U.S. DEPARTMENT OF THE TREASURY

PRESS RELEASES

TREASURY NEWS

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

PREPARED STATEMENT OF R. RICHARD NEWCOMB
DIRECTOR, OFFICE OF FOREIGN ASSETS CONTROL
DEPARTMENT OF THE TREASURY

before the

SUBCOMMITTEE ON INTERNATIONAL DEVELOPMENT, FINANCE,
TRADE AND MONETARY POLICY
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C.

August 1, 1989

U.S. Bank Loans to South Africa

Chairman Fauntroy and Members of the Subcommittee:

I. Introduction

Good morning. My name is Richard Newcomb. I am the Director of the Office of Foreign Assets Control (FAC) of the Treasury Department. It is a pleasure to testify before the Subcommittee on International Development, Finance, Trade and Monetary Policy on regulatory and enforcement issues arising from our responsibilities under the Comprehensive Anti-Apartheid Act of 1986 (the "Act") and rescheduling of South African debt under the Act.

II. Overview of FAC and the Act

A. FAC Background

FAC is the office within Treasury responsible for implementing the import, financial, and new investment prohibitions of the Comprehensive Anti-Apartheid Act of 1986 (the "Act"). I would like to give you a brief overview of FAC and our implementation of the Act in general, and then to comment more specifically on the legal requirements of the Act and U.S. policy towards South African debt rescheduling under the Act.

FAC's experience in sanctions enforcement dates back to World War II following the German invasion of Norway and Denmark. The assets of these countries were blocked to prevent their forced repatriation by the Germans. Similarly, the assets of the Baltic countries located in the U.S. were blocked following their annexation by the Soviet Union. During the war, sanctions were implemented against the Axis powers. Sanctions were implemented against China and North Korea in 1950, Rhodesia in 1965, and against Iran during the hostage crisis of 1979. Certain aspects of the first Iranian sanctions program are still in place today as an adjunct to the implementation of the Algiers Accords and the administration of the Iran-US Claims Tribunal. FAC has nine other programs in place today in addition to the South African sanctions program. They are against North Korea, which has been in place since 1950, Cuba since 1963, Vietnam since 1964, Kampuchea since 1975, Nicaragua since 1985, Libya since 1986, Iran a second time in 1987, and now against Panama, invoked by President Reagan on April 8. We also administer certain residual assets controls involving the Baltic Republics and East Germany, as well as restrictions on exports of strategic materials to communist nations.

FAC's sanctions against South Africa actually pre-dated the Act. The 1985 FAC South African Sanctions Program was implemented under the International Emergency Economic Powers Act (IEEPA) pursuant to Executive Order. These sanctions prohibited financial institutions in the U.S. from making or approving loans or other extensions of credit to the Government of South Africa, and prohibited imports of South African Krugerrands. Congress incorporated and expanded these sanctions in the Comprehensive Anti-Apartheid Act of 1986. It also prohibited loans by all U.S. nationals to both public and private entities in South Africa, and imports of all South African gold coins as well as various other South African products, into the United States.

B. Import Prohibitions

In addition to South African Krugerrands and other gold coins minted in South Africa, the list of other South African products subject to the Act's import prohibitions includes agricultural products and food, iron ore, iron, steel, sugar, uranium ore, uranium oxide, coal, and textiles, and products from parastatal entities (i.e., organizations owned or controlled by the Government of South Africa). In enforcing these import prohibitions, FAC works closely with U.S. Customs. You should know that we are enforcing all of the Act's prohibitions vigorously, taking a pro-active enforcement posture in all areas of responsibility. I will explain FAC's enforcement program in greater detail in a moment.

C. Prohibitions on Loans and New Investment

The Act prohibits U.S. nationals from making any new investment in South Africa directly or through another person. (22 U.S.C. 5060). "New investment" is defined as "a commitment or contribution of funds or other assets" and "a loan or other extension of credit." (22 U.S.C. 5001). Under these provisions, a disinvesting U.S. parent corporation may not extend credit to corporations or individuals in South Africa (other than firms owned exclusively by black South Africans) to facilitate their purchase of its South African subsidiary. In addition, a U.S. parent corporation may not contribute or lend working capital to its South African subsidiary unless it is necessary to enable it to operate in an economically sound manner without expanding its operations, a strictly interpreted exception subject to registration requirements.

The Act also contains certain exceptions to the prohibition on new investment. New investment does <u>not</u> include the reinvestment of profits generated by a controlled South African entity into that same controlled South African entity; or the investment of such profits in another private South African entity; or the ownership, control, or transfer of preenactment South African debt and equity interests (i.e., those issued prior to October 2, 1986). The only other exception to the new investment prohibition is for investment in firms owned by black South Africans. To date, we have had only a few registrations under this provision.

Moreover, the definition of "loan" does not include normal short-term trade financing, such as letters of credit or similar trade credits; sales on open accounts where those sales are normal business practice; or the rescheduling of existing loans, provided that no new funds or credits are thereby extended to a South African entity or to the Government of South Africa. (22 U.S.C. 5001). The legislative history of the loan rescheduling exception indicates that it is quite broad, and that it includes substitution of private sector borrowers as well as substitution under South Africa's debt moratorium measures, of a governmental body called the Public Investment Commissioners, or "PIC", as the obligor on a private sector loan. I will discuss this more fully in a moment.

III. FAC Enforcement of Loan and New Investment Prohibitions

A. Overview of FAC Enforcement of the Act

Enforcement of the South African sanctions is among FAC's top priorities. Customs, which provides assistance to FAC in enforcing the import prohibitions, has initiated 24 investigations concerning alleged violations of the sanctions since the Act's enactment. Of the 10 investigations closed, one investigation resulted in the seizure of a shipment of agricultural products valued at $75,000.00. The case settled with a penalty payment of $15,000.00 and the shipment was released and exported.

The investigation of the Air Ground Equipment Sales Corp. by U.S. Customs JFK International Airport Enforcement Office resulted in the seizure and forfeiture of four jet engines valued at $7 million. The company fraudulently entered the engines which were sold by a South African parastatal. The case further resulted in the first criminal indictment for violations of the Act. The company and its chief executive officer entered guilty pleas. The company was fined $1 million, and the officer was sentenced to imprisonment and given a $100,000.00 fine.

A third investigation which is currently active resulted in the arrest of four persons including two South Africans. The case involves the alleged illegal importation of South African manufactured handguns. The Customs Service has also made six commercial seizures of merchandise imported from South Africa in violation of the Act.

In addition to Customs' assistance in enforcing import prohibitions under the Act, FAC utilizes its own independent authority to addresss possible violations and, if necessary, to assess penalties against violators. Accordingly, we have our own staff of professionals in our enforcement and penalties divisions whose responsibilities are to identify potential violators of the Act who attempt to circumvent the import and new loan prohibitions. Penalties for individuals and corporations range from $50,000.00 to $1,000,000.00 in fines and/or up to 10 years in prison. This year we have already assessed five civil penalties against violators of the Act's import prohibitions which have resulted in the payment of over $27,000.00.

We will continue to pursue vigorously possible violations of all prohibitions under the Act both civilly and criminally, as appropriate, to the full extent of the law.

B. Loan and New Investment Compliance Programs

I would now like to describe our South African compliance programs:

Our compliance staff monitors compliance with the Act by U.S. nationals. In order to more effectively monitor compliance with the prohibitions against loans and new investments, we have initiated a written dialogue with all U.S. corporations and financial institutions doing business in South Africa. First, we sent out over 250 letters to all known U.S. corporations with operations in South Africa advising them of the Act's restrictions on capital contributions, loans, or other extensions of credit in the context of their subsidiaries' on-going operations or disinvestment. Responses to these compliance letters were closely monitored for possible violations.

In many cases, follow-up phone calls were made to these companies to ensure complete compliance. In cases where the disinvestment strategy or other financial transactions involved a possible prohibited payment or loan, letters were sent to violating companies demanding that they cease illegal acts and/or that they restructure their agreements of sale or other violating transactions to bring those companies into compliance.

In June 1987, we sent many of the largest U.S. banks and brokerage houses a letter containing responses to several frequently-asked questions on permissible transactions involving PIC loans and South African securities.

We have sent letters to over 200 brokerage houses, stock exchanges, broker/dealers, asset management firms, and U.S. traders of mutual funds, gold funds, international funds and money market funds to ensure that they are on written notice about the Act's restrictions on investment in South African securities. Generally, only trading in preenactment (pre-October 2, 1986) securities, including American Depository Receipts evidencing preenactment issues, is permitted. In addition, while U.S. nationals may trade in futures and options contracts on South African commodities, many commodities, such as agricultural commodities, and gold bullion marketed by the South African Reserve Bank (a parastatal organization) are subject to U.S. import restrictions under the Act. We asked that those companies engaged in South African securities transactions provide us with a complete description of their compliance procedures.

We have worked with the Securities and Exchange Commission and the National Association of Securities Dealers so that we can identify others who may be affected by the Act. We are actively pursuing information which may lead us to potential problems in this area and investigating all cases which are brought to our attention. We have developed training programs for enforcement, banking, and corporate personnel to ensure that they know about the CAAA's prohibitions.

We have also advised banks of the Act's prohibitions on loans and other extensions of credit to the South African government or its controlled entities, or to any person or entity in South Africa. The prohibition on loans to the South African government became effective November 11, 1985, under sanctions which pre-dated the Act. To ensure that this is enforced, we have been working closely with the bank supervisory agencies. We have developed a special publication entitled Foreign Assets Control Regulations for the Financial Community, containing a special section on "South African Transactions Regulations for the Banking Community." We have taken steps to distribute these publications to financial institutions throughout the United States in cooperation with the Comptroller of the Currency, the Federal Reserve Bank, the FDIC, and the Federal Home Loan Bank System. State regulatory bodies, such as the State of New York Banking Department, have cooperated with us, as have various industry groups--including the Council on International Banking and the Institute of International Bankers--in notifying their members about our program. A special course module is also being developed to train Federal Bank Examiners in our FAC regulations.

As part of our South African compliance programs, professionals from our enforcement and compliance divisions have provided briefings and participated in panels and seminars for U.S. Customs, financial institutions, international delegations, and the import/export community on the South African sanctions. In addition, we maintain daily telephone communication with U.S. corporations, individuals, and financial institutions both to monitor their activities and to provide accurate information on questions of compliance with the South African sanctions.

IV. Rescheduling is not Contrary to Spirit and Intent of Law

Section 3(3)(B)(iii) of the Comprehensive Anti-Apartheid Act of 1986 states that the term "loan," for purposes of the prohibitions of the Act, "does not include -- . . .rescheduling of existing loans, if no new funds or credits are thereby extended to a South African entity or the Government of South Africa." 22 U.S.C. 5001(3)(B)(iii). This provision was contained in S. 2701, the bill later enacted, as it emerged from the Senate Foreign Relations Committee.

Senator Lugar, Committee Chairman and Senate floor manager of the bill, discussed the intent behind this rescheduling exclusion in his introductory explanation of the bill on the Senate floor. 132 Cong. Rec. S11627 (daily ed. Aug. 14, 1986). Congressman Roth did so as well during House debate on the bill. 132 Cong. Rec. H6765 (daily ed. Sept. 12, 1986). Both gentlemen indicated that the provision was necessary to avoid penalizing Americans, rather than South Africa, in implementing the sanctions program. In House debate, Congressman Roth stated, in part:

> In August 1985, South Africa declared a moratorium on payment of short-term debt owed by South African residents to foreign creditors. South African debt outstanding and subject to the moratorium totalled approximately $14 billion. The reason for the suspension of payments was that South Africa lacked the aggregate foreign exchange for South African private and public sector debtors to meet all payments owed in foreign exchange when due.
>
> Such a unilateral suspension of payments clearly was untenable from the viewpoint of the creditors, who immediately began pressing the South African authorities to resume repayments on an orderly schedule at the earliest possible date, and made clear that no new foreign exchange would be provided. The result of these efforts was as follows:
>
> South Africa provided to its public and private sector debtors a repayment of 5 percent of the principal amounts covered by the moratorium and maturing beginning April 15, 1986.
>
> South Africa committed to provide foreign exchange to South African debtors so they could continue to make interest payments on the debt. Moreover, South Africa agreed that interest could be charged and paid at up to a 1 percent spread over the rates then in place, reflecting increasing risk on the credits.
>
> South Africa agreed that the remainder of outstanding principal would be paid June 30, 1987.

> South Africa further provided that: (1) the foregoing commitments would apply even where a creditor chose to substitute one private sector borrower for another on outstanding debt (for example, a creditor could substitute a more creditworthy borrower); and (2) the South African government (through the Public Investment Commissioners [PIC]) would assume a private sector debt directly if the creditor so chose (for example, during such time as a substitution of one private debtor for another is being arranged).
>
> H.R. 4868 allows restructured loans, under the foregoing arrangements, to remain outstanding, and, if appropriate, for further restructurings to be arranged that are aimed at achieving full repayment to foreign creditors. Failure to make these exceptions to the prohibitions on loans to the private and public sector in South Africa would grant a windfall financial benefit to South Africa, since South Africa could refuse to make the repayments.
>
> As no South Africa loan presently is in default, U.S. creditors at this time would have no legal basis on which to demand payment -- by litigation or otherwise -- on the loans: rather, the effect would be outright debt forgiveness to South Africa.
>
> Moreover, even if there were some legal basis for suit now, or in the future, the expenses of international litigation and the limited amount of South African assets located outside South Africa on which a recovery might be sought (relative to the aggregate outstanding debt) indicate that U.S. creditors would suffer extensive losses from which South Africa directly would gain.
>
> Accordingly, the exceptions to the prohibition on loans to South African residents created for rescheduled loans (including the substitution of debtors on outstanding loans) avoids unjustified financial losses to creditor institutions, and has a corresponding financial cost to South Africa.

132 Cong. Rec. H 6765 (daily ed. Sept. 12, 1986).

FAC's implementation of the Act's two prohibitions on new lending--section 305 prohibitions on loans to the South African Government and section 310 prohibitions on loans to any person, public or private, located in South Africa--has been entirely consistent with the legislative intent behind the rescheduling exclusion as set forth in the statements of Congressman Roth and Senator Lugar. Thus, so long as no new credits or funds are extended to the borrowers, rescheduling of pre-enactment loans for the benefit of the South African public sector or private sector South African residents is permissible under the Act and FAC's implementing South African Transactions Regulations. This is true whether the rescheduling affects the original borrowers or substituted borrowers under the PIC loan program.

The Treasury Department believes that this treatment of rescheduling, mandated by the Act, is the correct policy to maintain for the future. The determination made by this Congress in 1986 was based upon preventing windfalls to South Africa through loan defaults -- windfalls which undermine the economic impact of our sanctions program, and corresponding losses which injure American financial institutions. We believe that the statutory provision that avoids this result cannot properly be seen as a "loophole," since there is no benefit to the target of sanctions through the policy. Indeed, if this is viewed as a loophole, closing it would strengthen South African interests at the expense of American interests -- a result we can all agree would be wrong.

Since the 1985 moratorium and so-called Interim Arrangements during 1985-87 did not enable South Africa to fully repay its outstanding public and private sector foreign debts, a further set of reschedulings was negotiated between South Africa and the foreign banks in 1987: the Second Interim Arrangements. This program provides for repayment of 13% of the outstanding principal on South African loans over the 3-year period from July 1, 1987 through June 30, 1990 on loans maturing during this period. Current interest is also payable on the rescheduled principal. Finally, a creditor wishing to ensure full repayment of principal backed by governmental guarantees can do so by rescheduling the loan to be payable over 10 years, receiving 13% of principal between the conversion date and June 30, 1990, no further principal through 1992, and then 10 equal semiannual installments of the remaining principal running through 1997.

It is generally agreed that South Africa will not be in a position to repay its outstanding debts by June 30, 1990, so that the foreign bank creditors anticipate that a Third Interim Arrangement will be promulgated.

The reschedulings under each of these interim arrangements have assisted foreign banks, including U.S. banks, to keep their South African loans performing. Payments of interest and principal under the interim arrangements continue to remove hard currency resources from South Africa's economy, consistent with the pressure intended by enactment of the sanctions.

Some $2.6 billion in unpaid principal remained outstanding to U.S. financial institutions at the end of March 1989. Were this amount to be simply defaulted on by the South African borrowers because U.S. lending institutions were prevented by Congress from participating in further reschedulings, the benefit to the South African economy is evident. Equally evident is the loss such defaults would entail for U.S. financial institutions, their shareholders, and federal, state, and local taxing authorities. Banks could lose the $2.6 billion already loaned to South Africa prior to the Act, plus the interest income that would derive from those loans. The money center banks would be most adversely affected. The nine largest U.S. banks held 74% of total U.S. banks claims on South Africa. This amount represents 3.4% of their capital base. Such a capital loss would impair these banks' ability to comply with regulatory and market pressures to increase capital strength.

Other U.S. borrowers could also be adversely affected. U.S. bank claims on South Africa are primarily concentrated within the banking community, with claims on bank borrowers constituting 63% of total U.S. claims in South Africa for the year ending 1988. Public borrowings accounted for 26% of total claims, with the remaining 11% of claims on private non-bank borrowers.

The process of gradual divestiture is already taking place quite rapidly and effectively. U.S. bank claims on South African borrowers have already been declining steadily over the last few years. From year end 1984 to March of this year, such claims have declined $1.8 billion from $4.3 billion. Since the end of 1986 to the first quarter of 1989, a period of two and one-quarter years, such claims have fallen $447 million.

In addition, U.S. bank claims on South Africa have been declining vis-a-vis bank claims on South Africa of other countries. Bank claims on South African borrowers totaled $14.6 billion on a global basis as of year end 1988. Since 1986, the U.S. portion of such global claims on South Africa has declined from 19% to 17%.

Finally, a substantial amount of U.S. bank claims on South Africa are expected to mature within the next five years. As of year end 1988, 39% of claims were due within a year or less, 25% due in a one to five year period, and 36% due in over five years. Thus, it is reasonable to expect a continued gradual decline in U.S. bank claims to South African based borrowers if claims are paid according to their scheduled maturities.

The deleterious consequences on U.S. banks and other creditors that would be caused by an outright prohibition on reschedulings which I have outlined above bear no reasonable relation to the stated goals of the Comprehensive Anti-Apartheid Act of 1986. The Treasury Department believes, therefore, that Congress should not fix what is not broken, and strongly urges that this Subcommittee endorse the existing implementation of the Act's prohibitions on loans to South Africa.

V. Additional Measures to Strengthen Enforcement Under the Act

You have asked for comments on additional measures that can be taken to terminate U.S. lenders' ability to reschedule existing loans. Again, I would repeat that the current sanctions are having their intended effect on U.S. bank claims--the trend is clearly down. As I have said in previous testimony before this Committee regarding pending legislation to enact new sanctions, any new measures to end U.S. lenders' ability to reschedule loans made in South Africa prior to the Act would harm American, not South African, interests. My view was then, and remains, that the termination of this protection would force U.S. banks to provide, in effect, debt relief to South Africa and subsidies to those who purchase the claims at the discounted prices that would ensue as loans were sold at what would likely be firesale prices. U.S. banks would lose all leverage in seeking repayment, without any corresponding damage to the South African borrowers.

The losses to the banking community could be substantial and they would be concentrated in the nine money center banks. Although the level of exposure has been declining in recent years, it remains substantial at $2.6 billion. Of that total, the money center institutions hold about ~~$2.2~~ 1.9 billion or about 3.4% of their capital. As this Committee knows, there is strong regulatory and market pressure on these banks to increase capital. Efforts to end the current ability to reschedule South African debt would undercut that effort.

Let me say again, however, that should new measures be enacted to terminate the present provision on rescheduling, we would, of course, vigorously enforce those measures.

SOUTH AFRICA

Adjusted Claims {1} of U.S. Banks on South Africa ($ millions/percent where indicated)

	1984	1985	1986	1987	1988	1989 I Qtr.
All Banks {2} [number involved]	[205]	[199]	[187]	[182]	[181]	[172]
Outstanding Claims at end period	4,324	3,273	2,998	2,939	2,583	2,551
Change in claims during period	(98)	(1,051)	(275)	(59)	(356)	(32)
Claims as % of Cap. at end period	4.7	3.1	2.6	2.2	1.9	1.9

{1} Includes adjustments to reflect guarantees and indirect borrowings.
{2} Includes all banks that have, on a fully consolidated basis, total outstanding claims on residents of foreign countries exceeding $30 million.

SOURCE: Country Exposure Lending Survey, Federal Financial Institutions Examination Council.

Claims {3} of International Banks on South Africa ($ millions/percent where indicated)

	Dec. 1986	% of Total	Dec. 1987	% of Total	Dec. 1988	% of Total
All reporting banks {4}	15,618	100%	16,027	100%	14,582	100%
U.S. banks	2,957	19%	2,888	18%	2,510	17%
Other banks	12,661	81%	13,139	82%	12,072	83%

{3} Unadjusted - does not reflect guarantees and indirect borrowings.
{4} Banks whose positions are included in reports prepared by Bank for International Settlements.

SOURCES: BIS: "The Maturity Distribution of International Bank Lending".
USA: Country Exposure Lending Survey(Federal Financial Institutions Examination Council).

International Banking and
Portfolio Investment

July 28, 1989

TREASURY NEWS

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

August 1, 1989

Harvey S. Rosen
Appointed Deputy Assistant Secretary
for Tax Analysis

Secretary of the Treasury Nicholas F. Brady today announced the appointment of Harvey S. Rosen, Professor of Economics at Princeton University, as Deputy Assistant Secretary of the Treasury for Tax Analysis, effective August 7, 1989.

