting tenders for customers, must submit a separate tender for each customer whose net long position in the bill being offered exceeds $200 million.

A noncompetitive bidder may not have entered into an agreement, nor make an agreement to purchase or sell or otherwise dispose of any noncompetitive awards of this issue being auctioned prior to the designated closing time for receipt of tenders.

Payment for the full par amount of the bills applied for must accompany all tenders submitted for bills to be maintained on the book-entry records of the Department of the Treasury. A cash adjustment will be made on all accepted tenders for the difference between the par payment submitted and the actual issue price as determined in the auction.

No deposit need accompany tenders from incorporated banks and trust companies and from responsible and recognized dealers in investment securities for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches. A deposit of 2 percent of the par amount of the bills applied for must accompany tenders for such bills from others, unless an express guaranty of payment by an incorporated bank or trust company accompanies the tenders.

Public announcement will be made by the Department of the Treasury of the amount and yield range of accepted bids. Competitive bidders will be advised of the acceptance or rejection of their tenders. The Secretary of the Treasury expressly reserves the right to accept or reject any or all tenders, in whole or in part, and the Secretary's action shall be final. Subject to these reservations, noncompetitive tenders for each issue for $1,000,000 or less without stated yield from any one bidder will be accepted in full at the weighted average bank discount rate (in two decimals) of accepted competitive bids for the respective issues. The calculation of purchase prices for accepted bids will be carried to three decimal places on the basis of price per hundred, e.g., 99.923, and the determinations of the Secretary of the Treasury shall be final.

Settlement for accepted tenders for bills to be maintained on the book-entry records of Federal Reserve Banks and Branches must be made or completed at the Federal Reserve Bank or Branch on the issue date, in cash or other immediately-available funds or in Treasury bills maturing on that date. Cash adjustments will be made for differences between the par value of the maturing bills accepted in exchange and the issue price of the new bills. In addition, Treasury Tax and Loan Note Option Depositaries may make payment for allotments of bills for their own accounts and for account of customers by credit to their Treasury Tax and Loan Note Accounts on the settlement date.

In general, if a bill is purchased at issue after July 18, 1984, and held to maturity, the amount of discount is reportable as ordinary income in the Federal income tax return of the owner at the time of redemption. Accrual-basis taxpayers, banks, and other persons designated in section 1281 of the Internal Revenue Code must include in income the portion of the discount for the period during the taxable year such holder held the bill. If the bill is sold or otherwise disposed of before maturity, the portion of the gain equal to the accrued discount will be treated as ordinary income. Any excess may be treated as capital gain.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76 and 27-76, Treasury's single bidder guidelines, and this notice prescribe the terms of these Treasury bills and govern the conditions of their issue. Copies of the circulars, guidelines, and tender forms may be obtained from any Federal Reserve Bank or Branch, or from the Bureau of the Public Debt.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE June 30, 1986

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,401 million of 13-week bills and for $7,411 million of 26-week bills, both to be issued on July 3, 1986, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing October 2, 1986			:	26-week bills maturing January 2, 1987		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	5.96%	6.14%	98.493	:	5.94% a/	6.21%	96.981
High	6.00%	6.18%	98.483	:	5.97%	6.24%	96.965
Average	5.99%	6.17%	98.486	:	5.96%	6.23%	96.970

a/ Excepting 1 tender of $325,000

Tenders at the high discount rate for the 13-week bills were allotted 23%.
Tenders at the high discount rate for the 26-week bills were allotted 46%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 38,275	$ 38,275	:	$ 36,255	$ 36,255
New York	19,842,855	5,461,755	:	20,564,465	6,285,385
Philadelphia	30,035	30,035	:	20,385	20,385
Cleveland	41,375	41,375	:	28,000	28,000
Richmond	38,155	38,155	:	43,720	43,720
Atlanta	38,985	38,985	:	36,475	35,475
Chicago	1,375,715	149,165	:	1,456,940	299,535
St. Louis	37,215	21,215	:	35,190	19,190
Minneapolis	17,250	13,400	:	17,650	14,950
Kansas City	52,570	52,570	:	62,655	59,575
Dallas	37,405	33,555	:	27,375	24,675
San Francisco	1,457,915	1,176,715	:	485,795	247,015
Treasury	305,360	305,360	:	296,845	296,845
TOTALS	$23,313,110	$7,400,560	:	$23,111,750	$7,411,005
Type					
Competitive	$20,248,685	$4,336,135	:	$19,596,310	$3,895,565
Noncompetitive	1,043,030	1,043,030	:	858,375	858,375
Subtotal, Public	$21,291,715	$5,379,165	:	$20,454,685	$4,753,940
Federal Reserve	1,890,010	1,890,010	:	1,850,000	1,850,000
Foreign Official Institutions	131,385	131,385	:	807,065	807,065
TOTALS	$23,313,110	$7,400,560	:	$23,111,750	$7,411,005

An additional $59,515 thousand of 13-week bills and an additional $401,835 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

B-642