Mr. Rosen, 40, will serve as the economic deputy to Assistant Secretary Kenneth W. Gideon, who has principal responsibility for formulation and execution of United States domestic and international tax policy.

Mr. Rosen earned a B.A. degree in economics from the University of Michigan in 1970 and a Ph.D. from Harvard University in 1974. He has taught economics and public finance at Princeton for 15 years, published a textbook on public finance, and authored or co-authored over 40 articles in scholarly journals.

Mr. Rosen is married to Marsha E. Novick. They have two children, Lynne and Jonathan.

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TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.
August 1, 1989

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $13,200 million, to be issued August 10, 1989. This offering will result in a paydown for the Treasury of about $1,250 million, as the maturing bills are outstanding in the amount of $14,443 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, August 7, 1989. The two series offered are as follows:

91-day bills (to maturity date) for approximately $6,600 million, representing an additional amount of bills dated May 11, 1989, and to mature November 9, 1989 (CUSIP No. 912794 TD 6), currently outstanding in the amount of $7,095 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $6,600 million, to be dated August 10, 1989, and to mature February 8, 1990 (CUSIP No. 912794 TQ 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 August 10, 1989. 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 $1,905 million as agents for foreign and international monetary authorities, and $4,058 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

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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 one-half hour prior to the closing time for receipt of tenders 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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.

10/87

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

FOR IMMEDIATE RELEASE
August 1, 1989

CONTACT: LARRY BATDORF
(202) 566-2041

PROTOCOL TO U.S.-BELGIUM INCOME TAX TREATY RATIFIED

The Treasury Department today announced that on July 19, 1989 in Brussels, instruments of ratification were exchanged to the Supplementary Protocol and Related Exchange of Notes, signed at Washington on December 31, 1987, modifying and supplementing the Convention Between the United States of America and the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed in Brussels on July 9, 1970.

The Protocol provides for a reduced rate of tax at source of 5 percent on direct investment dividends and introduces rules to ensure that the benefit of the reduced withholding rates on dividends, interest and royalties provided in the treaty accrue only to persons intended to enjoy those benefits.

The Protocol and exchange of notes will enter into force on August 3, 1989. The provisions will have effect, retroactively, with respect to dividends, interest and royalties paid or credited on or after January 1, 1988.

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

RA ROOM 5310

FOR RELEASE AT 4:00 P.M.
August 1, 1989

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CONTACT: Office of Financing
202/376-4350

TREASURY OFFERS $5,000 MILLION
OF 45-DAY CASH MANAGEMENT BILLS

The Department of the Treasury, by this public notice, invites tenders for approximately $5,000 million of 45-day Treasury bills to be issued August 7, 1989, representing an additional amount of bills dated March 23, 1989, maturing September 21, 1989 (CUSIP No. 912794 SY 1).

Competitive tenders will be received at all Federal Reserve Banks and Branches prior to 1:00 p.m., Eastern Daylight Saving time, Thursday, August 3, 1989. 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 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 Monday, August 7, 1989. 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

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 566-2041

PREPARED STATEMENT OF R. RICHARD NEWCOMB
DIRECTOR, OFFICE OF FOREIGN ASSETS CONTROL
DEPARTMENT OF THE TREASURY

before the

SUBCOMMITTEE ON HUMAN RIGHTS AND INTERNATIONAL ORGANIZATIONS
SUBCOMMITTEE ON WESTERN HEMISPHERE AFFAIRS
SUBCOMMITTEE ON INTERNATIONAL ECONOMIC POLICY
COMMITTEE ON FOREIGN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

August 2, 1989

U.S. Policy Toward Cuba: The Administration's Perspective

Chairman Yatron, Chairman Crockett, Chairman Gejdenson, and Members of the Subcommittees:

My name is R. Richard Newcomb, and I am the Director of the Treasury Department's Office of Foreign Assets Control. I am pleased to be with you today to discuss the U.S. Government's sanctions against Cuba. I have been asked this morning to discuss the U.S. embargo on Cuba and to answer certain questions concerning changes in the Cuban Assets Control Regulations required by the Omnibus Trade and Competitiveness Act of 1988, as well as trade with Cuba by foreign subsidiaries of U.S. companies.

I. FAC Background

The Office of Foreign Assets Control ("FAC") has primary responsibility within the Executive branch for administering financial and trade sanctions against foreign countries under the

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authority of the Trading with the Enemy Act ("TWEA"), the International Emergency Economic Powers Act ("IEEPA"), the Comprehensive Anti-Apartheid Act of 1986, and the International Security and Development Cooperation Act. Currently, FAC is responsible for administering assets freezes and economic embargoes against Cuba, North Korea, Vietnam, Cambodia, Libya, and Panama, and trade and economic sanctions against Iran, Nicaragua, and South Africa. In addition, FAC administers certain residual assets controls involving Iran, East Germany, and the Baltic Republics, as well as restrictions on U.S. persons' ability to finance and deal in exports of strategic materials from foreign countries to certain Eastern Bloc nations.

Powers under TWEA and IEEPA to prohibit or regulate commercial or financial transactions with specific foreign countries have been employed in two principal ways. First, they have been used to "freeze" assets of designated nations, by prohibiting transfer of those assets which are subject to U.S. jurisdiction, or in the possession or control of U.S. persons. Frozen assets (e.g., property and bank deposits) cannot be paid out, withdrawn, set off, or transferred in any manner without a Treasury license.

Second, the powers under TWEA and IEEPA also can be used to impose economic sanctions against designated foreign nationals, including prohibitions on financial transactions, such as bank lending. These embargoes may be either selective, prohibiting a specific class of economic transactions or, as in the case of Cuba, comprehensive, prohibiting all unlicensed economic transactions involving the designated country or its nationals.

II. Cuba Embargo Background

Since 1963, the United States has maintained an economic embargo against Cuba under the authority of the Trading with the Enemy Act. The Cuban Assets Control Regulations prohibit virtually all direct or indirect commercial or financial transactions by persons subject to the jurisdiction of the United States with Cuba or with Cuban nationals, including the importation of Cuban-origin merchandise without a license issued by the Department of the Treasury.

The embargo on Cuban imports and exports and the restrictions on the amount of money Cuba can earn from U.S. visitors serve to deny the Cuban government the opportunity to earn hard currency through trade and tourism transactions with its largest and most natural market--the United States. Restricting the resources available to Cuba helps to limit the Castro regime's ability to pursue policies inimical to U.S. national interests, including human rights violations, a military presence in Africa and the Middle East, Cuban adventurism in this Hemisphere and support for subversive groups seeking to destabilize democratic governments in Latin America.

The comprehensiveness of the trade restrictions and the geographical proximity of Cuba, just 90 miles from Key West, have aided the effectiveness of the U.S. embargo in denying Cuba hard currency earnings. The inability of Cuba to trade with the country that, by reasons of geography and history, otherwise would be its major trading partner compounds the difficulties the country already experiences as a result of its inefficient state-owned economic system. The current embargo inflicts obvious hard currency shortages and other costs on the Cuban economy. I emphasize that the Cuban embargo is an instrument of foreign policy, so that positive changes in Cuban behavior on vital U.S. interests could lead to changes in our program.

III. Elements of the Program

A. Exceptions

There are four principal exceptions to the embargo.

1. Family Remittances - U.S. persons may send up to $500 every three months to the household of a close relative in Cuba

and up to $500, on a one-time basis, to enable a close relative to emigrate from Cuba. U.S. persons may also pay the travel expenses for a Cuban national, who has already obtained an entry visa from the State Department to visit the United States. Those funds are limited. No other money may be sent to Cuba for any other reason without special permission from the U.S. Treasury.

2. Travel - Spending money related to Cuban travel is restricted to five authorized categories. Individuals falling into these categories may do so without special permission from FAC. These categories are:

a. Family visit to visit close relatives in Cuba

b. Official government business

c. News gathering

d. Professional research which is specifically related to Cuba and the product of which is very likely to be disseminated; and

e. Fully hosted or sponsored travel (i.e., that which is paid for entirely by the Cuban government or a non-U.S. entity). No services may be provided to Cuba during the visit.

3. Subsidiary Trade - You have requested the Administration's position on Senator Mack's amendment to the State Department Authorization bill which would prohibit foreign subsidiaries of U.S. companies from trading with Cuba. As this bill has only recently passed the Senate, we have not had sufficient time to formulate an official position on it; however, I can explain how our current policy developed as well as the scope of this particular type of trade.

From the inception of the Cuban embargo in July 1963, until October 1975, the Cuban Assets Control Regulations effectively prohibited virtually all trade transactions by foreign subsidiaries of U.S. firms with Cuba. However, in the mid-1970's, a South American subsidiary of a U.S. firm received a valuable order from Cuba for a shipment of trucks. Its application for a license to make the shipment was denied. This resulted in strong diplomatic protests, adding to existing pressures on the United States Government to modify provisions of the Cuban Assets Control Regulations affecting foreign subsidiaries of U.S. firms. At the same time, the Organization of the American States, which had formerly supported the embargo against Cuba, softened its stand with respect to trade with Cuba. In light of these pressures, Treasury published a regulation (31 C.F.R. section 515.559) setting forth terms and conditions under which specific licenses would be granted for certain kinds of foreign subsidiary trade with Cuba. The essential requirements of the policy are as follows:

(i) The transactions must be by a U.S. subsidiary, that is, a foreign-incorporated American-owned or controlled firm operating in a third country. If the foreign entity does not have a separate foreign legal personality but is merely a branch, office, or agency, trade transactions (and other transactions) involving Cuba cannot be licensed.

(ii) Goods exported must be non-strategic. "Strategic goods" are defined as items designated with the letter "A" on the Commerce Department's Control List, signifying strategic or sensitive items, as well as items subject to State Department munitions controls, or to regulations relating to the export of nuclear energy facilities or materials.

(iii) No transfer of U.S.-origin technical data (other than maintenance, repair, and operations data) is authorized.

(iv) Any U.S.-origin parts or components must be separately licensed by the Department of Commerce. Commerce will generally license re-export if the U.S.-origin components do not constitute more than 20% of the value of the finished product.

(v) No U.S. dollar accounts or dollar financing may be involved.

(vi) No person within the U.S. may be involved; the subsidiary must act on its own and conduct the transaction completely offshore. Involvement includes assistance or participation by a U.S parent firm, or any officer or employee thereof, in the negotiation or performance of a licensed transaction.

(vii) The subsidiary must be generally independent of the U.S.-based parent firm in the conduct of transactions of the type for which the license is being sought in such matters as decision-making, risk-taking, negotiation, financing, and performance.

(viii) The law or policy of the country in which the subsidiary is incorporated must require or favor trade with Cuba.

(ix) Both imports from and exports to Cuba may be authorized. Service contracts can also be authorized.

Between fiscal years 1982 and 1987, FAC received a total of 1,279 applications for licenses for subsidiaries to engage in trade with Cuba. This constituted an average of 213 applications per year, with the number of denials of licenses ranging from none in 1982 to two in 1984. Few licenses are denied, in large part due to self-selection prior to the filing of applications by persons not meeting the above-mentioned criteria.

The attached statistical summaries provide an analysis of licenses issued for fiscal years 1982 through 1987. Table I of the summaries lists the types of goods and commodities licensed for export to Cuba each year, broken down by consumable and non-consumable categories. From 1982 through 1986 a higher percentage of licensed exports in terms of dollar value were consumables, such as grain and wheat, while in 1987 the value of non-consumable exports was greater. The total value of licensed exports to Cuba each year ranged from a low of $87 million in 1983 to a high of $162 million in 1985. The average amount exported per year was $114 million.

As far as imports are concerned, Table I indicates that the two primary categories of commodities licensed for importation by foreign subsidiaries were sugar and naphtha. Relatively small amount of molasses and tobacco were also license for importation during this period. The total value of licensed imports from Cuba to countries where foreign subsidiaries of U.S. firms are importing from Cuba ranged from a low of $55 million in 1983 to a high of $161 million in 1982, The average amount imported per year was $145 million.

The value of exports to Cuba from third countries where U.S. subsidiaries are located exceeded that of imports to U.S. subsidiaries in third countries from Cuba in four of the six years for which statistics are available. It should be noted that wide fluctuations have occurred in the total value of licensed exports and imports, which may be due to international shortages and surpluses of certain agricultural crops such as sugar and wheat. For example, 1986 experienced a 23 percent increase in total exports and imports over 1985, while 1987 experienced a 31 percent decline in total exports and imports from 1986.

In descending order of value, foreign subsidiaries in the United Kingdom, Switzerland, Canada, and Argentina have had the greatest dollar value of licensed trade with Cuba, as is indicated in Table II of the summaries. These countries, however, are not necessarily the source of the ultimate destination of the commodities, as the companies operating in them may merely be acting as brokers for goods originating from or destined to another location.

4. Publications and other Informational Material - Section 2502(a) of the Omnibus Trade and Competitiveness Act, Pub.L. No. 100-416, 102 Stat. 1107 (the "Trade Act"), the so-called Berman Trade Act Amendments amended the Trading with the Enemy Act by restricting the President's authority under section 5(b). The amendment provides that the President may

not regulate or prohibit, directly or indirectly, the importation or exportation of publications, films, posters, phonograph records, photographs, microfilms, microfiche, tapes and other informational materials. Prior to the amendment, absent a specific license from FAC, importation of informational material from Cuba was restricted to single copies. Commercial importation was permitted, but payment for such importation had to be made into a blocked account. Exportation of U.S. publications to Cuba was permitted under a general license administered by the Commerce Department.

On February 2, 1989, FAC amended the Cuban Assets Control Regulations to reflect the change contained in the Trade Act amendment. All financial and other transactions directly incident to the physical importation and exportation of informational materials are now authorized. In drafting the Regulations, we paid careful attention to the legislative history of the amendment. Our review of this material, as well as the plain language of the statute, led us to define "informational materials" as including tangible items that are fully created and in existence at the time of the proposed transaction.

The goal of the amendment is to permit physical importation and exportation of publications and similar items; it is not to dismantle the current embargo. So, while a U.S. person may engage in any financial transaction necessary to import a Cuban film, for example: he could not commission the creation of a film under the authority of the Trade Act amendment because the commissioning of a work goes far beyond mere importation and necessarily involves countless transactions in which Cuban nationals would have an interest, and which are not incidental to the actual importation of the film into the United States.

Similarly, our Regulations exclude telecommunications transmissions from the definition of "informational materials." This decision reflects both our reading of the legislative history, and the longstanding definition of "publications" and similar materials used in other FAC sanctions programs. Congress commented favorably on the treatment of "publications" under both the Libya and the Nicaragua sanctions programs. In both cases, the importation and exportation of publications were permitted, but the definition of "publications," which covered each category of informational materials cited in the Trade Act amendment, was limited to tangible items. The Libyan sanctions have a separate general license for telecommunications, wholly unrelated to the exemption for publications.

Telecommunications transmissions, are intangible and cannot be "imported" in the traditional meaning of the word. Nor is it possible to determine until after a transmission is completed whether the transmission complies with the restrictions in the Trade Act amendment on materials containing sensitive and controlled information. We believe Congress intended the amendment to be administrable. The authority of the Trade Act amendment cannot, in our view, be stretched to authorize the type of transactions that result from the instantaneous transmission of events from an embargoed country.

Given the plain language of the statute and legislative history citing the publications exemptions in our other sanctions programs, it is apparent that Congress intended to cover the movement of ideas contained in existing works. Telecommunications transmissions include both live and prerecorded works, and thus do not, as a class, fit the "work in being" criterion.

The exception for the importation and exportation of publications and other informational materials must be reconciled with the existing embargo on Cuba. In satisfying our obligation to accommodate the free flow of informational materials, we must insure that we do not inadvertently damage the integrity of the existing economic sanctions against Cuba. The inclusion of telecommunications in the scope of the Trade Act authorization would have that effect; it would result in a substantial flow of hard currency to Cuba to permit instantaneous transmission of information that could otherwise be made readily available in tangible form in a short time. Practically, this means that a videotape of a Cuban cultural event already in existence may be imported into the U.S. under the exemption, but transactions for a live broadcast of the event are not permitted without a specific license. Such transactions have on occasion in the past been given a specific license.

In amending the Regulations to reflect the Trade Act amendment, we specifically stated that the importation and exportation of informational materials did not alter the existing prohibition on travel related transactions. This matter is currently the subject of a case brought by a poster seller who asserts tht the amendment exempts travel for the purchase of these materials (Walsh v. Brady). It is our position that travel-related transactions are too tangential to the act of physical importation and exportation to be swept into the authorization of the Trade Act.

Moreover, the Libyan Sanctions Regulations, cited favorably in the legislative history, include a complete ban on travel-related transactions despite the authorization of the importation of publications. Permitting unfettered travel to Cuba any time an individual states that he intends to purchase publications will effectively eliminate the travel transaction restrictions contained in the Regulations. Those restrictions have been upheld against constitutional challenge by the Supreme Court. The denial of this important and desirable source of hard currency is an important aspect of the embargo, and we do not believe that Congress mandated its elimination so indirectly.

The enforcement of the restrictions on travel-related transactions does not represent a new policy on the part of FAC. These restrictions have been in effect since 1982 when President Reagan limited the transactions that are generally authorized for travel.

B. Prohibitions

Other than the four limited categories I have just discussed, all other commercial, financial and trade relations of any nature are prohibited. These prohibitions affect all U.S. citizens and permanent residents wherever they are located, all people and organizations physically in the United States, and all branches and subsidiaries of U.S. organizations throughout the world.

All of the following are prohibited: all imports, exports, financial transactions, bank lending, sending money to Cuba for any reason other than for families in limited amounts as discussed earlier. There is a total freeze on assets in the U.S., both Government and private. Any Cuban property or property in which Cuba has an interest coming into the U.S. will be blocked by operation of law.

All transactions with Cuba anywhere in the world by a U.S. person are prohibited. Anyone in the world acting for or on behalf of Cuba is considered a Specially Designated National of Cuba.

IV. Programs

Now I would like to turn to several FAC Enforcement and Licensing programs that are of special concern to us at this time.

A. Specially Designated Nationals of Cuba

Individuals or organizations who act on behalf of Cuba anywhere in the world are considered by the U.S. Treasury Department to be "Specially Designated Nationals" of Cuba. When identified, their names are published in the Federal Register. The listing, however, is a partial one, and any U.S. individual or organization engaging in transactions with foreign nationals must take reasonable care to make certain that such foreign nationals are not specially designated.

Specially Designated Nationals of Cuba operating in the United States are subject to criminal prosecution and U.S. individuals or organizations who violate the Regulations by transacting unauthorized business with them are also subject to criminal prosecution. All prohibitions of the embargo apply to SDN's as though they were physically located on the island of Cuba.

FAC is continually updating this list to enhance the effectiveness of the embargo--currently, it contains 258 names. Over the past several months we have published the names of 51 vessels that are Cuban-owned but flying a non-Cuban flag. These vessels are prohibited from entering U.S. ports or conducting any transport or services whatsoever on behalf of U.S. persons. This message was sent clearly to Havana last year when the foreign flagged Cuban-owned ship, the ACEFROSTY, entered a U.S. port and was seized.

B. Family Remittance Forwarders and Travel Service Providers

As I mentioned earlier, transmission of funds and travel to Cuba are restricted. To insure that only permissible payments are being forwarded to Cuba, on November 23, 1988, we initiated a program to effectively regulate all entities that are providing these types of services. The program:

1. Requires that persons engaged in service transactions related to travel to Cuba obtain specific licenses from FAC for such transactions and provides that such licenses will be

available only for persons who do not participate in discriminatory practices of the Cuban government against residents and citizens of the United States; and

2. Requires that persons wishing to provide commerical services related to the collection or forwarding of remittances to close relatives in Cuba obtain specific licenses from FAC.

We are currently in the middle of this licensing process.

The changes in the Regulations institute a specific licensing program which applies to those persons engaged in or intending to become engaged in the provision of family remittance forwarding or provision of travel services.

a. Travel and Carrier Service Providers. Under the Regulations, transactions of travel service providers are authorized only in connection with arranging and assisting persons whose travel to, from, and within Cuba is authorized pursuant to one of the general or specific licenses. It is the responsibility of travel service providers, as well as the individual traveler, to ensure that all travel to, from, and within Cuba is within one of these authorizations.

Prior to the recent changes, transactions of travel service providers assisting authorized travelers to, from, and within Cuba were permitted under a general license. Such service providers did not need to file a written application and receive a specific license from FAC in order to engage in these activities. Now, as a result of the amendment, the general license provisions have been removed and a requirement has now been imposed that a specific written license be sought and obtained in order to provide any type of travel service with respect to Cuba. Under the Regulations, there are many procedures and responsibilities, including recordkeeping and reporting, which licensed service providers must follow.

b. Family Remittance Forwarders. As I mentioned earlier, the Regulations authorize individuals to make remittances to their close relatives in Cuba in amounts not to exceed $500 in any consecutive 3-month period to any one payee or household. In addition, remittances may be made for the purpose of enabling emigration from Cuba on a one-time basis in an amount not to exceed $500 to any one payee. Now, however, the amendment requires specific licensing of persons who provide the service of forwarding family remittances to Cuba for others. Such remittance forwarding services were not previously subject to a specific licensing requirement under the Regulations. Banks are exempt from this provision and, thus, are not required to obtain a specific license from FAC.

Currently, there are 52 entities that have been extended provisional authority to provide the services outlined above. FAC will act on each full and complete application as expeditiously as possible to provide the applicant with either a license or denial decision.

C. Cuban Bank Accounts and Other Assets

Any property of Cuba whatsoever which comes into the U.S. is blocked. There is a total freeze on Cuban assets, both governmental and private, and on financial dealings with Cuba; all property of Cuba, of Cuban nationals, and of Specially Designated Nationals of Cuba in the possession of U.S. persons is "blocked." Any property in which Cuba has an interest which comes into the United States will automatically be blocked. While Cuba or the Cuban national continues to own the property, blocking imposes a complete prohibition against transfer or transactions of any kind. No payments, transfers, withdrawals, or other dealings may take place with regard to blocked property unless authorized by the Treasury Department.

Since July 8, 1963, the Treasury Department has blocked all property subject to the jurisdiction of the United States in which a direct or indirect Cuban interest exists. This includes all public and private Cuban-titled bank deposits and other properties actually in the U.S. on July 8, 1963, and all Cuban-titled properties and funds, including third-party funds to the extent to which a Cuban interest in the funds exists, which have come within the United States since that date. The blocked property, which consists of approximately 1,550 accounts at 85 different U.S. financial institutions, now totals over $77 million.

Another important objective of the sanctions is to maintain the U.S.-located assets of Cuba in a blocked status as a bargaining chip for use in negotiating an eventual normalization of relations and claims settlement. The assets constitute important collateral for the settlement of U.S. private property claims for expropriation, defaulted bank loans, unpaid U.S. exports and other claims.

D. General Enforcement Program

I will now highlight briefly those general law enforcement matters that are of concern to us.

1. Illegal importations into the U.S. of Cuban origin merchandise, such as artwork, cigars and agricultural commodities, such as sugar, nickel, seafood and tobacco.

2. Illegal exportation of U.S. merchandise to Cuba, directly, or indirectly via third countries, including not only strategic items such as high tech goods, but also merchandise and commodities of any nature whatsoever.

3. The illegal transmission and facilitation of family remittances to Cuba in excess of amounts authorized.

4. The extortion of monies from the Cuban community by the Cuban Government or by its agents or sympathizers residing in the U.S. or abroad, or by specially designated nationals of Cuba, which results in the transfer of money or anything of value either directly or indirectly to Cuba.

5. The unauthorized travel to Cuba by persons who do not qualify for general licenses or who do not hold specific licenses issued by FAC.

6. The illegal arranging, promoting or facilitating of travel to Cuba by travel service providers for unauthorized travelers.

7. The transaction of business with firms which are owned, controlled or acting for or on behalf of the Government of Cuba or nationals thereof, i.e., Specially Designated Nationals.

8. The transfer of currency to or from Cuba either directly or through third countries for any reason whatsoever other than a purpose authorized under the Cuban Assets Control Regulations or with approval of FAC.

V. Enforcement Activities

Over the past year, FAC has been developing and instituting joint procedures with other Federal agencies for the early and continuous coordination of investigative information, program development, technical assistance, case monitoring, effective prosecution and penalties for violations of controls.

We have coordinated our efforts with the U.S. Customs Service; the Department of Commerce; the Federal Bureau of Investigation; the Justice Department's Criminal Division; and the United States Attorneys' offices around the nation.

FAC has also been developing and instituting a program for the systematic training of inspectors, agents, and other Customs personnel in the scope and nature of the economic embargo and sanctions programs which the office enforces.

The office also has developed and instituted a program of "public awareness" for both public and private sectors. This effort has enabled FAC to identify areas where violations are most likely to occur and to publicize FAC requirements more widely to selected target groups.

VI. Enforcement Results

The following actions are representative of the results of recent enforcement initiatives undertaken by FAC:

A. Individuals pled guilty to conspiracy to violate the Trading With the Enemy Act in connection with the exportation of computer equipment to Cuban front companies located in Panama.

B. A Cuban-owned merchant vessel the ACEFROSTY was blocked in the port of Savannah, Georgia for entering U.S. territorial waters and subsequently released under an agreement to forfeit a $250,000 bond.

C. An aircraft belonging to a specially designated national of Cuba, American Airways Charter, was seized and subsequently sold at auction and the proceeds were placed in a blocked bank account in the United States.

D. A third country-flag oil tanker was seized in Puerto Rico for carrying Cuban-origin cargo into the United States in violation of the Trading With the Enemy Act.

In addition to these enforcement results, I should mention that we have several other ongoing investigations and court actions. I am not at liberty to discuss these matters. We shall enforce this program fairly and equitably and to the fullest extent possible under existing law.

U.S. FOREIGN SUBSIDIARY TRADE WITH CUBA

FISCAL YEARS 1982 - 1987

TABLE I
SUMMARY OF LICENSED U.S. FOREIGN SUBSIDIARY TRADE WITH CUBA

A. APPLICATIONS	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986	FY1987
1. Applications approved	163	~~144~~ 146	243	245	247	198
2. Applications denied	0	~~7~~ 1	2	1	0	2
3. Applications not acted upon	7	6	5	10	2	1
TOTAL APPLICATIONS	170	153	250	256	249	201
B. EXPORTS TO CUBA IN MILLIONS OF U.S. DOLLARS* AND AS A PERCENTAGE OF TOTAL TRADE						
1. Grain, Wheat, and other consumables	$ 48 19 %	$ 55 39 %	$ 82 30 %	$ 109 38 %	$ 58 16 %	$ 54 22 %
2. Industrial and other non-consumables	$ 44 17 %	$ 32 23 %	$ 34 12 %	$ 53 18 %	$ 49 14 %	$ 75 31 %
Subtotal Exports	$ 92 36 %	$ 87 62 %	$ 116 42 %	$ 162 56 %	$ 99 30 %	$ 129 53 %
C. IMPORTS FROM CUBA IN MILLIONS OF U.S. DOLLARS* AND AS A PERCENTAGE OF TOTAL TRADE						
1. Naphtha	$ 54 21 %	$ 28 20 %	$ 120 44 %	$ 35 12 %	$ 65 18 %	$ 33 14 %
2. Sugar	$ 105 42 %	$ 26 18 %	$ 39 14 %	$ 91 32 %	$ 181 52 %	$ 81 33 %
3. Tobacco	$ 0.7 0.2%	$ 0.4 0.3%	$ 0.2 0.07%	$ 0.2 0 %	$ 0.3 0 %	$ 0.2 0 %
4. Molasses	$ 1 0.4%	$ 0 0 %	$ 0 0 %	$ 0 0 %	$ 0 0 %	$ 0 0 %
5. Others	$ 0 0 %	$ 0.7 0.5%	$ 0 0 %	$ 0 0 %	$ 0 0 %	$ 0 0 %
Subtotal Imports	$ 161 64 %	$ 55 38 %	$ 159 58 %	$ 126 44 %	$ 254 70 %	$ 114 47 %
D. TOTAL EXPORTS & IMPORTS	$ 253	$ 142	$ 275	$ 288	$ 354	$ 243
PERCENT INCREASE (DECREASE)	21 %	(44) %	94 %	5 %	23 %	(31) %
E. EXPORT/IMPORT RATIO	36/64	62/38	42/58	56/44	30/70	53/47

SOURCE: U.S. TREASURY DEPARTMENT
Office of Foreign Assets Control
MAY ~~[illegible]~~ 1988

*=Numbers are rounded. Items may not add to totals due to rounding.

TABLE II

U.S. DOLLAR VALUES OF LICENSED U.S. SUBSIDIARY TRANSACTIONS WITH CUBA
(IN MILLIONS OF DOLLARS*)

COUNTRY	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986	FIVE YEAR TOTAL	FY87
Argentina	$22.00	$10.00	$12.00	$31.69	$22.35	$103.04	74.49
Australia	0.40	0	0	0	0	.40	0
Austria	0.10	0	0	2.39	0	2.49	0
Belgium	0.10	0.10	0.11	.36	.64	1.31	1.38
Bermuda	53.00	47.00	65.00	0	0	165.00	0
Brazil	0	0	0.02	0	0	.02	0
Canada	45.00	29.40	40.20	33.35	63.38	211.33	26.26
Costa Rica	0	0	0.02	1.35	0	1.37	0
Denmark	0	0.50	0	0	0	.50	0
France	18.00	0.03	0.20	1.29	5.06	24.58	10.03
Italy	0	0	0	0	.67	.67	0
Japan	0.10	0.10	0.09	0.08	.11	.48	0.15
Mexico	0	0.70	0.73	9.50	4.98	15.91	3.50
Netherlands	0.10	0.20	0.83	0.60	.87	2.60	0
Panama	1.00	0.50	25.00	0	0	26.50	0
Spain	6.00	4.00	5.00	7.59	10.93	22.59	9.42
Sweden	0.20	0.10	0.26	5.73	.09	6.38	0.21
Switzerland	0	17.00	82.03	63.30	76.34	238.77	56.93
United Kingdom	107.00	31.00	43.08	130.47	168.54	480.09	109.92
Venezuela	0	0.10	0	0	n	.10	14.56
West Germany	0.50	0.60	1.00	1.02	.17	3.29	0.91
TOTALS	$253.00	$142.00	$275.00	$288.72	$354.13	$1307.42	306.7[illegible]

n = Negligible (less than $ 10,000)
* = Numbers are rounded, therefore totals may not add.

SOURCE: TREASURY DEPARTMENT
Office of Foreign Assets Control
MAY ~~1987~~ 1988

TABLE III

ITEMIZED U.S. DOLLAR VALUE* FOR LICENSED IMPORT/EXPORT TRANSACTIONS WITH CUBA BY U.S. SUBSIDIARIES
(In millions of dollars)

COUNTRY	FY 1982 Cuban Imports	FY 1982 Cuban Exports CON.	FY 1982 Cuban Exports N-CON.	FY 1983 Cuban Imports	FY 1983 Cuban Exports CON.	FY 1983 Cuban Exports N-CON.	FY 1984 Cuban Imports	FY 1984 Cuban Exports CON.	FY 1984 Cuban Exports N-CON.	FY 1985 Cuban Imports	FY 1985 Cuban Exports CON.	FY 1985 Cuban Exports N-CON.	FY 1986 Cuban Imports	FY 1986 Cuban Exports CON.	FY 1986 Cuban Exports N-CON.	FY 1987 Imp	FY 1987 Exp. CON	FY 1987 N-C
Argentina	0	4.00	18.00	0	0	10.00	0	9.00	3.00	0	21.70	9.95	0	8.92	13.42	62.5	10.5	1.4
Australia	0	0	0.40	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Austria	0	0	0.10	0	0	0	0	0	0	0	0	2.39	0	0	0	0	0	0
Belgium	0	0	0.10	0	0	0.10	0	0	0.11	0	0.12	0.24	0	0.44	0.20	0	1.2	0.98
Bermuda	53.00	0	0	27.00	20.0	0	65.00	0	0	0	0	0	0	0	0	0	0	0
Brazil	0	0	0	0	0	0	0	0	0.02	0	0	0	0	0	0	0	0	0
Canada	1.00	29.00	15.00	0.40	16.0	13.00	0.20	21.00	19.00	0.16	15.69	17.49	16.23	37.00	10.15	0.2	14.5	11.3
Costa Rica	0	0	0	0	0	0	0	0	0.02	0	0	1.35	0	0	0	0	0	0
Denmark	0	0	0	0.50	0	0	0	0	0	0	0	0	0	0	0	0	0	0
France	0	17.00	1.00	0	0	0.03	0	0	0.20	0	0	1.29	0	0	5.06	0	0.29	9.7
Italy	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0.67	0	0	0
Japan	0	0	0.10	0	0	0.10	0	0	0.09	0	0	0.08	0	0	0.11	0	0	0.15
Mexico	0	0	0	0	0	0.70	0	0	0.73	0	0	9.50	0	0	4.98	0	0	3.5
Netherlands	0	0	0.10	0.20	0	0	0	0.10	0.83	0	0.29	0.30	0	0	0.87	0	0	0
Panama	1.00	0	0	0	0.5	0	0	25.00	0	0	0	0	0	0	0	0	0	0
Spain	0	0	6.00	0	0	4.00	0	0	5.00	0	2.46	5.12	0	0.02	10.91	0	0.26	8.5
Sweden	0	0	0.20	0	0	0.10	0	0	0.26	0	2.46	3.27	0	0	0.09	0	0	0.02
Switzerland	0	0	0	0	17.0	0	55.00	27.00	0.03	35.00	25.83	2.46	65.0	11.34	0	35.0	21.9	0
United Kingdom	105.00	0	2.00	26.00	2.0	3.00	39.00	0.08	4.00	91.36	37.86	1.23	165.36	0.60	2.57	78.0	5.5	25.3
Venezuela	0	0	0	0	0	0.10	0	0	0	0	0	0	0	0	0	0	0	14.6
West Germany	0	0	0.50	0	0	0.60	0	0	1.00	0	0	1.02	0	0	0.17	0	0	0.9

* = Numbers rounded. Items may not add to totals due to rounding.
CON. = Consumable goods
N-CON. = Non-Consumable goods
n = Negligible

SOURCE: TREASURY DEPARTMENT
Office of Foreign Assets Control
MAY ~~1987~~ 1988

TREASURY NEWS

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

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE
August 2, 1989

CONTACT: Office of Financing
202/376-4350

TREASURY AUGUST QUARTERLY FINANCING

The Treasury will raise about $13,600 million of new cash and refund $15,904 million of securities maturing August 15, 1989, by issuing $10,000 million of 3-year notes, $9,750 million of 10-year notes, and $9,750 million of 30-year bonds. The $15,904 million of maturing securities are those held by the public, including $2,151 million held, as of today, by Federal Reserve Banks as agents for foreign and international monetary authorities.

The three issues totaling $29,500 million are 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.

In addition to the public holdings, Federal Reserve Banks hold $3,134 million of the maturing securities for their own accounts, which may be refunded by issuing additional amounts of the new securities at the average prices of accepted competitive tenders.

The Treasury will postpone these auctions unless it has assurance of enactment of legislation to raise the statutory debt limit before the scheduled auction dates.

The 10-year note and 30-year bond being offered today will be eligible for the STRIPS program.

If, under Treasury's usual operating procedures, the auction of 3-year notes results in the same interest rate as the outstanding 7-1/4% bonds of August 15, 1992, the new notes will be issued with a 7-1/8% or a 7-3/8% coupon. The 7-1/8% coupon will apply if the auction results in a yield in a range of 7.13% through 7.31%.

Details about each of the new securities are given in the attached highlights of the offering and in the official offering circulars.

oOo

Attachment

NB-404

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC
AUGUST 1989 QUARTERLY FINANCING

August 2, 1989

Amount Offered to the Public......	$10,000 million	$9,750 million	$9,750 million
Description of Security:			
Term and type of security.........	3-year notes	10-year notes	30-year bonds
Series and CUSIP designation......	Series T-1992 (CUSIP No. 912827 XV 9)	Series C-1999 (CUSIP No. 912827 XW 7)	Bonds of 2019 (CUSIP No. 912810 ED 6)
CUSIP Nos. for STRIPS Components..	Not applicable	Listed in Attachment A of offering circular	Listed in Attachment A of offering circular
Issue date	August 15, 1989	August 15, 1989	August 15, 1989
Maturity date.....................	August 15, 1992	August 15, 1999	August 15, 2019
Interest rate.....................	To be determined based on the average of accepted bids	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	To be determined at auction
Premium or discount...............	To be determined after auction	To be determined after auction	To be determined after auction
Interest payment dates............	February 15 and August 15	February 15 and August 15	February 15 and August 15
Minimum denomination available....	$5,000	$1,000	$1,000
Amount required for STRIPS........	Not applicable	To be determined after auction	To be determined after auction
Terms of Sale:			
Method of sale....................	Yield auction	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%	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	Accepted in full at the average price up to $1,000,000
Accrued interest payable by investor...............	None	None	None
Payment Terms:			
Payment by non-institutional investors........................	Full payment to be submitted with tender	Full payment to be submitted with tender	Full payment to be submitted with tender
Payment through Treasury Tax and Loan (TT&L) Note Accounts.....	Acceptable for TT&L Note Option Depositaries	Acceptable for TT&L Note Option Depositaries	Acceptable for TT&L Note Option Depositaries
Deposit guarantee by designated institutions...........	Acceptable	Acceptable	Acceptable
Key Dates:			
Receipt of tenders................	Tuesday, August 8, 1989, prior to 1:00 p.m., EDST	Wednesday, August 9, 1989, prior to 1:00 p.m., EDST	Thursday, August 10, 1989, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):			
a) funds immediately available to the Treasury......	Tuesday, August 15, 1989	Tuesday, August 15, 1989	Tuesday, August 15, 1989
b) readily-collectible check......	Friday, August 11, 1989	Friday, August 11, 1989	Friday, August 11, 1989

TREASURY NEWS

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

For Release Upon Delivery
Expected at 2:00 p.m. EST
August 3, 1989

STATEMENT OF
KENNETH W. GIDEON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ENERGY AND AGRICULTURE
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to present the views of the Treasury Department regarding the tax implications of S. 828, the "Enhanced Oil and Gas Recovery Tax Act of 1989." The bill would amend the Internal Revenue Code of 1986 (the "Code") to provide incentives for the removal of crude oil and natural gas through enhanced oil recovery techniques.

The bill, as introduced, has three major components: (1) an increased depletion rate of 27.5 percent for domestic oil and gas recovered through enhanced recovery techniques, phased-down as the price of crude oil increases above $30 per barrel (adjusted for inflation); (2) an exception from the alternative minimum tax rules for excess depletion and excess intangible drilling costs ("IDCs") incurred with respect to domestic properties that produce oil and gas through the use of enhanced recovery techniques if the average annual removal price of oil for the taxpayer is less than $30 per barrel (adjusted for inflation); and (3) a 10-percent research and development tax credit for research to discover or improve tertiary recovery methods. In addition, the bill generally would not treat barrels of enhanced domestic tertiary oil and gas produced by an independent producer or royalty owner as barrels of oil or gas produced by such person in applying the 1,000 barrel-per-day limitation on the percentage depletion deduction. Finally, the bill would increase the net income limitation from 50 percent to 100 percent of net income in the case of depletable property which produces domestic incremental tertiary crude oil or natural gas during the enhanced recovery period. The increase would apply to both independent and integrated producers.

As you are aware, the President proposed in his budget for fiscal year 1990 a new incentive program for the oil and gas industry which would provide tax incentives for both the removal of crude oil and gas through enhanced recovery techniques and the exploration for new oil and gas fields. Under the President's proposal, the Code would be amended to: (1) allow a temporary 10-percent tax credit for the first $10 million of expenditures (per year per company) on exploratory IDCs and a 5-percent credit for the balance; (2) allow a temporary 10-percent tax credit for all capital expenditures on projects that represent new application S of tertiary enhanced recovery techniques to a property; (3) eliminate the "transfer rule," which discourages the transfer of proven properties to independent producers and royalty owners; (4) increase the percentage depletion deduction limit for independent producers to 100 percent of the net income of each property; and (5) eliminate 80 percent of current alternative minimum tax ("AMT") preference items generated by exploratory IDCs incurred by independent producers. The temporary tax credits would be phased out if the average daily U.S. wellhead price of oil is at or above $21 per barrel for a calendar year. These proposals would take effect on January 1, 1990. The President's initiative will be detailed in a bill currently under preparation.

The President's proposal and S. 828 share the goal of increasing domestic oil and gas reserves as a means of improving our energy security. While we prefer the proposals outlined in the budget, we believe that alternative proposals, such as S. 828 should be explored. Indeed, S. 828 and the President's program have many similar features. Like the President's proposal, the bill addresses the need to increase the percentage depletion deduction limit, although we would apply the increase to independent producers with respect to all domestic oil and gas projects. In addition, we are encouraged to learn that modifications suggested by Senator Domenici and his staff to S. 828 would limit the amount of the bill's depletion incentive to recovery of investment in a tertiary project and would replace the R&D credit for tertiary recovery methods with a more general credit for capital expenditures on tertiary projects. As modified, either of these provisions would be more closely aligned with the President's proposed tax credit for tertiary projects.

We believe, however, that a tax credit, whether along the lines of the President's proposal or the bill's credit provisions (if modified as suggested), would provide a more effective incentive than the 27.5 percent depletion rate proposal, because the credit corresponds directly to the expenditure. We would not favor providing both a credit and increased depletion.

It is also our belief that oil and gas tax provisions should not be limited to encouraging the reclamation of old fields but also should encourage exploratory drilling. The bill focuses the depletion incentive and tax credit on tertiary recovery projects. The President's program goes a step further and encourages exploratory drilling with a combination of temporary IDC credits, less restrictive rules for the use of percentage depletion and AMT relief. These incentives are targeted particularly to independent producers, which have historically drilled a majority of our exploratory wells.

In addition to these substantive views, we have several technical comments on S. 828. I will discuss these in more detail after reviewing the provisions of the bill.

Provisions of the Bill

Increased Depletion Rate. Under percentage depletion, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year. The amount deducted cannot exceed 50 percent of the taxable income from the property for the taxable year, computed without regard to the depletion deduction (the "net income limitation"). Under present law, only independent producers and royalty owners may use percentage depletion, for up to 1,000 barrels of average daily domestic crude oil production, or an equivalent amount of domestic natural gas. Integrated producers, those that refine or retail oil or gas, must use generally less favorable cost depletion for oil and gas production. Percentage depletion is not allowed with respect to the transferee of a transferred proven oil- or gas-producing property.

Under present law, the cost of certain tertiary injectants is deductible. Such cost includes any cost paid or incurred for a tertiary injectant which is used as part of a tertiary recovery method. A tertiary recovery method is any method enumerated in subparagraphs (1) through (9) of section 212.78(c) of the June 1979 energy regulations. A taxpayer may also use any method approved by the Secretary.

S. 828 would amend section 613A of the Code to permit all taxpayers (including both independent and integrated producers) to use percentage depletion with respect to the production of domestic "incremental tertiary crude oil and natural gas" during the "enhanced recovery period." The depletion rate would be increased to 27.5 percent, the historic rate for oil and gas which was in effect for 43 years until 1969. Under the bill, the 27.5 percent rate would be phased-down to 15 percent by one percentage point for every dollar that the taxpayer's average removal price of oil for the calendar year exceeds $30 per barrel, a ceiling which would be indexed for inflation.

Under the bill, the term "incremental tertiary oil or gas" means production eligible for incentive depletion. The increased depletion rate would be allowed for production of incremental tertiary oil or gas during a limited period, the "enhanced recovery period." The enhanced recovery period would be determined under a schedule published by the Secretary of the Treasury. The schedule would be designed to establish the average period of time necessary for a taxpayer to recover the investment in an enhanced recovery project. The schedule would specify enhanced recovery periods for each type of enhanced recovery project, and would also take into account any variations among regions of the country that might affect the length of the enhanced recovery period. A tertiary project qualifying for accelerated depletion would be defined under the provisions of the now repealed windfall profit tax, with certain modifications.

In addition, the bill would increase the net income limitation from 50 percent to 100 percent of net income in the case of depletable property which produces domestic incremental tertiary crude oil or natural gas during the enhanced recovery period.

The provision would be effective for oil and gas production after the date of enactment and before January 1, 2010. The provision would apply after December 31, 1999, only to production from a project begun before January 1, 2000. Expansion of a project begun on or after the date of enactment would be treated as a separate project. In the case of production from a project begun on or before the date of enactment, the rate for percentage depletion would be 18 percent rather than 27.5 percent.

Alternative Minimum Tax. Under present law, the deduction for depletion is an item of tax preference for purposes of the individual and corporate alternative minimum taxes, to the extent that the depletion deduction constitutes excess percentage depletion. Excess percentage depletion is defined as the excess of the taxpayer's allowable depletion deduction for the taxable year with respect to a particular oil- or gas-producing property over its adjusted basis in such property at the end of the year (prior to adjusting the basis for current year allowable depletion). The deduction for IDCs on successful oil and gas wells is also an item of tax preference for purposes of the individual and corporate alternative minimum taxes, to the extent that the taxpayer's excess IDCs exceed 65 percent of its net income from oil and gas properties.

S. 828 would repeal the treatment of excess depletion and excess IDCs as items of tax preference with respect to domestic properties that produce oil and gas through the use of enhanced tertiary recovery techniques if the average annual removal price of oil for the taxable year is less than $30 per barrel, a ceiling which would be indexed for inflation. These provisions would be effective for costs paid or incurred after the date of enactment.

Tax Credit. Under present law, a credit is allowed with respect to certain costs incurred by taxpayers for increasing qualified research activities (the "R&D credit"). The amount of the credit is equal to 20 percent of the excess of current qualified research expenses over the average of such expenses incurred by the taxpayer over the preceding three taxable years. A 20-percent credit is allowed for certain costs incurred domestically for an original investigation for the advancement of scientific knowledge which does not have a specific commercial objective. There are not any special rules which apply specifically to research relating to tertiary recovery methods. The bill, as introduced, provides that research to discover or improve tertiary recovery methods for domestic crude oil or natural gas will be treated as research which qualifies for the R&D credit if the research is based on accepted principles of engineering. The rules (including computation of base period amounts) would be applied separately to such research activities. The credit percentage applicable to such tertiary research would be 10 percent, rather than the 20-percent credit generally applicable under current law.

Discussion

I would now like to turn to a discussion of the specific provisions of the bill and offer some technical considerations.

Depletion Incentives. First, it is not clear under the bill, as introduced, whether the amount of percentage depletion will be limited to the recovery of the expenses of the qualified tertiary project involved, a so-called "pay-back" concept, or whether the amount of percentage depletion allowable may be higher than the taxpayer's investment. Proposed section 613A(e)(1)(A) states that the increased allowance for depletion "shall be computed in accordance with section 613." Under current law, section 613 does not have any limitation related to investment in a project. If a "pay-back" limitation on the bill's depletion incentive is intended, the bill should be modified to include such a limitation.

Second, the system of enhanced recovery periods set forth in the bill raises many questions. Proposed section 613A(e)(4) states that the schedule of enhanced recovery periods to be published by the Secretary will be "based on the average period which is required for a project to recover the expenses of the type of qualified tertiary recovery project involved." Rather than reliance on a schedule, we believe that each taxpayer's advanced recovery period should be determined by the actual length of time it takes to recover the taxpayer's investment. In our view, it will be difficult to provide a uniform schedule which treats taxpayers fairly without being extremely complex. The schedule may have to take into account variations in the price of oil, project size, regional variations, and, possibly, differences among major fields or producing areas in the same region. Given the wide fluctuations in oil prices in recent years, it will be necessary to revise the schedule fairly often, resulting in little uniformity in recovery periods and making the law difficult for taxpayers and the Service to apply. In addition, under a uniform schedule, taxpayers whose projects do not conform to the anticipated recovery period may recover significantly more or less accelerated depletion than their actual investment. Taxpayers will have an incentive to try to produce as much oil as possible within the enhanced recovery period, rather than by planning production based upon the field and specific project.

We believe it would not be difficult to define by statute the types of costs eligible for the credit. These types of projects tend to be large, expensive undertakings that taxpayers would normally account for in a comprehensive manner. Limitation of increased depletion to actual investment should not be an excessive burden.

Third, the phaseout provisions need modification. Under the bill, the phaseout with respect to any given taxpayer is dependent on the price at which the taxpayer actually sells oil during the year. While that may be the most accurate manner in which to measure the effect of rising prices on any particular taxpayer, it introduces an unnecessary level of complexity into the system. This is especially true since the phaseout is one percent for each dollar above $30 per barrel. Accordingly, a number of different depletion rates could apply for different taxpayers in a single year. It would be easier to administer the phaseout by tying it to a national price, so that the applicable depletion rate could be determined on a nationwide basis. It might also be preferable to adjust the depletion rate prospectively; thus, any year's depletion rate would be based on the prior year's prices. This would afford taxpayers certainty in planning for any given year.

Finally, the definition of a tertiary project should be updated. For its basic definition of a tertiary project, the bill refers to the now repealed windfall profits tax statute, which in turn refers to obsolete regulations that were issued by the Department of Energy in 1979 and were subsequently withdrawn. While the basic definition provided by this approach may well be reasonable, we believe it would be preferable to provide a definition in the statute. We would be pleased to work with the Subcommittee if it should decide to formulate a statutory definition of a tertiary project.

<u>Alternative Minimum Tax Provisions</u>. Although the Administration favors modifying the AMT provisions to encourage an increase in domestic reserves, we believe that such relief should be targeted to exploratory drilling, as we have proposed.

We also have a number of technical suggestions with respect to the AMT relief provisions of S. 828. Such relief is completely phased out for any year in which the taxpayer's average selling price exceeds $30 per barrel. As with the bill's depletion incentive, we believe that any such phaseout should be based on national prices rather than on the taxpayer's own selling price for oil. We also believe that the phaseout should be made effective commencing with the year following the year in which prices exceed $30 per barrel. Since this credit is reduced to zero when prices exceed $30 per barrel, taxpayers are entitled to know well in advance whether their investment in tertiary activities will be eligible for the credit.

Tax Credit. The Administration does not support the concept of an R&D credit targeted specifically to tertiary recovery methods. Under the bill, as introduced, the credit would only be available with respect to research to discover or improve a tertiary recovery method. Furthermore, the credit would be limited to expenses in excess of a base period limitation. We believe that a credit for investment in tertiary projects should be enacted. However, we believe it should be enacted in its own section and should not be made part of the general R&D credit. Furthermore, we believe it should function as an incentive for all investment in tertiary projects, not merely research and development.

We appreciate the opportunity to appear before your Subcommittee to discuss S. 828 and the President's energy proposals. I will be happy to answer any questions you may have about these matters.

TREASURY NEWS

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

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE
August 2, 1989

CONTACT: Office of Financing
202/376-4350

TREASURY OFFERS $10,000 MILLION OF 247-DAY CASH MANAGEMENT BILLS

The Department of the Treasury, by this public notice, invites tenders for approximately $10,000 million of 247-day Treasury bills to be dated August 15, 1989, and to mature April 19, 1990 (CUSIP No. 912794 UA 0).

Tenders will be received at Federal Reserve Banks and Branches prior to 12:00 noon, Eastern Daylight Saving time, Thursday, August 10, 1989. 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 of the Federal Reserve Banks and Branches.

Tenders will not be accepted for bills to be maintained on the book-entry records of the Department of the Treasury (TREASURY DIRECT). Tenders will not be received at the Department of the Treasury, Washington.

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.

The Treasury will postpone this auction unless it has assurance of enactment of legislation to raise the statutory debt limit before the scheduled auction date.

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 11:30 a.m., Eastern time, on the day of the auction. Such positions would include bills acquired through "when issued" trading, futures,

NB-406

and forward transactions. 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.

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 competitive 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 Tuesday, August 15, 1989. 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

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 566-2041

FOR IMMEDIATE RELEASE
August 3, 1989

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S AUCTION
OF 45-DAY CASH MANAGEMENT BILLS

Tenders for $5,002 million of 45-day Treasury bills to be issued on August 7, 1989, and to mature September 21, 1989, 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	7.95%	8.14%	99.006
High	8.00%	8.19%	99.000
Average	7.98%	8.17%	99.003

Tenders at the high discount rate were allotted 22%.

TOTAL TENDERS RECEIVED AND ACCEPTED
BY FEDERAL RESERVE DISTRICTS
(In Thousands)

Location	Received	Accepted
Boston	$ --	$ --
New York	20,705,000	3,809,560
Philadelphia	--	--
Cleveland	--	--
Richmond	--	--
Atlanta	--	--
Chicago	1,950,000	461,000
St. Louis	--	--
Minneapolis	15,000	--
Kansas City	--	--
Dallas	--	--
San Francisco	1,185,000	731,500
TOTALS	$23,855,000	$5,002,060

NB-407

TREASURY NEWS

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

FOR RELEASE AT 3:00 PM
August 4, 1989

Contact: Peter Hollenbach
(202) 376-4302

TREASURY ANNOUNCES ACTIVITY FOR
SECURITIES IN THE STRIPS PROGRAM FOR JULY 1989

The Department of the Treasury announced activity figures for the month of July 1989, of securities within the Separate Trading of Registered Interest and Principal of Securities program, (STRIPS).

Dollar Amounts in Thousands

Principal Outstanding (Eligible Securities)	$346,648,886
Held in Unstripped Form	$265,160,196
Held in Stripped Form	$81,488,690
Reconstituted in June	$2,092,400

The attached table gives a breakdown of STRIPS activity by individual loan description.

The Treasury now reports reconstitution activity for the month instead of the gross amount reconstituted to date. These monthly figures are included in Table VI of the Monthly Statement of the Public Debt, entitled "Holdings of Treasury Securities in Stripped Form." These can also be obtained through a recorded message on (202) 447-9873.

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TABLE VI—HOLDINGS OF TREASURY SECURITIES IN STRIPPED FORM, JULY 31, 1989
(In thousands)

Loan Description	Maturity Date	Principal Amount Outstanding			Reconstituted This Month[1]
		Total	Portion Held in Unstripped Form	Portion Held in Stripped Form	
11-5/8% Note C-1994	11/15/94	$6,658,554	$5,562,554	$1,096,000	-0-
11-1/4% Note A-1995	2/15/95	6,933,861	6,228,101	705,760	$44,000
11-1/4% Note B-1995	5/15/95	7,127,086	5,337,806	1,789,280	49,600
10-1/2% Note C-1995	8/15/95	7,955,901	7,143,501	812,400	20,000
9-1/2% Note D-1995	11/15/95	7,318,550	6,477,750	840,800	60,000
8-7/8% Note A-1996	2/15/96	8,411,839	8,109,439	302,400	-0-
7-3/8% Note C-1996	5/15/96	20,085,643	19,882,443	203,200	-0-
7-1/4% Note D-1996	11/15/96	20,258,810	20,147,610	111,200	32,000
8-1/2% Note A-1997	5/15/97	9,921,237	9,776,037	145,200	-0-
8-5/8% Note B-1997	8/15/97	9,362,836	9,362,836	-0-	-0-
8-7/8% Note C-1997	11/15/97	9,808,329	9,793,929	14,400	20,800
8-1/8% Note A-1998	2/15/98	9,159,068	9,158,428	640	-0-
9% Note B-1998	5/15/98	9,165,387	9,135,387	30,000	-0-
9-1/4% Note C-1998	8/15/98	11,342,646	11,221,046	121,600	-0-
8-7/8% Note D-1998	11/15/98	9,902,875	9,902,875	-0-	-0-
8-7/8% Note A-1999	2/15/99	9,719,628	9,719,628	-0-	-0-
9-1/8% Note B-1999	5/15/99	10,047,103	10,047,103	-0-	-0-
11-5/8% Bond 2004	11/15/04	8,301,806	3,447,406	4,854,400	180,800
12% Bond 2005	5/15/05	4,260,758	1,857,908	2,402,850	57,000
10-3/4% Bond 2005	8/15/05	9,269,713	7,220,913	2,048,800	80,000
9-3/8% Bond 2006	2/15/06	4,755,916	4,755,916	-0-	-0-
11-3/4% Bond 2009-14	11/15/14	6,005,584	1,616,584	4,389,000	238,200
11-1/4% Bond 2015	2/15/15	12,667,799	2,830,839	9,836,960	-0-
10-5/8% Bond 2015	8/15/15	7,149,916	1,847,516	5,302,400	-0-
9-7/8% Bond 2015	11/15/15	6,899,859	2,354,259	4,545,600	12,800
9-1/4% Bond 2016	2/15/16	7,266,854	5,196,454	2,070,400	32,000
7-1/4% Bond 2016	5/15/16	18,823,551	15,905,951	2,917,600	389,600
7-1/2% Bond 2016	11/15/16	18,864,448	9,892,368	8,972,080	204,400
8-3/4% Bond 2017	5/15/17	18,194,169	7,469,049	10,725,120	23,200
8-7/8% Bond 2017	8/15/17	14,016,858	9,348,058	4,668,800	344,000
9-1/8% Bond 2018	5/15/18	8,708,639	4,782,239	3,926,400	-0-
9% Bond 2018	11/15/18	9,032,870	4,201,470	4,831,400	80,000
8-7/8% Bond 2019	2/15/19	19,250,793	15,426,793	3,824,000	224,000
Total		346,648,886	265,160,196	81,488,690	2,092,400

[1] Effective May 1, 1987, securities held in stripped form were eligible for reconstitution to their unstripped form.

Note: On the 4th workday of each month a recording of Table VI will be available after 3:00 pm. The telephone number is (202) 447-9873.
The balances in this table are subject to audit and subsequent adjustments.

TREASURY NEWS

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

REVISED

FOR IMMEDIATE RELEASE
August 4, 1989

Contact: Peter Hollenbach
(202) 376-4302

CORRECTIONS TO JULY STRIPS DATA

The Department of the Treasury announced that July reconstitution activity figures for securities in the Separate Trading of Registered Interest and Principal of Securities program, (STRIPS) were published in error. The correct summary data is:

Dollar Amounts in Thousands

Principal Outstanding (Eligible Securities)	$346,648,886
Held in Unstripped Form	$265,160,196
Held in Stripped Form	$81,488,690
Reconstituted in June	$3,334,000

The reconstitution activity of the following loans was reported incorrectly. The correct amounts, in thousands, for reconstitution activity in July are:

	Reconstituted this Month
10-3/4% Bond 2005	$753,600
7-1/4% Bond 2016	$957,600

Corrections will be noted in the Monthly Statement of the Public Debt of the United States.

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NB-409

TABLE VI—HOLDINGS OF TREASURY SECURITIES IN STRIPPED FORM, JULY 31, 1989
(In thousands)

Loan Description	Maturity Date	Principal Amount Outstanding			Reconstituted This Month[1]
		Total	Portion Held in Unstripped Form	Portion Held in Stripped Form	
11-5/8% Note C-1994	11/15/94	$6,658,554	$5,562,554	$1,096,000	-0-
11-1/4% Note A-1995	2/15/95	6,933,861	6,228,101	705,760	$44,000
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Total		346,648,886	265,160,196	81,488,690	2,092,400

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Note: On the 4th workday of each month a recording of Table VI will be available after 3:00 pm. The telephone number is (202) 447-9873.
The balances in this table are subject to audit and subsequent adjustments.

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

FOR IMMEDIATE RELEASE
August 7, 1989

CONTACT: Office of Financing
202/376-4350

AMENDMENT TO TREASURY'S AUCTION OF 247-DAY CASH MANAGEMENT BILLS

The Treasury's announcement of $10,000 million of 247-day cash management bills to be dated August 15, 1989, and to mature April 19, 1990, is amended to increase the amount offered by $5,000 million to $15,000 million.

The $5,000 million increase in the amount offered is necessary to provide Treasury with cash for use by the Resolution Trust Corporation under the recently enacted thrift legislation, Financial Institutions Reform and Recovery Act of 1989.

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

FOR IMMEDIATE RELEASE
August 7, 1989

CONTACT: Office of Financing
202/376-4350

TREASURY AUGUST QUARTERLY FINANCING SCHEDULE

The Treasury announced that Congressional action to increase the debt limit permits the Treasury to proceed with the auctions of 3-year notes on August 8, 10-year notes on August 9, and 30-year bonds and 247-day cash management bills on August 10. All of these issues will settle on August 15, 1989.

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NB-411

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
August 7, 1989

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $6,605 million of 13-week bills and for $6,601 million of 26-week bills, both to be issued on August 10, 1989, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing November 9, 1989			:	26-week bills maturing February 8, 1990		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.90%	8.17%	98.003	:	7.66%	8.08%	96.127
High	7.96%	8.24%	97.988	:	7.71%	8.13%	96.102
Average	7.94%	8.21%	97.993	:	7.70%	8.12%	96.107

Tenders at the high discount rate for the 13-week bills were allotted 42%.
Tenders at the high discount rate for the 26-week bills were allotted 98%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 36,095	$ 36,095	:	$ 33,835	$ 33,835
New York	20,113,335	5,570,835	:	19,391,805	5,530,805
Philadelphia	17,370	17,370	:	19,300	19,260
Cleveland	36,880	36,880	:	42,205	42,205
Richmond	45,375	45,365	:	38,255	38,255
Atlanta	26,045	26,045	:	25,780	25,780
Chicago	1,225,055	102,555	:	1,069,165	44,165
St. Louis	30,855	30,855	:	28,200	28,200
Minneapolis	11,160	11,160	:	10,845	10,845
Kansas City	34,460	34,460	:	45,840	45,840
Dallas	21,290	21,290	:	17,530	17,530
San Francisco	927,540	115,540	:	788,845	123,545
Treasury	556,975	556,975	:	640,810	640,810
TOTALS	$23,082,435	$6,605,425	:	$22,152,415	$6,601,075
Type					
Competitive	$19,773,225	$3,496,215	:	$17,434,565	$2,083,225
Noncompetitive	1,210,695	1,210,695	:	1,209,650	1,209,650
Subtotal, Public	$20,983,920	$4,706,910	:	$18,644,215	$3,292,875
Federal Reserve	2,058,515	1,858,515	:	2,000,000	1,800,000
Foreign Official Institutions	40,000	40,000	:	1,508,200	1,508,200
TOTALS	$23,082,435	$6,605,425	:	$22,152,415	$6,601,075

1/ Equivalent coupon-issue yield.

NB-412

TREASURY NEWS

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

STATEMENT OF
TREASURY SECRETARY NICHOLAS BRADY
Monday, August 7, 1989

For Release 8:00 a.m.
Mexico City, Mexico

Good morning. As you know, there will be a series of meetings with Mexican officials today. We will be discussing a number of important issues, including the recently concluded debt agreement between Mexico and the commercial banks. Additionally, we will be discussing investment and financial issues, as well as joint efforts on money laundering and customs cooperation in our determined fight to curb the flow and use of illegal drugs.

This is a particularly interesting and exciting period in U.S.-Mexican relations. Great progress has been made in economic and financial fields that are important to our two countries.

-- In Mexico, foreign investment is now welcome. Foreign investment from the U.S. totaled more than $1.5 billion last year and aggregate U.S. investment in Mexico is about $16 billion.

-- Mexican trade practices have been liberalized in an impressive fashion. Trade between our two countries has been increasing at an annual rate of more than 25 percent.

-- Mexican tax reform in the last few years has made great strides:

    -- Corporate tax rates have been cut from 42 to 37 percent.

    -- Personal taxes have been lowered to a maximum of 40 percent.

    -- For individual taxes, the number of brackets has been reduced from 12 to 6.

-- I commend President Salinas and his cabinet for the progress made in these and other areas of reform, deregulation and market liberalization.

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The significance of the debt agreement between Mexico and its commercial banks is that it responds to a new reality and incorporates debt and debt service reduction as an integral part of the agreements between commercial banks and the heavily indebted countries. The agreement gives banks three options: an exchange of existing debt for bonds at a 35 percent discount; debt service reduction with a fixed interest rate of 6.25 percent; and/or new money.

We are particularly pleased with the immediate market reaction to the agreement. As evidence of increased Mexican and international confidence, significant amounts of capital have been moving back to Mexico and domestic interest rates have fallen sharply.

During the meetings today, I will also be emphasizing the importance of addressing problems of money laundering associated with narcotics trafficking. We want to work with the Mexican government to attack the problem of money laundering and to make offenders extraditable. We will also be offering U.S. Customs cooperation in our mutual effort to fight drug trafficking. I believe both our governments recognize the importance of close cooperation in this crucial endeavor.

Now I will be happy to take your questions.

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
August 8, 1989

CONTACT: Office of Financing
202/376-4350

SALE OF STATE AND LOCAL GOVERNMENT SECURITIES RESUMED

Following enactment of legislation to raise the public debt limit, the Treasury has authorized the resumption of delivery of all issues of time deposit State and Local Government Series securities, effective today, August 8, 1989. Subscribers for securities who were affected by the sales suspension and still desire to obtain the securities should contact their Federal Reserve Bank or Branch for instructions for filing amended subscriptions, or they may call the Office of the Chief Counsel, Bureau of the Public Debt, on 202/376-4320. New subscriptions will be processed normally.

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TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.
August 8, 1989

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 August 17, 1989. This offering will result in a paydown for the Treasury of about $ 475 million, as the maturing bills are outstanding in the amount of $ 14,883 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, August 14, 1989. 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 May 18, 1989, and to mature November 16, 1989 (CUSIP No. 912794 TE 4), currently outstanding in the amount of $ 6,928 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately $ 7,200 million, representing an additional amount of bills dated February 16, 1989, and to mature February 15, 1990 (CUSIP No. 912794 TR 5), currently outstanding in the amount of $ 9,088 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 August 17, 1989. 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 $ 2,796 million as agents for foreign and international monetary authorities, and $ 4,083 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

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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 one-half hour prior to the closing time for receipt of tenders 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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.

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE
August 8, 1989

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 3-YEAR NOTES

The Department of the Treasury has accepted $10,031 million of $28,608 million of tenders received from the public for the 3-year notes, Series T-1992, auctioned today. The notes will be issued August 15, 1989, and mature August 15, 1992.

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

	Yield	Price
Low	7.92%*	99.882
High	7.94%	99.829
Average	7.93%	99.856

*Excepting 2 tenders totaling $975,000.

Tenders at the high yield were allotted 9%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 18,940	$ 18,940
New York	26,162,245	9,510,430
Philadelphia	18,295	18,295
Cleveland	33,510	33,510
Richmond	33,330	24,230
Atlanta	17,515	17,465
Chicago	1,332,885	154,535
St. Louis	45,395	29,395
Minneapolis	17,810	17,810
Kansas City	49,985	47,935
Dallas	22,515	12,515
San Francisco	806,135	96,460
Treasury	49,810	49,810
Totals	$28,608,370	$10,031,330

The $10,031 million of accepted tenders includes $566 million of noncompetitive tenders and $9,465 million of competitive tenders from the public.

In addition to the $10,031 million of tenders accepted in the auction process, $922 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $2,534 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE
August 9, 1989

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 10-YEAR NOTES

The Department of the Treasury has accepted $ 9,763 million of $ 18,682 million of tenders received from the public for the 10-year notes, Series C-1999, auctioned today. The notes will be issued August 15, 1989, and mature August 15, 1999.

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

	Yield	Price
Low	8.02%*	99.864
High	8.05%	99.661
Average	8.03%	99.796

*Excepting 1 tender of $10,000.
Tenders at the high yield were allotted 4%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 14,731	$ 14,731
New York	16,968,360	9,136,400
Philadelphia	1,512	1,512
Cleveland	11,903	11,903
Richmond	7,114	7,114
Atlanta	7,370	7,370
Chicago	1,045,869	477,069
St. Louis	18,152	10,152
Minneapolis	3,204	3,202
Kansas City	7,364	7,364
Dallas	7,829	7,829
San Francisco	587,929	78,314
Treasury	392	392
Totals	$18,681,729	$9,763,352

The $ 9,763 million of accepted tenders includes $ 344 million of noncompetitive tenders and $ 9,419 million of competitive tenders from the public.

In addition to the $ 9,763 million of tenders accepted in the auction process, $400 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

1/ The minimum par amount required for STRIPS is $ 25,000. Larger amounts must be in multiples of that amount.

NB-417

RTC

O V E R S I G H T B O A R D

Resolution Trust Corporation

1825 CONNECTICUT AVENUE, N.W. WASHINGTON, D.C. 20232

FOR IMMEDIATE RELEASE
Text as prepared

Remarks by
Chairman of the Oversight Board
Nicholas F. Brady
at a Press Conference
Washington, D.C.
August 9, 1989

This morning President Bush signed into law the most comprehensive reform of the thrift industry since its founding more than 50 years ago. Just a few minutes ago, the Oversight Board of the Resolution Trust Corporation concluded its initial meeting during which it took the first steps necessary to implement those reforms.

This afternoon, the RTC Board will hold its first meeting. We invited FDIC Chairman William Seidman to attend our Oversight Board meeting because the FDIC will have the day-to-day operational responsibility for the RTC under policies set by the Oversight Board.

With these steps, we've begun fulfilling the promise made by the President in February when he announced his program and pledged to act quickly once legislation was passed. The legislation, which enjoyed broad bipartisan support in the Congress, will help protect depositors and taxpayers against future losses, overhaul the regulatory mechanism, provide stiff new penalties for those who would abuse the system, and resolve the problem of the insolvent thrifts.

It's the resolution of insolvent S&Ls that is the mission of the RTC. Today the Oversight Board took several actions that will permit the RTC to begin this work immediately.

The first actions taken were organizational. The Oversight Board adopted bylaws and named John Robson, the Deputy Secretary of the Treasury, to act as interim CEO for the Oversight Board. He'll continue to fulfill his duties as Deputy Secretary during this period. John brings considerable experience to the task as a former CEO of a Fortune 500 company, corporate lawyer and occupant of several high federal government jobs. The search for a permanent CEO, which John will lead, is already underway.

John Robson has already recruited a small interim staff from within the government to get the board's operations underway until a permanent staff can be hired. The Oversight Board authorized the CEO to enter into arrangements as necessary for office space and equipment. The board staff will be housed here in this building at 1825 Connecticut Avenue, N.W.

In addition to its organizational work, the Oversight Board also adopted initial policies that will permit the RTC to begin relatively simple case resolutions immediately. A funding request from the RTC for handling the first cases was also approved.

The Oversight Board established a Joint Policy Development Task Force with personnel from both the Oversight Board and the RTC to make recommendations to the oversight Board on overall strategies, policies and goals. Procedures for approving future RTC funding requests were approved by the Oversight Board.

The Oversight Board also adopted policies providing interim ethics and conflict of interest standards and providing guidelines for the use of private contractors.

In addition, the Oversight Board adopted a policy requiring the RTC to provide by September 30 an initial draft of the methodology to be used in analyzing the 1988 FSLIC deals. Similarly, the Oversight Board asked the RTC to provide by September 30 a proposal for the appropriate disposition of the Federal Asset Disposition Association.

In other actions today, the new Office of Thrift Supervision (OTS) has taken over as federal regulator of federally and state chartered institutions. The OTS, which will have offices in the old Federal Home Loan Bank Board building, has become an office of the Treasury Department.

As of today, the Savings Association Insurance Fund (SAIF), replaces the Federal Savings and Loan Insurance Corporation (FSLIC). SAIF has been placed under the FDIC, which will maintain separate thrift and bank insurance funds. The result is one strong, independent insurer managing both funds.

The Federal Housing Finance Board has been formed to supervise the 12 regional Federal Home Loan Banks, and the Federal Home Loan Mortgage Corporation (Freddie Mac) becomes an independent government-sponsored enterprise subject to the oversight of the Department of Housing and Urban Development.

We've taken seriously President Bush's promise to the American people to move swiftly but with care to return the thrift industry to a sound condition. With the adoption of the legislation and the actions initiated today, we're off to a good start. We're committed to work diligently until we complete the task.

I'd like to thank Chairman Greenspan and Secretary Kemp for their contributions to our initial efforts and John Robson for agreeing to take on the initial organizational tasks. And I'd like to acknowledge the fine work done by Under Secretary Bob Glauber and Assistant Secretary David Mullins and a number of other people who worked with such dedication on the initial proposal and the legislation.

RTC

O V E R S I G H T B O A R D

Resolution Trust Corporation

1825 CONNECTICUT AVENUE, N.W. WASHINGTON, D.C. 20232

<u>FOR RELEASE:</u>
August 9, 1989, 12:45 P.M.

CONTACT PERSON: Art Siddon
Oversight Board 387-7667
Treasury Department 566-5252

POLICIES FOR RTC ESTABLISHED AT FIRST OVERSIGHT BOARD MEETING

1. Establishment of joint Oversight Board-RTC policy development task force.

2. Procedures and documentation for approving RTC funding requests and the use of notes and guarantees.

3. Priorities for initial case resolutions.

4. Interim ethics and conflicts of interests standards.

5. Utilization of private sector.

6. Restructuring 1988 FSLIC deals to save taxpayer costs.

7. Disposition of Federal Asset Disposition Association (FADA).

8. Adoption of existing FDIC policies for RTC in other areas until the Oversight Board establishes appropriate general policies.

RTC
O V E R S I G H T B O A R D
Resolution Trust Corporation
1825 CONNECTICUT AVENUE, N.W. WASHINGTON, D.C. 20232

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August 9, 1989, 12:45 P.M.

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Oversight Board 387-7667
Treasury Department 566-5252

ORGANIZATION AND STRUCTURAL FACT SHEET

Oversight Board of the Resolution Trust Corporation

- The Oversight Board of the RTC will establish general policies for the RTC and oversee RTC activities.

- The Board will consist of the Secretary of the Treasury (chairman), the Chairman of the Federal Reserve Board, the Secretary of Housing and Urban Development, and two public members to be appointed by the president.

- Offices will be located at 1825 Connecticut Avenue, N.W., Washington, D.C.

- The Oversight Board will establish a National Advisory Board to assist and advise on policies for the disposition of real estate assets held by the RTC.

  - The National Advisory Board will consist of a chairman appointed by the Oversight Board and the chairpersons of any regional boards.

  - The Oversight Board also may establish no less than six regional boards of up to five members each.

    - Regional boards can be established in any region determined to have a significant portfolio of real estate assets held by the RTC.

    - Members will be residents of the region with knowledge of and experience regrading business, financial and real estate matters.

- The Oversight Board will report annually to Congress.

Resolution Trust Corporation (RTC)

- The RTC will resolve all thrifts that have failed or will fail between January 1, 1989, and August 9, 1992, using $30 billion raised by the Resolution Funding Corporation (REFCORP) with industry funds, and $20 billion raised by the industry and Treasury.

- The Federal Deposit Insurance Corporation (FDIC) shall be the exclusive manager of the RTC subject to oversight by the Oversight Board to resolve failed thrifts.

- The RTC will handle all specific cases and have all day-to-day operating responsibilities. However, it will not establish the general policies, which will be set by the Oversight Board of the RTC.

- The directors of the FDIC will serve as the board of directors of the RTC. The chairman of the FDIC will be the chairman of the RTC.

- The RTC will have no employees of its own, although it may use personnel from other agencies or private contractors.

- The RTC will review and analyze all assistance agreements entered into by the Federal Savings & Loan Insurance Corporation from January 1, 1988, to January 1, 1989, and will take appropriate steps to restructure these agreements if taxpayer savings could be achieved.

- No later than April 30 of each year the RTC will provide an annual report of its operations, activities, budget receipts and expenditures for the preceding calender year, as well as reports throughout the year.

- The RTC will terminate on December 31, 1996.

- RTC offices will be located at 801 17th Street, N.W., Washington, D.C.

<u>Office of Thrift Supervision</u>

o Will replace the Federal Home Loan Bank Board as the new thrift regulator.

o Will become an office in the Department of the Treasury.

o The Director of the Office of Thrift Supervision will be the current chairman of the Federal Home Loan Bank Board.

o Offices will be located in the current Federal Home Loan Bank Board offices at 1700 G Street, N.W., Washington, DC.

<u>Savings Association Insurance Fund</u> (SAIF)

o Will replace the Federal Savings & Loan Insurance Corporation (FSLIC) as the thrift industry insurance fund.

o Will be supervised by the FDIC but will be kept separate from the fund insuring banks.

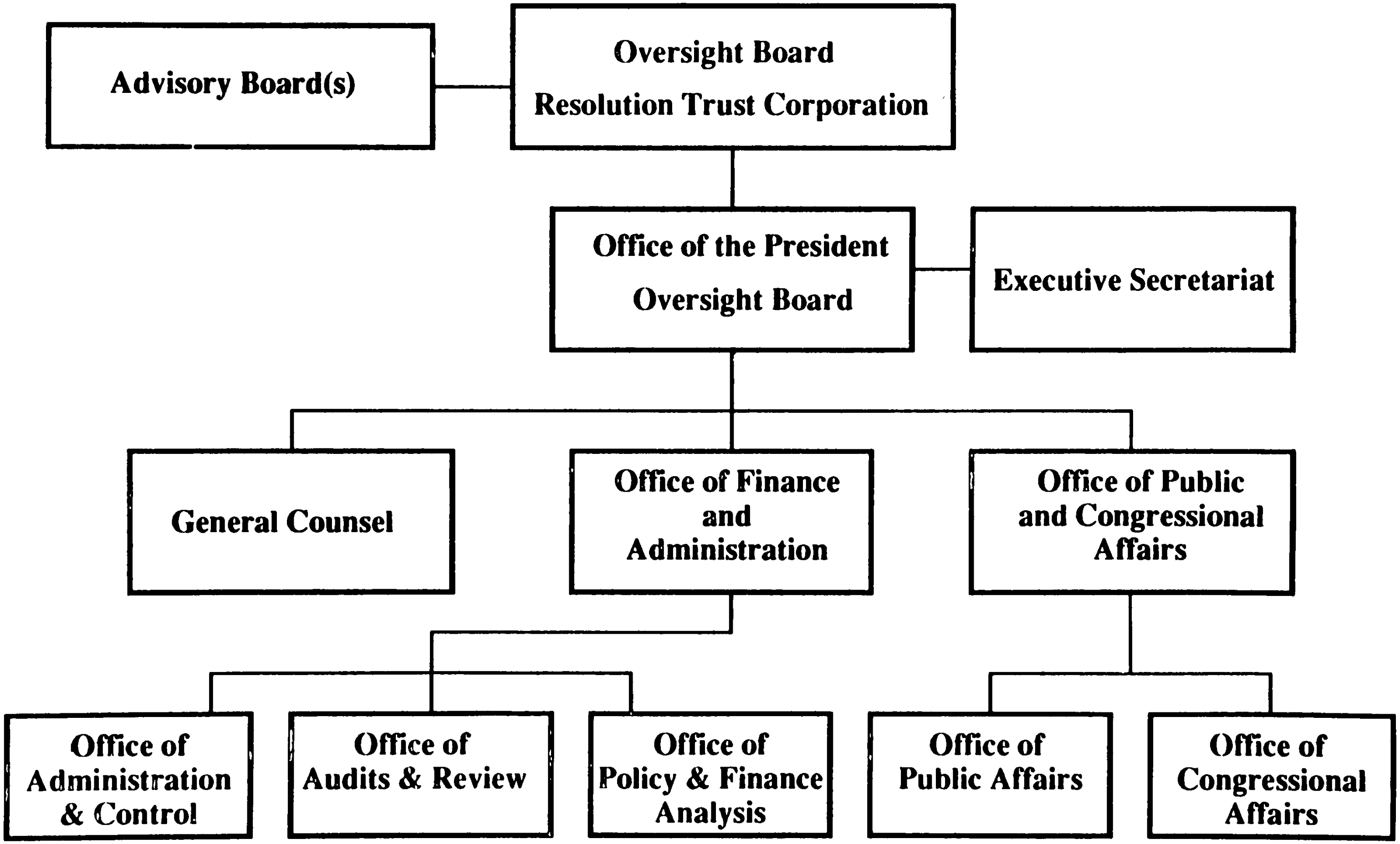
<u>Federal Home Loan Mortgage Corporation (Freddie Mac)</u>

o Will become an independent government-sponsored enterprise.

o Will be subject to oversight by the Department of Housing and Urban Development.

o Offices are located 1776 G Street, N.W., Washington, D.C.

Organization
Oversight Board
Resolution Trust Corporation



RTC

O V E R S I G H T   B O A R D

Resolution Trust Corporation

1825 CONNECTICUT AVENUE, N.W.   WASHINGTON, D.C. 20232

OFFICIAL SEAL

THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release August 9, 1989

FACT SHEET

Key Provisions of the Financial Institutions
Reform, Recovery and Enforcement Act of 1989

STRONG THRIFT CAPITAL REQUIREMENTS

- The bill was designed to require thrifts to meet generally the same capital and accounting standards as national banks. In addition to new, tougher minimum capital requirements for thrifts, the bill provides other new standards which reflect national bank capital provisions.

- The bill also creates a tangible capital requirement of at least three percent of assets. This will prevent the current situation in which institutions with an enormous negative tangible net worth are able to comply with minimum capital rules and continue active expansion. All "supervisory goodwill" must be phased out by January 1, 1995.

- Investments in thrift subsidiaries engaging in nontraditional activities must be deducted from capital. This will prevent the risk of sudden failure of insured institutions as a result of losses in subsidiary businesses.

- Growth by undercapitalized firms will be strictly limited or prohibited.

- Brokered deposits will not be permitted for undercapitalized thrifts.

ESTABLISHMENT OF NEW DEPOSIT INSURANCE FUND

- o Deposit insurance for thrifts will be provided by a new insurance fund, called the Savings Association Insurance Fund (SAIF). SAIF will replace the current Federal Savings and Loan Insurance Corporation. The SAIF fund will be directed and administered by the Federal Deposit Insurance Corporation, although it will be separately maintained from the existing bank insurance fund.

- o SAIF will continue to receive assessments paid by its members after 1991, and should it become necessary, Treasury payments to maintain the Fund's net worth at specified levels.

RESOLUTION TRUST CORPORATION (RTC) AND RTC OVERSIGHT BOARD

- o The RTC will be established to merge or liquidate all existing failed thrifts, as well as any thrifts that fail prior to August, 1992.

- o The RTC Oversight Board will establish general policies for the RTC and oversee its activities. Members of the Oversight Board will be the Secretary of the Treasury (Chairman), the Chairman of the Federal Reserve Board, the Secretary of Housing and Urban Development and two public members appointed by the President.

- o The Federal Deposit Insurance Corporation (FDIC) will be the exclusive manager of the RTC, handling day-to-day operations.

FINANCING FOR CLOSING AND RESOLUTION OF FAILED THRIFTS

- o The bill will establish the Resolution Funding Corporation (REFCORP) to fund the case resolutions undertaken by the RTC. Refcorp will be headed by a three member Directorate, and it will be authorized to issue up to a $30 billion principal amount of long-term bonds to pay the costs of closing down or otherwise resolving insolvent thrifts.

- o For current cases, the bill provides $20 billion to pay for resolution activities in FY 1989, including $18.8 billion from Treasury funds, and $1.2 billion from Federal Home Loan Banks.

- o The bill provides $32 billion in public and private funds to resolve thrifts that fail from 1992-1999, and to capitalize the new SAIF.

- The bill provides all necessary funds for FSLIC cases resolved before January 1, 1989.

REGULATORY RESTRUCTURING

- The FDIC will be given independent enforcement authority to take action against violations of safety and soundness requirements by any insured thrift. This will enable the FDIC to act to protect the insurance fund against risks allowed by chartering or supervisory agencies.

- Under the legislation, the Federal Home Loan Bank Board will be abolished. Its former activities will be divided into several functions.

- The primary function of examining and supervising both federally and state-chartered thrifts and their holding companies will be performed by a new agency, the Office of Thrift Supervision (OTS). The OTS will be an office of the Department of the Treasury. As an office of the Treasury Department, the interests of taxpayers and the general public can be more fully protected.

- The Federal Savings & Loan Insurance Corporation will be replaced by SAIF, which will be administered by the FDIC.

- The Federal Housing Finance Board will supervise the credit activities of the 12 regional Federal Home Loan Banks.

- The Federal Home Loan Mortgage Corporation (Freddie Mac) will become an independent government-sponsored enterprise.

RESTRICTIONS ON THRIFT POWERS

- The FDIC will have authority to prohibit or limit activities of state-chartered thrifts that it determines involve unacceptable risk levels.

- Investments in junk bonds, either directly or through a subsidiary, will be prohibited, but may be placed in a separately capitalized affiliate where insured deposits will not be at risk.

- Equity investments (such as direct real estate investments) will be prohibited within federally-insured thrifts.

- Loans to one borrower will be generally limited to the amount allowed for national banks.

QUALIFIED THRIFT LENDER (QTL) TEST

o Thrifts must maintain 70 percent of their assets in housing-related loans and other qualified assets.

o Thrifts that fail the QTL test must convert to a bank charter or be subject to certain restrictions.

HOUSING

o Federal Home Loan Banks will be required to contribute at least $100 million a year by 1995 to subsidize interest rates on advances to member institutions that make loans for low and moderate income housing.

o The RTC must provide a three-month "first look" period to qualified buyers of single family homes held by the RTC, and similar opportunities for qualified buyers of eligible multi-family housing extending up to 135 days.

ENFORCEMENT

o Maximum sentences for major financial institution crimes, such as bribery and fraud, are increased to 20 years in prison. The maximum criminal fine for these violations is increased to $1 million.

o The basis for civil penalties imposed by the regulators is expanded, and current generally low penalties are increased to a maximum penalty of $1 million per day.

o The Department of Justice will be authorized to receive substantial new appropriations to enable it to more than double investigators and prosecutors of financial fraud cases.

STUDIES

o The Treasury, in consultation with the depository institutions regulators and others, will conduct major studies on the federal deposit insurance system as well as a study on the risk exposure to the federal government of government-sponsored enterprises.

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE
August 10, 1989

CONTACT: Office of Financing
202/376-4350

RESULTS OF TREASURY'S AUCTION OF 247-DAY CASH MANAGEMENT BILLS

Tenders for $15,020 million of 247-day Treasury bills to be issued on August 15, 1989, and to mature April 19, 1990, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low	7.87%	8.34%	94.600
High	7.90%	8.38%	94.580
Average	7.88%	8.36%	94.593

Tenders at the high discount rate were allotted 7%.

TOTAL TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 1,040	$ 40
New York	42,829,745	14,774,335
Philadelphia	1,420	1,420
Cleveland	--	--
Richmond	11,000	1,000
Atlanta	2,050	190
Chicago	1,232,000	60,600
St. Louis	5,000	--
Minneapolis	--	--
Kansas City	10,100	3,450
Dallas	--	--
San Francisco	1,220,020	179,270
TOTALS	$45,312,375	$15,020,305

The $15,020 million of accepted tenders includes $14 million of noncompetitive tenders and $15,006 million of competitive tenders from the public.

NB-418

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

FOR IMMEDIATE RELEASE
August 10, 1989

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 30-YEAR BONDS

The Department of the Treasury has accepted $9,752 million of $20,100 million of tenders received from the public for the 30-year Bonds auctioned today. The bonds will be issued August 15, 1989, and mature August 15, 2019.

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

	Yield	Price
Low	8.13%	99.944
High	8.15%	99.721
Average	8.14%	99.833

Tenders at the high yield were allotted 53%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 1,065	$ 1,065
New York	18,628,214	9,273,932
Philadelphia	180	180
Cleveland	3,273	3,273
Richmond	3,512	3,042
Atlanta	4,350	4,350
Chicago	789,683	372,423
St. Louis	13,999	5,999
Minneapolis	8,165	5,815
Kansas City	3,061	3,061
Dallas	3,020	3,020
San Francisco	641,459	75,909
Treasury	167	167
Totals	$20,100,148	$9,752,236

The $ 9,752 million of accepted tenders includes $ 374 million of noncompetitive tenders and $ 9,378 million of competitive tenders from the public.

In addition to the $9,752 million of tenders accepted in the auction process, $ 200 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

1/ The minimum par amount required for STRIPS is $ 320,000. Larger amounts must be in multiples of that amount.

NB-419

Unnumbered press release:

Aten, Robert H.

"State and local finance in a command economy: the case of the Soviet Union.

INTERNATIONAL JOURNAL OF PUBLIC ADMINISTRATION Vol. 13, 503-535, May 1990

Final Report to The Congress on Life Insurance Company Taxation

Department of the Treasury
August 1989

THE SECRETARY OF THE TREASURY
WASHINGTON

AUG 11 1989

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

Section 231 of Public Law 98-369 the Deficit Reduction Act of 1984 (the "1984 Act") provides that the Treasury Department shall conduct a study of the operation of Part I of Subchapter L of Chapter 1 of the Internal Revenue Code of 1954, including studies on the amount of taxes paid by the life insurance industry and the relative tax burden of mutual life insurance companies and stock life insurance companies. The 1984 Act also provides that the Treasury shall prepare a final report by January 1, 1989. Pursuant to that directive, I hereby submit the "Final Report to the Congress on Life Insurance Company Taxation."

I am sending a similar letter to Lloyd Bentsen, Chairman of the Committee on Finance, Senator Bob Packwood, and Representative Bill Archer.

Sincerely,

Nicholas F. Brady

Nicholas F. Brady

Enclosure

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CHAPTER 1

INTRODUCTION AND SUMMARY

A. Purpose of the Report

In the Deficit Reduction Act of 1984 (Public Law 98-369) ("1984 Act"), Congress comprehensively revised the tax treatment of both stock and mutual life insurance companies and their products. During consideration of these life insurance provisions, Congress expressed concern about the complexity of the existing law, the failure of that law to tax life insurance companies on their economic income, and the development of new types of investment-oriented products. Congress also was concerned in 1984 about the amount of income taxes paid by the life insurance industry, and the relative income tax burden of mutual and stock life insurance companies ("segment balance").

The 1984 Act required the Treasury Department to submit annual revenue reports, and a final report covering the operation of part I of subchapter L of Chapter 1 of the Internal Revenue Code of 1954, the taxation of life insurance companies.[1] In response to this Congressional mandate, an interim report on life insurance company revenues was submitted to Congress in June, 1988. This report responds to the Congressional mandate for a final report on life insurance taxation.

The interim report examined both the amount of income taxes paid by the life insurance industry and the relative tax burden of stock and mutual life insurance companies in 1984 and 1985. The purpose of this report is to (1) provide additional analysis of the taxes paid by life insurance companies for 1984 through 1986, and (2) examine and evaluate the issues surrounding the differential taxation of stock and mutual life insurance companies.

B. Organization of the Report

Chapter 1 of this report sets forth the purpose of the report and its principal conclusions and findings. Chapter 2 describes the prior and current taxation of life insurance companies. Chapter 3 provides an analysis of the revenue effect of the life insurance company tax changes under the 1984 Act and provides data on taxes paid by the life insurance industry for 1984 through 1986. Chapter 4 examines and evaluates the differential taxation of stock and mutual life insurance companies and their policyholders and shareholders. Chapter 5 presents a recommendation and additional options for revising life insurance company taxation.

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[1] The Congressional mandate for this report -- section 231 of the Deficit Reduction Act of 1984 -- is contained in Appendix 1 of the Department of the Treasury, Interim Report to The Congress on Life Insurance Company Taxation (June 1988).

C. Principal Conclusions and Findings

The principal conclusions and findings of this report are the following:

- The 1984 Act changes have increased revenues from life insurance companies by a smaller amount than predicted. For 1984-86, receipts from the life insurance industry were estimated at the time of the 1984 Act to be $9.5 billion, whereas estimated actual receipts were $7.2 billion (including tax liabilities attributable to an adjustment made to mutual company income in 1987 which is related to the 1986 taxable year).[2] For 1986, actual tax payments were inflated by the unusually large capital gains taxes paid in 1986 by both stock and mutual companies.

- Although mutual and stock life insurance companies have substantially different forms of legal ownership, they are in direct competition with each other and they increasingly operate in competition with other financial intermediaries. The tax system should seek to provide a level playing field for these competitors.

- It is difficult to identify or measure the returns that policyholders receive on "participating" life insurance policies. Participating policies are those in which the policyholder purchases an equity-like interest in the insurance company in addition to some combination of term insurance and the equivalent of a savings certificate. Since stock companies increasingly sell participating policies, this problem applies to the taxation of stock company income as well as to the taxation of mutual company income.

- Different tax rules should apply to different forms of business organizations only to the extent necessary to measure accurately and tax equally the income of the different forms of business. Section 809 of the Internal Revenue Code, which imputes income to mutual life insurance companies in order to tax at the corporate level equity-like returns contained in policyholder dividends, was intended to equalize the tax treatment of mutual and stock life insurance companies, but it has not succeeded.

---

[2] The reported amount is based upon a sample of mutual and stock life insurance company tax returns provided by the Internal Revenue Service. On July 19, 1989, the mutual life insurance industry provided additional data not previously available to the Office of Tax Analysis in making this reported estimate. Based upon the data provided by the mutual life insurance industry, it appears that 1984-1986 taxes paid by the life insurance industry may be as high as $7.5 billion, rather than $7.2 billion as originally reported.

- Section 809 contains numerous and significant practical shortcomings, including: (1) not achieving the expected level of taxes from mutual and stock life insurance companies; (2) basing the taxes of each mutual company on the earnings of its competitors; (3) imputing income to mutual companies on the basis of short-term changes in the relative earnings rates of the stock and mutual segments of the industry; and (4) recomputing the addition to mutual company income after the current tax year.

- Section 809 has also been criticized on the theoretical ground that mutual life insurance companies prepay taxes on their policyholders' equity contributions (the "prepayment" analysis). Given its assumptions, the "prepayment" analysis generally demonstrates that mutual company policyholder dividends should be fully deductible to provide equal corporate-level tax treatment of equity-like returns to mutual and stock company investors. The prepayment analysis concludes that a tax on paid-in capital combined with a full deduction of dividends to policyholders (the situation of mutual companies without the additional tax under section 809) is equivalent in present value terms to the exclusion of capital contributions combined with no deduction for dividends to shareholders (the situation of stock companies issuing only nonparticipating policies).

- The prepayment analysis, however, does not address the problem that returns to participating policyholders, both stock and mutual, enjoy an individual tax advantage when compared to returns to shareholders or bondholders. In addition, some uncertainty remains regarding certain assumptions on which the prepayment analysis is based. Finally, unlike income flowing through other financial institutions, a significant portion of income flowing through life insurance companies is not taxed at either the corporate or personal levels.

- In enacting section 809, Congress intended to tax the equity-like returns of mutual policyholders. Due to the proliferation of participating policies sold by stock companies, however, we believe that accomplishment of the Congressional objective requires a broader focus. That focus should include the following goals: (1) equal tax treatment of returns to participating policyholders of both stock and mutual companies, (2) treatment of stock company shareholders' equity income commensurate with the current individual tax treatment of participating policyholders, and (3) more consistent tax treatment of income flowing through life insurance companies and income flowing through other financial institutions.

- To accomplish these goals, the Treasury Department recommends that section 809 be repealed and replaced with an investment earnings tax that applies to all life insurance companies and a shareholder dividends-paid credit. Under this proposal, life insurance companies would pay a tax equal to a percentage of net investment income of life insurance contracts. A 1.0 percent rate should be considered in order for this tax (combined with the shareholder dividends-paid credit) to be approximately revenue neutral with estimates of tax receipts under section 809 for the period 1990-91. Due to expected increases in the level of collections under section 809, this rate would be phased up to a rate of slightly more than 2.0 percent to maintain revenue neutrality in later years. This tax would be payable in addition to and separately from the tax payable on gain from operations after policyholder dividends.

- Because equity returns to stock company shareholders are taxed twice, whereas equity returns to mutual company policyholders are not, stock life insurance companies would be allowed a shareholder dividends-paid credit equal to the estimated individual tax liability on dividends paid. This credit would be against the new investment earnings tax described above. A credit equal to 15 percent of shareholder dividends paid would account for the effective tax rates on dividends paid to shareholders.

- An investment earnings tax on all life insurance companies, with a shareholder dividends-paid credit, would have several advantages over the current system of life insurance company taxation. First, the taxation of total returns on participating policies would apply equally to mutual and stock companies, and the conceptually and practically flawed section 809 would be repealed. Second, the double taxation of equity returns of stock company shareholders would be reduced with the dividends-paid credit to put them on a par with the current individual tax treatment of participating policyholders. Third, the taxation of financial products across different financial institutions would be made more consistent by ensuring that investment income flowing through life insurance companies is taxed at least once at either the corporate or individual levels.

- Congress may also wish to consider the following alternative approaches to life insurance company taxation: (1) repeal of section 809; (2) an alternative add-on tax on life insurance companies issuing participating policies that is based on the rate of stock company shareholder dividend payments; (3) simplification of section 809; and (4) a tax imposed at the corporate level to serve as a proxy for the individual-level tax on equity-like returns to participating policyholders.

CHAPTER 2

SUMMARY OF PRIOR AND CURRENT LAW TAXATION OF LIFE INSURANCE COMPANIES

Since 1921, life insurance companies have been subject to tax under three different sets of rules. Between 1921 and 1958, life insurance companies were taxed only on "free" investment income. Free investment income was the amount of investment income that was not needed to fund obligations to policyholders. This amount was calculated under formulae that changed over the years. Income and losses from underwriting operations (e.g., premium income and benefits paid to policyholders) were ignored as were gains and losses from the sale of investment assets.

A. Taxation Under the Life Insurance Company Tax Act of 1959

Between 1958 and 1984, life insurance companies were taxed under a complex "three-phase" system enacted by the Life Insurance Company Tax Act of 1959 (the "1959 Act"). The three phases referred to the three different tax bases that could be applicable to a life insurance company. The first tax base was the company's free ("taxable") investment income. The second tax base was the company's gain from operations. The gain from operations tax base included premium income and taxable investment income. In calculating gain from operations, deductions were allowed for additions to reserves for future obligations. The amount of the reserve deductions was generally equal to the amount of the additions to the reserves required by state regulators. In addition, limited deductions were allowed for policyholder dividends and certain "special deductions."

Under the 1959 Act, a life insurance company was taxed on the lesser of its taxable investment income or its gain from operations. In calculating its gain from operations, the amount of deductions for policyholder dividends and special deductions was limited to $250,000, plus the amount by which the gain from operations (before these deductions) exceeded taxable investment income. Thus, these deductions could not reduce a company's taxable income to more than $250,000 below its taxable investment income. If a company's gain from operations exceeded its taxable investment income, the company was taxed on 50 percent of such excess. The untaxed gain from operations (along with the special deductions) was added to a deferred tax account and, subject to certain limitations, was taxed only when distributed to shareholders. When triggered, this deferred tax account was the third tax base under the 1959 Act.

B. Modified Coinsurance Transactions and Life Insurance Company Taxation

The existence of multiple tax bases under the 1959 Act produced differing tax treatment of different types of income.

For example, a company that had reached the limit on the deduction of policyholder dividends and special deductions would be taxed on the receipt of additional investment income, but not on the receipt of additional underwriting income. Life insurance companies were able to manipulate the character of their income by entering into so-called "modified coinsurance" transactions.

In a modified coinsurance transaction, a life insurance company (the ceding company) reinsures certain risks, but retains ownership of the assets and the reserve liabilities connected with the risks reinsured. Former section 820 of the Code, however, permitted the parties to treat the transaction as if the assets and reserves had been transferred to the reinsurer, and as if investment income earned on the assets and reserves were earned by the reinsurer. As part of a modified coinsurance transaction, the reinsurer would pay "experience refunds" to the ceding company. The experience refunds reflected the investment income actually earned by the ceding company, but which was treated under section 820 as if it were earned by the reinsurer. The experience refunds were characterized as underwriting income to the ceding company. Thus, a modified coinsurance transaction had the effect of converting taxable investment income of the ceding company into more favorably taxed (or untaxed) underwriting income.

The special treatment of modified coinsurance transactions under former section 820 of the Code was repealed by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). At the same time, however, the limitation on the deductibility of policyholder dividends was revised for a temporary two-year period. In general, under the revised limitation, a partial deduction (85 percent for stock companies and 77.5 percent for mutual companies) was allowed for all policyholder dividends. Several other favorable tax provisions were enacted for a temporary two-year period.

C. Consolidated Tax Returns of Life Insurance Companies

Prior to 1981, life insurance companies were not permitted to join in the filing of consolidated income tax returns with affiliated corporations that were not life insurance companies. Thus, income and losses of life insurance companies and affiliated non-life companies could not be used to offset one another. The filing of consolidated returns by life and non-life companies has been permitted since 1981, subject to two restrictions. First, consolidated returns may be filed by a life company and a non-life company only if they have been affiliated for the preceding five years. Second, the amount of non-life losses that can be offset against the income of life companies is limited to the lesser of 35 percent of the non-life losses or 35 percent of the life company income. The second restriction does not limit the use of life insurance losses to offset income of non-life affiliates. These consolidation rules were not changed by the 1984 Act discussed below.

D. Current Law Taxation of Life Insurance Companies

The rules for taxing life insurance companies were subtantially revised in 1984 in response to concerns that the 1959 Act rules were unduly complex and that they did not result in an appropriate measure of life insurance company income in an environment of high interest rates and new insurance products. Under the 1984 Act, life insurance companies are taxed on a single income tax base corresponding generally to the tax base applicable to other corporations. Many of the special deductions and accounting rules that had applied under the 1959 Act were repealed. Even with these changes, however, the tax base of life insurance companies differs from that of other corporations in three significant respects.

First, 1984 Act allowed life insurance companies a "special life insurance company deduction" and a "small life insurance company deduction." The "special" deduction, which was repealed by the Tax Reform Act of 1986, was equal to 20 percent of the company's taxable income from insurance businesses, and had the effect of reducing the maximum marginal rate of tax from 46 percent to 36.8 percent. The "small company" deduction, which applies to companies with assets of less than $500 million, is equal to 60 percent of the first $3 million of the company's taxable income from insurance businesses, and is phased out at income levels of between $3 million and $15 million.

Second, as under the 1959 Act, life insurance companies are allowed to deduct additions to life insurance reserves and similar items. In calculating the maximum amount of the reserves, the 1984 Act required that the reserves be calculated using Federally prescribed rules. In general, the Federally prescribed reserve rules specify a tax reserve method and require use of the highest interest rate and most recent mortality or morbidity table permitted to be used by insurance regulators in a majority of states. For taxable years beginning after 1987, the interest rate that must be used in calculating reserves is the greater of the prevailing state rate or a five-year average of the Federal mid-term rate.

Third, to address the perception that the rules relating to the deduction of policyholder dividends may not tax mutual companies on their economic income, the 1984 Act imposed a limitation on the deduction by mutual life insurance companies of policyholder dividends. Under section 809 of the Code, the deduction of policyholder dividends by a mutual company is reduced by the company's "differential earnings amount." The differential earnings amount is equal to the product of the mutual company's average equity base and the "differential earnings rate." The differential earnings rate, in turn, is equal to the excess of the "imputed earnings rate" (90.55 percent of a three-year average of the earnings rates of the 50 largest stock life insurance company groups) over the average earnings rate of all mutual life insurance companies for the second calendar year preceding the taxable year. The differential earnings amount for a taxable year is "recomputed" in the subsequent taxable year. The recomputed amount reflects the average mutual earnings rate for the calendar year in which the taxable year begins (rather than the second preceding calendar year). The difference between the differential earnings amount and the recomputed differential earnings amount (the so-called "true-up") is included in (or deducted from) income in the subsequent year. Table 2.1 shows the figures used in the calculation of the differential earnings rate.

For example, the differential earnings amount of mutual companies for 1985 was calculated using the 1983 average mutual earnings rate of 10.166 percent. The recomputed differential amount for 1985 was calculated using the 1985 average mutual earnings rate of 13.135 percent. The difference between the differential earnings amount for 1985 and the recomputed differential earnings amount for 1985 (i.e., 2.969 percent of each company's 1985 average equity base) was allowed as a deduction in calculating the taxable income of each mutual life insurance company in 1986.

Table 2.1

Data for Calculation of Section 809 "Differential Earnings Rate"
(Percent)

Year	Stock Earnings Rate 1/	Current Stock Earnings Rate 2/	Imputed Earnings Rate 3/	Average Mutual Earnings Rate	Differential Earnings Rate 4/	Recomputed Differential Earnings Rate 5/	"True-Up" Rate on Subsequent Year Returns 6/
1988	NA	16.042*	14.527*	NA	0*	NA	NA
1987	9.165	18.564	16.811	8.783	3.676	8.028	4.352
1986	20.279	17.983	16.285	17.980	10.539	0	-10.539
1985	18.683	18.026	16.323	13.135	6.157	3.188	-2.969
1984	16.731		16.5	5.746	7.8 7/	10.754	2.954
1983	18.535			10.166			
1982	18.812						
1981	17.316						

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SOURCE: IRS, Revenue Ruling 87-98 and Announcement 88-47.

*Tentative

1/ Unweighted earnings rate of the top 50 stock life companies in the current year.

2/ Preceeding three-year average of the stock earnings rate.

3/ Equal to 0.9055 of the current stock earnings rate (CSER), since the imputed earnings rate is 16.5 percent times the ratio of the CSER divided by the base period (1981-3) stock earnings rate (18.221).

4/ Equal to the maximum of the imputed earnings rate minus the average mutual earnings rate from two years earlier or zero.

5/ Equal to the maximum of the imputed earnings rate minus the average mutual earnings rate from the same year or zero.

6/ The recomputed differential earnings rate minus the tentative differential earnings rate.

7/ Set by statute.

CHAPTER 3

ANALYSIS OF THE REVENUE EFFECTS OF CHANGES IN THE TAXATION OF LIFE INSURANCE COMPANIES UNDER THE DEFICIT REDUCTION ACT OF 1984

A. Introduction and Summary

During the consideration of the life insurance provisions of the 1984 Act, the Congress expressed concern about two issues: (1) the amount of taxes paid by the life insurance industry, and (2) the relative tax burden of mutual and stock life insurance companies. The 1984 Act required the Treasury Department to submit annual reports on the taxes paid by the life insurance industry. In response to the Congressional mandate contained in section 231(a) of the 1984 Act, the Treasury Department transmitted an interim report to Congress in June, 1988, which analyzed the taxes paid by life insurance companies in 1984 and 1985.[1] The purpose of this chapter is to provide additional analysis of the revenue effects of the life insurance company tax changes of the 1984 Act and to provide data on taxes paid by the life insurance industry for 1986.

The 1988 report found that the 1984 Tax Act changes to life insurance company taxation have increased revenues by a smaller amount than predicted. In particular, the tax payments of the life insurance industry and the relative shares paid by the mutual and stock segments in 1984 and 1985 did not meet Congressional expectations. These shortfalls were attributed to the difficulty in estimating receipts from the life insurance company tax rules, including the complexity of the tax law changes, the difficulty in predicting accurately taxpayers' responses to those changes, and the changing nature of the life insurance industry's products and practices.

The analysis contained in this chapter generally confirms the findings in the 1988 report that the 1984 Tax Act changes have increased revenues by a smaller amount than predicted. Moreover, actual tax payments for 1986 were inflated by the unusually large capital gains taxes paid in 1986. Income from capital gains realizations was unexpectedly large in 1986, related in large part to the anticipated capital gains tax increase in 1987 enacted under the Tax Reform Act of 1986. Without the large capital gains realizations due primarily to that subsequent legislation, revenues from the life insurance industry would have been far short of predicted levels.

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[1] Department of the Treasury, <u>Interim Report to the Congress on Life Insurance Company Taxation</u> (June 1988).

The findings in the 1988 report and this report are based upon an analysis of life insurance company tax returns. The results of that analysis for 1984, 1985, and 1986 are summarized in Table 3.1. Although receipts from the life insurance industry were estimated at the time of the 1984 Act to be $9.5 billion for 1984 through 1986, actual payments were $7.2 billion (including tax liabilities attributable to the mutual sector's "true-up", i.e., an adjustment to income made in a subsequent year).[2] Receipts were estimated to be $5.2 billion (55 percent of the total) for mutual life insurance companies and $4.3 billion (45 percent of the total) for stock life insurance companies. Actual collections were $2.8 billion from mutual life insurance companies (including the true-up) and $4.4 billion from stock life insurance companies.[3]

This chapter also provides data on tax obligations reported on financial statements for 1984 through 1988. Since tax liabilities are measured differently for tax and financial reporting, the financial data do not reflect the actual level of life insurance company tax payments. Nevertheless, these data may provide an indication of whether actual tax payments are likely to increase or decrease in 1987 and 1988. Data provided on financial statements indicate that life insurance company tax payments are likely to fall in 1987 and increase in 1988. The expected reduction in tax payments for 1987 is partly attributable to lower capital gains income and losses on health insurance business. For mutual companies, the expected decrease in tax payments in 1987 also reflects a negative true-up (an estimated $1.4 billion reduction in tax liability) that is attributable to 1986.

It is hoped that the data contained in this chapter will be useful in evaluating the success of current law in raising the amount of revenue expected under the 1984 Act. However, a more appropriate standard for evaluating the success of the 1984 Act is whether it measures accurately the economic income of life insurance companies. An analysis of whether current law is properly taxing life insurance companies is contained in Chapter 4.

B. Analysis of Taxes Paid by the Life Insurance Industry: 1984-1986

This section provides an analysis of the revenue effect of the life insurance company tax changes under the 1984 Act for 1984 through 1986. It summarizes the results from the 1988 report on taxes paid by the life insurance industry for 1984 and 1985 and provides data on taxes paid by the life insurance industry and the mutual and stock segments for 1986.

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[2] This amount may be as high as $7.5 billion. See footnote 2 of Table 3.1.

[3] Actual collections for mutual life insurance companies may be as high as $3.1 billion. See footnote 2 of Table 3.1.

Table 3.1

Comparison of Estimated and Actual Tax Payments
of the Life Insurance Industry: 1984-1986
($ billions)

	1984	1985	1986	Total 1984-86
Life Insurance Industry				
1984 estimate	3.0	3.1	3.4	9.5
Actual payments	2.4	2.9	3.3	8.5
Actual payments including true-up	2.7	2.2	2.3	7.2
Mutual Life Insurance Companies 1/				
1984 estimate	1.6	1.7	1.9	5.2
Actual payments	1.0	1.3	1.9 2/	4.1
Actual payments including true-up	1.3	0.6	0.9 2/	2.8
Stock Life Insurance Companies				
1984 estimate	1.4	1.4	1.5	4.3
Actual payments	1.4	1.6	1.4	4.4

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NOTE: Details may not add to totals because of rounding.

SOURCES: Actual payments for 1984 and 1985 and estimates for 1984-1986, Department of the Treasury, Interim Report to the Congress on Life Insurance Company Taxation (June 1988). Actual payments for 1986, sample of 1986 life insurance company tax returns.

1/ Includes stock life company subsidiaries of mutual life companies.

2/ On July 19, 1989, the mutual sector provided additional data not previously available to the Office of Tax Analysis (OTA) in making this estimate. Based on the data provided by the mutual sector, OTA estimates that actual payments for the mutual sector in 1986 may be $2.2 billion or $1.2 billion including the "true-up".

The results for taxes paid in 1986 are based on an analysis of a sample of life insurance company tax returns for 1986. Appendix A describes the data and the methodology used for calculating taxes paid in 1986. Since tax year 1986 is the last year for which tax liability information is available from the Internal Revenue Service, financial statement data on tax obligations are provided in the next section of this chapter to indicate the direction of tax liability changes for later years.

1. Background

The complete overhaul of the life insurance industry's tax rules in 1984 made it difficult to estimate the revenue effects of changes in specific provisions. Thus, the principal focus of the legislative debate was on expected revenues from the industry after the tax law changes, rather than the revenue change from the legislation. The Treasury and the Joint Committee on Taxation (JTC) estimated that the expected level of receipts from the industry after the 1984 Act would grow from $3.0 billion in 1984 to between $3.8 and $3.9 billion in 1988, as shown below.

Table 3.2

Estimates of Life Insurance Industry Receipts
After The 1984 Act
($ billions)

	Fiscal Years				
	1984	1985	1986	1987	1988
Treasury estimates	2.5*	3.1	3.3	3.5	3.8
Joint Committee on Taxation estimates	3.0	3.1	3.4	3.6	3.9

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*Difference from JCT estimate due to lower estimate of 1983 calendar year receipts with full effect of end of the safety net between FY 1984 and 1985. The 1984 calendar year receipts estimate was $3.0 billion.

Estimates of the revenues from the mutual and stock segments of the life insurance industry also were made for 1984. For calendar year 1984, the total life insurance industry was expected to pay $3.0 billion, divided approximately 55 percent for the mutual segment ($1.6 billion with rounding) and 45 percent for the stock segment ($1.4 billion).

2. Summary of Taxes Paid by the Life Insurance Industry: 1984-1985

This section summarizes the results for taxes paid in 1984 and 1985 presented in the 1988 report. A detailed reconciliation of revenues estimated at the time of the 1984 Act and actual revenues for 1984-85 is contained in Chapter 3 of that report.

Table 3.1 provides estimates of taxes paid by the life insurance industry that are comparable to those used to estimate receipts from the 1984 Act. Actual collections from the industry in 1984 were $2.4 billion, $1.0 billion from the mutual segment and $1.4 billion from the stock segment. Actual 1984 collections for the mutual segment were $1.4 billion including the true-up for 1984 which occurred in 1985. The revenue estimates of the 1984 Act projected that in 1984 receipts from the life insurance industry would be $3.0 billion and that the mutual segment of the life insurance industry would pay approximately $1.6 billion in tax and the stock segment would pay approximately $1.4 billion in tax.

Table 3.1 also shows that in 1985 actual receipts from the life insurance industry were $2.9 billion, $1.3 billion from the mutual segment and $1.6 billion from the stock segment. Actual collections for the mutual segment were $0.6 billion including the negative true-up for 1985 which occurred in 1986 and excluding the true-up for 1984 which occurred in 1985. .The original estimates of the 1984 Act implied total receipts of $3.1 billion, approximately $1.7 billion in revenues from the mutual segment and approximately $1.4 billion from the stock segment.

The 1988 report concluded that these shortfalls were attributed to the difficulty in estimating receipts from the life insurance industry at the time of the 1984 Act. These difficulties were attributed to (1) the complexity of the changes in the tax rules, (2) the difficulty predicting the effect of the changes on taxpayers' behavior, (3) the significant changes in the industry's practices and products during the last decade, and (4) the limitations of the available data.

3. Taxes Paid by the Life Insurance Industry: 1986

Based upon a sample of life insurance company tax returns for 1986, actual collections were estimated to be $3.3 billion in 1986, consisting of $1.9 billion for the mutual segment and $1.4 billion for the stock segment (Table 3.1). Actual collections for the mutual segment were $0.9 billion including the negative true-up for 1986 which occurred in 1987 and excluding the negative true-up for 1985 which is reflected in 1986.[4] The

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[4]Actual collections of mutual life insurance companies may be as high as $2.2 billion, or $1.2 billion including the true-up. See footnote 2 of Table 3.1.

revenue estimate of the 1984 Act projected that the life insurance industry would pay $3.4 billion in tax in 1986, $1.9 billion from the mutual segment and $1.5 billion from the stock segment.

The mutual and stock segment tax payments for 1986 reflect in large part unexpectedly high realizations of capital gains in 1986 related to the anticipated capital gains tax increase in 1987 enacted under The Tax Reform Act of 1986. In addition, for mutual companies the timing of the true-up increased tax payments in 1986 but reduced tax payments in 1987.

4. Capital Gains

Capital gains income as a percentage of total taxable income was unusually high in 1986 for both mutual and stock life insurance companies. Capital gains were approximately 89 percent of taxable income ($5.6 billion out of $6.3 billion) for mutual life insurance companies and 65 percent of taxable income ($2.9 billion out of $4.4 billion) for stock life insurance companies.[5] The corresponding percentages for mutual and stock life insurance companies in 1978 (the base year for forecasting revenues) were under 1 percent for mutual companies ($15 million out of $3.7 billion) and under 4 percent for stock companies ($88 million out of $2.4 billion). Without these high capital gains realizations, revenues from the life insurance industry in 1986 would have been far short of their predicted levels.

Table 3.3 provides data on realized capital gains reported on financial statements of mutual and stock life insurance companies

Table 3.3

Realized Capital Gains Reported on Financial Statements
($ billions)

Year	Mutuals	Stocks
1980	-0.1	0.2
1981	-0.2	-0.1
1982	0.1	0.1
1983	0.2	0.9
1984	-0.2	-0.1
1985	1.4	1.5
1986	3.9	3.4
1987	1.0	1.2

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Source: A.M. Best Company

[5] Based on additional data provided by the mutual life insurance industry, capital gains are estimated to be 88 percent of taxable income ($6.3 billion out of $7.2 billion).

for 1980 through 1987.[6] These data show that realized capital gains for 1986, $3.9 billion for mutual life insurance companies and $3.4 billion for stock life insurance companies, are unusually high for the 1980s. Table 3.3 also shows that capital gains realizations fall substantially in 1987.

5. Effect of True-up Adjustments on Mutual Sector Tax Payments

Tax payments reported on tax returns of mutual life insurance companies for the current taxable year include an adjustment to income from the prior taxable year, called the "true-up", related to the "recomputation" of the mutual companies' differential earnings rate for the preceding taxable year. This true-up arises because Internal Revenue Code section 809 tentatively imputes income to mutual companies in the current tax year based on mutual companies' earnings data for the second preceding tax year. The recomputation provision of section 809 requires that the imputation be recalculated in the subsequent tax year. Thus, for example, the imputation for 1986 uses the mutual earnings rate for 1984, which is then recomputed in 1987. The difference based upon this recomputation (the true-up) is added to income in the subsequent tax year.

Table 3.4 summarizes the effects of the true-up adjustments on mutual sector tax payments.[7] Line 1 shows mutual sector tax payments according to tax returns of $4.1 billion for 1984 through 1986. This amount includes the tax receipts attributable to the true-up adjustment for the prior year (on line 2), and excludes the tax receipts for the true-up attributable to the current year that occurs in the subsequent year (line 4). Line 5 shows the tax receipts for the mutual sector after attributing the true-up adjustments to the current tax year. It shows that mutual sector tax receipts were $2.8 billion for 1984 through 1986.

Table 3.4 shows that for 1986, for example, the $1.9 billion in tax receipts includes a negative true-up of $0.4 billion attributable to 1985, but excludes a negative true-up of $1.4 billion attributable to 1986 which occurs in 1987. By excluding the true-up attributable to 1985 and including the true-up attributable to 1986, the 1986 tax liabilities are reduced to $0.9 billion. A detailed discussion of true-up computations for 1986 is contained in Appendix B of this report.

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[6] Realized capital gains reported on financial statements may differ from realized capital gains reported on tax returns because of differences between tax and financial statement rules for measuring income.

[7] Mutual sector tax payments may be higher than the amounts reported in the text. See footnote 2 of Table 3.4.

Table 3.4

Mutual Segment Tax Payments Before and After "True-Up" Adjustments: 1984-1986[1]
($ billions)

	1984	1985	1986	1987	1984-1986 Total
1. Current year tax payments after "true up" from previous year and before "true-up" for current year	1.0	1.3	1.9[2]	n.a.	4.1
2. Tax payments attributable to prior year "true-up"	0.0	0.4	-0.4	-1.4	
3. Current year tax payments before "true up" from prior year and before "true-up" for current year (line 1 minus line 2)	1.0	0.9	2.2	n.a.	
4. Tax payments in subsequent year attributable to current year "true-up"	0.4	-0.4	-1.4	n.a.	
5. Current year tax payments before "true-up" from previous year and after "true-up" for current year (line 3 plus line 4)	1.4	0.6	0.9[2]	n.a.	2.8

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Details may not add to totals because of rounding.

1/ Includes tax payments of stock company subsidiaries of mutual life companies.

2/ On July 19, 1989, the mutual sector provided additional data not previously available to the Office of Tax Analysis (OTA) in making this estimate. Based on the data provided by the mutual sector, OTA estimates that actual payments for the mutual sector may be $2.2 billion (line 1), or $1.2 billion after "true-up" adjustments (line 5).

6. Tax Before Credits and Before Non-Life Losses: 1984-1986

The 1984 Act estimated tax payments for the life insurance industry after credits and after the use of nonlife losses. This measure is intended to reflect actual collections by the Federal government. However, taxes before credits and nonlife losses may be the appropriate measure of tax liability for examining the effects of tax law changes on life insurance companies. Although the use of nonlife losses reduced the taxes paid by life insurance companies, these refunds are not attributable to life insurance business activity and could be characterized as reducing the tax payments of other industries. Moreover, tax credits are provided in recognition of taxes paid or as incentive payments to business for undertaking certain activities, rather than as reductions in tax liabilities.

Table 3.5 compares taxable income and tax before and after nonlife losses for 1984, 1985, and 1986. It shows that tax before credits and nonlife losses for the life insurance industry was $2.8 billion and $3.6 billion for 1984 and 1985, respectively. Nonlife losses and tax credits reduced taxes paid to $2.4 billion in 1984 and $3.0 billion in 1985. The majority of the decrease for both years is attributable to nonlife losses of stock companies.

Table 3.5 also shows that the life insurance industry had tax before credits and nonlife losses of $3.9 billion in 1986, including $2.0 billion for mutual life insurance companies and $1.9 billion for stock life insurance companies.[8] The use of nonlife losses reduced tax before credits by about $0.2 billion for stock companies in 1986.

C. Tax Obligations From Financial Statements: 1984-1988

Table 3.6 provides tax obligations of the life insurance industry based on financial statement data for 1984 through 1988. For comparison, it also includes tax payments reported on tax returns. Taxes reported on financial statements are generally higher than taxes reported on tax returns for several reasons. Tax liabilities are measured differently for tax and financial reporting purposes. Financial statement amounts are estimates of tax that are made several months before a company files a tax return. The taxes reported on financial statements may include amounts never reported on tax returns, such as assessed tax deficiencies relating to audits of prior year tax returns. Where financial and tax accounting differ on the timing of income recognition, the financial statement taxes may include amounts that are not actually paid to the Treasury until later years. In addition, the regulatory statements do not allow consolidation with nonlife companies, although life insurance companies have been allowed to file consolidated tax returns with nonlife companies since 1981.

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[8] Tax before credits and nonlife losses may be as high as $4.3 billion for the life insurance industry and $2.4 billion for the mutual sector. See footnote 4 of Table 3.5.

Table 3.5

Taxable Income and Tax Before and After Credits for Life Insurance Companies
Filing Life/Nonlife Consolidated Returns for 1984, 1985, and 1986
($ billions)

	Mutuals 1/			Stocks			Total		
	Taxable income 2/	Tax before credits	Tax after credits 3/	Taxable income 2/	Tax before credits	Tax after credits 3/	Taxable income 2/	Tax before credits	Tax after credits 3/
Before nonlife losses									
1984	2.4	1.1	n.a.	4.1	1.8	n.a.	6.5	2.8	n.a.
1985	3.6	1.5	n.a.	5.1	2.2	n.a.	8.7	3.6	n.a.
1986	6.4[4]	2.0[4]	n.a.	5.0	1.9	n.a.	11.4	3.9	n.a.
After nonlife losses									
1984	2.3	1.0	1.0	3.4	1.4	1.4	5.7	2.4	2.4
1985	3.4	1.4	1.3	4.0	1.6	1.6	7.4	3.0	2.9
1986	6.3[4]	2.0[4]	1.9[4]	4.4	1.7	1.4	10.7	3.6	3.3

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Notes: Details may not add to totals because of rounding. N.a. = not available.

Sources: For 1984 and 1985, Department of the Treasury, Interim Report to the Congress on Life Insurance Company Taxation (June 1988). For 1986, sample of 1986 life insurance tax returns.

1/ Includes stock life company subsidiaries of mutual life companies.

2/ Mutual sector taxable income includes a "true-up" in 1985 of approximately $0.95 billion for an additional $0.35 billion tax liability in 1985. Mutual sector taxable income for 1986 includes a negative "true-up" of approximately $1.0 billion due to the recomputation of the 1985 differential earnings rate. Taxable income of the mutual segment in 1987, not shown on this table, includes a negative "true-up" of $3.7 billion, reflecting the mutual segment's recomputed differential earnings rate for 1986.

3/ For life/non-life consolidated companies, tax payments for 1986 are calculated in accordance with the proportional tax allocation method. See Appendix 2 for a discussion of this method. Tax liability figures for 1984 and 1985 reflect the actual method elected for allocating tax to consolidated companies.

4/ On July 19, 1989, the mutual sector provided additional data not previously available to the Office of Tax Analysis (OTA) in making this estimate. Based on the data provided by the mutual sector, OTA estimates that taxable income and tax before credits may be $7.4 billion and $2.4 billion before nonlife losses. The estimates after nonlife losses may be $7.2 billion for taxable income, $2.3 for tax before credits, and $2.2 billion for tax-after credits.

Table 3.6

Life Insurance Company Tax After Credits
Reported on Financial Statements and Tax Returns
($ billions)

	1984	1985	1986	1987	1988
Financial Statements[1]					
Mutual companies:	1.2	2.1	2.3	0.5	1.5
Capital gains	0.1	0.6	2.1	1.0	1.2
Ordinary income	1.2	1.5	0.2	-0.5	0.4
Stock companies:	1.5	2.0	2.4	1.4	1.9
Capital gains	0.1	0.4	1.1	0.6	0.3
Ordinary income	1.4	1.6	1.2	0.7	1.6
Total	2.8	4.1	4.7	1.8	3.5
Tax Returns[2]					
Mutual companies[2]	1.0	1.3	1.9[4]	n.a.	n.a.
Stock companies	1.4	1.6	1.4	n.a.	n.a.
Total	2.4	2.9	3.3	n.a.	n.a.

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n.a. = not available.

Details may not add to totals because of rounding.

1/ Data are from the A.M. Best Co. Figures for 1988 are preliminary.

2/ Includes stock company subsidiaries of mutual life companies.

3/ Figures for 1984 and 1985 are derived from the 1987 Treasury Department Survey of Life Insurance Companies. Figures for 1986 are from a sample of life insurance company tax returns for 1986.

4/ On July 19, 1989, the mutual sector provided additional data not previously available to the Office of Tax Analysis (OTA) in making this estimate. Based on the data provided by the mutual sector, OTA estimates that tax after credits for mutual companies for 1986 may be as high as $2.2 billion.

Although financial statement data do not measure accurately the actual level of life insurance company tax payments, they provide an indication of whether actual tax payments are likely to increase or decrease in 1987 and 1988. These data indicate a drop in life insurance company taxes from $4.7 billion in 1986 to $1.8 billion in 1987 and then an increase to $3.5 billion in 1988. The reduction in taxes for 1987 is partly attributable to lower capital gains income as well as losses on health insurance business. For mutual companies, the 1987 payments also include a negative true-up ($1.4 billion) attributable to 1986.

CHAPTER 4

ANALYSIS OF THE DIFFERENTIAL TAXATION OF STOCK AND MUTUAL LIFE INSURANCE COMPANIES

A. Background and General Observations

Measuring the economic incomes of life insurance companies and their policyholders has been difficult and controversial for many years. With an unintegrated individual and corporate tax system, the proper taxation of life insurance company income involves the following question: To what extent should mutual company policyholders be treated like partners in an unincorporated business, or like corporate owners of their businesses? A closely related question is: Should payments to "participating" policyholders of income produced at the corporate level be treated as payments with respect to debt, and thus as deductible interest at the corporate level, or as payments to owners, and thus as nondeductible dividends?

A major difficulty in taxing the income of life insurance companies, both stock and mutual, is that the total income of companies selling "participating" policies cannot be identified directly. A "participating" policy is one through which a policyholder buys not only some amount of term insurance and the equivalent of a savings certificate, but also an equity-like interest in the insurance company. In participating policies, the policyholder may also provide, through premiums, funds necessary for company surplus. Surplus is used to cover contingencies and for other capital requirements, such as buildings and equipment. Such equity-like contributions have been called "redundant" premiums.

The return that a participating policyholder may receive on his equity interest is difficult to identify or measure because the return can be received in many forms, including increased policyholder dividends, reduced premiums, or increased cash values. Further, to impose a tax on life insurance company corporate profits, a determination must be made of what portion of policyholder dividends should be taxable and what portion should not. This determination is complicated by the fact that policyholder dividends may blend together price reductions, interest payments (reflecting the companies' use of any redundant premiums between receipt and repayment), and equity-like returns.[1] Unfortunately, there has never been a practical or

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[1] Other elements of policyholder dividends have also been identified, including repayment of the policyholder's investment principal, and capital gain on the amount invested in ownership.

accurate means of determining what portion of policyholder dividends falls in each category.[2]

The difficulty created by the sale of participating life insurance has generally been viewed as a problem of devising a satisfactory measure of mutual life insurance company profits. This view is based on the assumption that mutual companies sell only participating policies and stock companies sell only nonparticipating policies. Increasingly, however, stock companies are also issuing participating policies. For example, stock companies sell universal life policies, which are policies that credit interest at rates that may not be fixed in the contract. The dollar amount of universal life insurance in force in the United States increased sevenfold between 1983 and 1987.[3] As the 1984 Act recognized, when any amount paid or credited to a policyholder is not fixed in the contract, but depends on the experience of the company or the discretion of management, the amount paid should be considered a policyholder dividend for tax purposes.[4]

Thus, the identification and appropriate taxation of any equity-like returns to participating (or similar) policyholders is an issue that is also involved in the taxation of stock life insurers. The identification and measurement of equity-like returns to participating policyholders is even more difficult in the case of stock companies because these policyholders share the equity risk with stock company shareholders.

Mutual companies have contended that policyholder rights do not include ownership rights, and thus no equity return is present. While the limitations on policyholders' contractual rights do distinguish them from conventional equity owners,[5] it is clear that the return received through policyholder dividends does not represent classic debt.[6] Furthermore, the

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[2] See, generally, Henry J. Aaron, The Peculiar Problem of Taxing Life Insurance Companies (Washington, D.C., The Brookings Institution, 1983); Thomas Neubig and C. Eugene Steuerle, Office of Tax Analysis, "The Taxation of Income Flowing Through Financial Institutions: General Framework and Summary of Tax Issues," OTA Paper No 52 (September 1983).

[3] See American Council of Life Insurance, Life Insurance Fact Book (1988).

[4] See Staff of the Joint Committee on Taxation, 98th Congress, 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 611 (1984).

[5] See, e.g., Paulsen v. Commissioner, 469 U.S. 131 (1987).

[6] See, e.g., Texas Farm Bureau v. United States, 725 F.2d 307 (5th Cir. 1984); W.T. Plumb, Jr., "The Federal Income Tax Significance of Corporate Debt," 26 Tax L. Rev. 369 (1971).

argument that policyholder dividends are entirely customer rebates ignores the fact that such rebate may be received many years after the purchase. Any premium overcharge will earn interest or an equity-like return during the time that it is held by the company. As a result, the policyholder dividend must include an interest or equity-like return.

A person who buys a participating life insurance policy from a mutual or stock company acquires a life insurance policy and a right to share in the surplus or profits of the company. Both types of companies sell a large amount of cash value insurance policies, which comprise both a savings fund and pure insurance protection. By issuing cash value policies, life insurers act as financial intermediaries -- borrowing money from their policyholders and lending these funds to other borrowers -- and as poolers of their policyholders' mortality. Although stock and mutual companies have substantially different forms of legal ownership, they are in direct competition with each other. Moreover, life insurance companies increasingly operate in competition with other financial intermediaries. The tax system should not place any of these competitors at a disadvantage.

B. Reasons for Enactment and Design of Section 809

Section 809 was enacted primarily to assure that mutual companies are taxed on a base that is neither greater or less than their economic income.[7] Congress believed that a portion of the policyholder dividends paid by mutual companies is a distribution of corporate earnings to the policyholders as owners. Because stock life insurance companies cannot deduct amounts paid to their shareholders as dividends, Congress thought it appropriate to impute equity income to mutual companies.[8]

To determine the amount of equity income, an imputation mechanism was chosen because there was no means available to segregate and measure directly the ownership return of participating policies. Thus, section 809 operates to impute additional income to mutual companies based on a comparison of the returns on equity of the mutual and stock segments of the industry. Congress believed that profit-oriented enterprises generally distribute earnings to their owners in amounts that are proportional to the owners' equity in the business and, thus, determined that the equity earnings can be measured as a

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[7] *See* S. Rep. No. 169, Vol. 1, 98th Cong., 2d Sess. 521 (1984); H.R. Rep. No. 432, Prt. 2, 98th Cong., 2d Sess. 1397 (1984).

[8] The imputation of equity income was described as a limitation on policyholder dividend deductions, but in fact it is an income imputation. If the imputed income exceeds current policyholder dividends, the current reserve deduction is reduced by the excess. Section 809(a)(2).

percentage of mutual company equity. Congress also believed that mutual and stock companies in the same industry will earn comparable rates of return on equity over a period of several years. It observed, however, that the average post-dividend, pre-tax return on equity of mutual companies was lower than that for a comparable group of stock companies. This difference, Congress concluded, was attributable to the tax-deductible distribution by mutual companies of earnings to their policyholders.

Congress therefore determined that the appropriate percentage of mutual company equity was generally equal to the difference between the average earnings rate of all mutual companies and the average of the earnings rates of the 50 largest stock companies. Congress believed, however, that the stock earnings rate should be adjusted so that the mutual segment of the industry would bear 55 percent of the aggregate industry tax burden for 1984. This allocation was thought appropriate in light of the historic allocation of the industry's tax burden between the mutual and stock segments, the relative percentages of assets held by the stock and mutual segments of the industry, and the difference in tax treatment at the individual level of mutual company policyholders and stock company shareholders.[9] Historical data on these relationships were presented in the 1988 interim report.

C. Conceptual Shortcomings of Section 809

Different tax rules, such as section 809, should apply to different forms of business organizations only to the extent necessary to measure accurately and tax equally their net income. Correct measurement and equal taxation of net income is important so that the tax system does not favor one form of business over another; instead, it should provide a level playing field to all forms of business. Stated differently, the tax system is "neutral" between alternative investments if investments with the same pre-tax return have the same after-tax return to the investors.

1. <u>The "Prepayment" Analysis</u>

The mutual companies have argued that section 809 is unnecessary to provide a level playing field in the insurance industry because any deduction of corporate earnings through mutual company policyholder dividends is exactly offset by the additional tax due from mutuals when they raise capital through premiums by selling participating insurance policies. Stock companies, in contrast, are not required to include in income capital contributions of their shareholders. According to the "prepayment" analysis, a tax on paid-in capital combined with the full deductibility of the return to contributors (policyholder dividends) provides the same after-tax returns at the company level as the exclusion of paid-in capital combined with no deduction for dividends paid to shareholders.

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[9] See S. Rep. No. 169, at 549; H.R. Rep. No. 432, at 1423.

The prepayment analysis was first described fully in 1986 by Professor Michael J. Graetz of Yale Law School and is based on the following assumptions: (1) that mutual company redundant premiums were and continue to be taxed upon receipt, (2) tax rates are constant over time, (3) returns on equity are identical in the stock and mutual segments of the life insurance industry, (4) both segments face the same tax rules, and (5) the private and social discount rates are equivalent.[10]

The analysis is illustrated by the following example. Assume a capital contribution of $100 each to a stock company and a mutual company, the latter in the form of a premium. Assume also a 10 percent annual rate of return and a 34 percent tax rate. The stock company will pay no tax on the capital contribution and will then earn $10 per year. The $10 will be taxed at a 34 percent rate ($3.40), leaving $6.60 to be paid out as a shareholder dividend. On the other hand, the mutual company will receive $100 as premium income and immediately pay a tax of $34. This will leave $66 which will earn $6.60 per year to be paid out as a deductible dividend. In this example, the capital supplied to both the stock and the mutual company has produced the same return to the suppliers of the capital and a tax burden of the same present value at the company level. Table 4.1 provides a one-year illustration of this example.

Table 4.1

Illustration of Prepayment Analysis

	Mutual	Stock
(1) Capital contribution	$100	$100
(2) Tax on contribution (34% rate)	34	0
(3) Capital on hand (1)-(2)	66	100
(4) Return on capital (10% x (3))	6.60	10
(5) Deductible distribution to policyholder	6.60	0
(6) Tax on earnings (34% rate)	0	3.40
(7) Non-deductible distribution to shareholder		6.60

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[10] See Michael J. Graetz, "Life Insurance Company Taxation: An Overview of the Mutual-Stock Differential," Life Insurance Company Taxation: The Mutual vs. Stock Differential, 1-9 (M. Graetz ed. 1986).

Thus, given its assumptions, the prepayment analysis demonstrates that mutual company policyholder dividends should be fully deductible to provide equal corporate tax treatment for investments in mutual companies. Stock life insurance companies and certain commentators, however, have raised questions concerning the various assumptions underlying the prepayment analysis and have criticized the analysis in other respects, as well. The significant questions and criticisms are discussed below.

2. Individual-Level Tax Advantages to Policyholders

First, the prepayment analysis demonstrates that conventional equity and policyholder equity are treated equally (i.e., have the same after-corporate tax return) only at the company level. Policyholders, however, enjoy a tax advantage at the individual level. Shareholder dividends and interest payments to bondholders are fully taxed when received (and stock appreciation is taxed when sold). In contrast, policyholder dividends are not taxed until the full amount of premiums has been recovered, which generally results in effectively exempting any income included in policyholder dividends from taxation at the individual level.[11]

As Professor Graetz acknowledges, the disparity between the treatment of policyholders and shareholders at the individual level could justify a corporate-level tax on the equity return and interest element of policyholder dividends as a proxy for the absent investor-level tax. The approach of section 809 is not, however, appropriate for such a proxy. For example, section 809 uses corporate tax rates, not the individual income tax rates appropriate to address the tax exemption at the individual level. Furthermore, section 809 does not take account of the returns to stock company participating policyholders, who also enjoy a similar individual-level tax advantage. However, identifying the portion of returns to stock company participating policyholders that is an equity-like return is particularly difficult because of the need to determine the relative amount of equity risk borne by stock company policyholders and shareholders.

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[11] The amount of premiums that may be recovered is overstated by the cost of comparable renewable term insurance. That is, by allowing recovery of total premiums paid as the policyholder's investment in the contract, the cost of personal insurance protection is effectively deducted from investment returns. See Testimony of Dennis E. Ross, Deputy Assistant Secretary for Tax Policy, Department of the Treasury, before the Subcommittee on Select Revenue Measures Committee on Ways and Means, U.S. House of Representatives (March 15, 1988); Thomas Neubig and C. Eugene Steuerle, Office of Tax Analysis, "The Taxation of Income Flowing Through Life Insurance Companies," OTA Paper 53 (January 1984).

3. Initial Taxation of Any Redundant Premium

The second significant question relates to a premise of the prepayment analysis. Stock companies and several commentators have objected that the redundant premiums of mutual life companies were not initially taxable and, thus, the conclusion that mutual companies do not enjoy any tax advantage is invalid. This question has been raised in two different contexts.

a. The Use of Tax Preferences

The first context involves the question of whether tax preferences shelter the redundant premium from tax. Stock companies have argued that mutual companies enjoy a competitive advantage because mutual companies do not have to pre-pay taxes on the "capital" that the government has contributed through a tax preference. For example, assume an accelerated deduction of $100 in the first year and an increase in taxable income of $100 in the second year. The accelerated deduction would provide each type of company tax savings of $34 (at a 34 percent tax rate) in the first year. This tax savings is, in effect, interest-free "capital" contributed by the government that must be repaid in the second year. The stock company would invest the $34, pay tax of $1.16 on the $3.40 of investment income (assuming a 10 percent return), repay the $34 capital contribution, and have $2.24 to pay as dividends. The mutual company would invest the $34, repay the $34 capital contribution, and pay $3.40 as policyholder dividends. Thus, if the assumption is made that the stock company pays the earnings to its shareholders, the mutual company would have an advantage.

In a competitive industry, however, it is much more likely that the tax preference gains are passed through to customers. If the stock company passes these gains to its customers rather than its shareholders, there is no advantage to mutual companies. In that event, the tax preferences will have the same effect as any other cost reduction, producing no different impact on stock and mutual companies. For example, the stock company could use the additional "capital" of $34 to replace outside borrowing which, at a 10 percent rate, would reduce company interest costs by $3.40. Taxable income is unchanged if premiums are reduced by the same amount. Each type of company will owe $34 in tax when the deferral ends and income is increased by $100.[12]

b. Untaxed Pre-1984 Equity

The second context involves the question of whether mutual companies enjoy a continuing tax advantage because pre-1984

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[12] See Daniel I. Halperin, "Commentary," in Life Insurance Company Taxation: The Mutual vs. Stock Differential 5-3 (M. Graetz ed. 1986).

redundant premiums escaped taxation. Mutual companies have attempted to determine whether any equity accumulated by mutual companies from redundant premiums escaped taxation prior to 1984.[13] This empirical question cannot be answered directly because of the limitations in the data available with respect to years prior to 1958. Thus, mutual companies have used an indirect procedure of estimating the mutual company equity that existed as of December 31, 1957, assuming that equity was derived from untaxed redundant premiums. Their analysis concludes that the economic income of mutual companies was sufficiently over-taxed under the 1959 Act (effective in 1958) from the limitation on policyholder dividend deductions to compensate for any pre-1958 capital that was received tax-free.

Mutual companies contend that their net income was over-taxed under the 1959 Act because that Act limited policyholder dividend deductions. Stock companies have argued that this untaxed equity analysis is flawed because it relies on the prepayment analysis for the definition of mutual company net income. The analysis is based explicitly on the assumption that untaxed capital existed in the mutual segment in 1957. Since it is reasonable to assume that some portion of policyholder dividends paid in years after 1957 represents a return on that untaxed 1957 equity, even under the prepayment analysis, that portion of post-1957 policyholder dividends should not have been deductible. The mutual company empirical analysis assumed that all post-1957 dividends should have been deductible and thus does not make the necessary comparison of untaxed equity and properly deductible policyholder dividends. No information exists, however, that would allow an accurate determination of the portion of dividends that should not have been deductible. As a result, the question of whether mutual company equity escaped corporate-level taxation prior to 1984 is not answered.

Even if untaxed equity exists and was not offset by subsequent disallowance of policyholder dividend deductions, the competitive balance between mutual and stock companies may not be affected adversely. Untaxed equity would affect the pricing of current and future participating policies only if mutual companies transfer income to new policyholders from existing and prior policyholders. It cannot be determined from existing data whether this has occurred. Although the prior tax savings benefited participating policholders in the past, an adjustment in the future for those prior tax savings would be likely to affect the pricing of future policies.

Section 809 was not justified, nor is it well designed, to account for any prior untaxed equity which Congress might conclude exists.

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[13] See Policy Economics Group, The Taxation of Insurance Companies: An Analysis of Transitional Equity Under the Prepayment Approach (March 10, 1989).

4. Absence of Redundant Premiums

Stock companies have also argued that mutual companies raise capital currently through retained earnings, not by charging redundant premiums. The stock companies contend that unless capital is raised through redundant premiums, the prepayment analysis is invalid.

Mutual companies currently may not derive significant amounts of capital through redundant premiums.[14] Even if all mutual company capital received currently, however, is derived from retained earnings, the only issue appears to be one of potentially untaxed equity, as discussed in the preceding section. Retained earnings are taxed in the same fashion for both types of insurers. Thus, assuming both sell the same participating policy, earn the same return on the policy cash value, and retain the same portion of earnings, the mutual company would be able to pay policyholder dividends to its policyholders equal to the dividends the stock company could pay to its shareholders. Competition would eliminate the return that is retained, unless it relates to shareholders' equity in the stock company case and existing untaxed equity in the mutual company case. If the amount of existing equity in each type of company is the same, which it must be for the rate of return earned by each type of company to be equal, the only question is whether the previously existing mutual company equity was subject to tax. If it was, the prepayment analysis implies that the mutual company policyholder dividends paid out of the retained earnings should be deductible.

5. Equivalence of Private and Social Discount Rates

Finally, stock companies have argued that, when mutual companies "prepay" their corporate taxes, the present value of the stream of mutual company tax payments to the government is lower than the present value of the stream of stock company tax payments. They argue that a mutual company's prepayment of taxes has a lower present value to the government than the stream of future tax payments by an equivalent stock company because Federal government borrowing rates are lower than private insurers' pre-tax rates of return.

One example presented to the Treasury Department assumed a mutual company with $1 million of redundant premiums and a stock company with $1 million of non-taxable capital contributions. At a 34 percent corporate tax rate, the mutual company pays $340,000 in the first year. The example assumes that the mutual company pays no future taxes because it distributes in the form of

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[14] See Report of the Task Force on Mutual Life Insurance Company Conversion, XXXIX Transactions of the Society of Actuaries 295 (1987).

deductible policyholder dividends all of the 20 percent annual pre-tax rate of return on its net capital (20 percent times $660,000 = $132,000). In contrast, if the stock company earns the same pre-tax return on its net capital and distributes $132,000 in after-tax earnings each year, it will pay $680,000 in taxes over a ten year period, or twice the nominal tax liability of the identical mutual company.[15]

The stock industry contends that the prepayment analysis, therefore, does not result in equal tax payments to the Federal government. This argument is not valid for the following reasons.[16] First, in the above example, the timing of the stock and mutual company tax payments matters. When discounted at the 20 percent pre-tax rate of return, the 10-year stream of $68,000 tax payments by the stock company has the same present value as the $340,000 initial tax payment of the mutual company.

Second, some stock companies have argued that the Federal government's discount rate is lower than the pre-tax rate of return to profit-making companies. When discounted at a rate below 20 percent, the present value of the stock company payments is greater than the mutual company's initial payment. However, it should be noted that in the example the mutual company policyholders and the stock company shareholders receive identical income streams from the same investment, and thus would be indifferent between investing in mutual and stock companies. Further, in terms of competitive neutrality, the expected pre-tax rates of return of stocks and mutuals are relevant, not the government borrowing rate.[17]

Thus, the present value equivalence of the prepayment analysis depends on the method of discounting future payment streams. The stock industry argument that a discount rate lower than the companies' expected pre-tax rate of return results in unequal tax payments is not relevant if Congress is concerned about placing mutual and stock companies in competitive balance. The companies' expected pre-tax rate of return is the appropriate discount rate for these comparisons, and results in the same present value of tax liability under the prepayment analysis.

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[15] Letter from William B. Harman, Jr. and John T. Adney to the Treasury Department (December 2, 1988).

[16] These arguments were made in a letter from Professor John Shoven of Stanford University to the Treasury Department (April 26, 1989).

[17] On a theoretical basis, the Federal government would have the option of investing the mutual company's $340,000 in shares of stock companies if it wanted to earn the same future value of tax payments as from the stock company.

D. Design Shortcomings of Section 809

Even if Congress concludes that it should continue to be concerned solely about the equity returns of mutual policyholders (as opposed to the similar returns earned by all "participating" policyholders), there are nevertheless numerous shortcomings in section 809's attempt to implement this imputed addition to income. The more serious of these difficulties are discussed below.

1. Imputing Income on the Basis of Earnings Differences Between Industry Segments

Section 809 links the taxes owned by mutual companies to the actions and economic performance of stock companies. Mutual companies owe more taxes when the stock segment performs relatively better than the mutual segment. As a result, stock company earnings will increase (or decrease) taxes paid by their mutual competitors.

For example, assume that a small mutual company decides to sell universal life products, which are products that credit interest at a variable, rather than a fixed, rate. As a result of substantial operating costs associated with marketing a new product, the company's earnings rate is reduced. Assume that during the same period the earnings rate of the stock segment increases as its earlier sales of universal life products become profitable. Thus, the imputed stock segment earnings rate rises from the base period rate of 16.5 percent to a 20 percent rate. Assuming the earnings rate of the mutual segment remained constant during this period, the small mutual company will have additional imputed income under section 809. Consequently, even though it earned less income, the mutual company will pay more tax.[18]

Under this system, mutual company tax payments are disconnected from the earnings experience of the mutual segment, generally, and from the earnings of individual mutual companies, in particular.

2. Socialization in Measurement of Mutual Segment Earnings Rate

Under section 809, mutual companies are treated as if they earn one pre-tax return on equity. As a result, a decrease in one mutual company's earnings produces an offsetting increase in tax for the mutual segment. Thus each mutual company's performance affects the tax of all other mutual companies.

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[18] See Arthur L. Bailey, "Practical Aspects of Section 809," in Life Insurance Company Taxation: The Mutual vs. Stock Differential 6-3 (M. Graetz ed. 1986).

Furthermore, the business or tax planning of one mutual company will shift part of the mutual segment tax burden to other mutual companies.[19]

3. Measuring Rates of Return Relative to Book Value

Under the comparative rate of return theory which Congress described for section 809, rates of return should be measured against current equity value. Section 809, however, measures rates of return against the book value of company (stock and mutual) equity. These book values may vary in random fashion from current market values. As a result, the comparison of the aggregate rates of return for the stock and mutual company industry segments will be inaccurate and arbitrary.

Furthermore, individual companies may be able to manipulate their equity base (and their rate of return) by shifting holdings of assets or liabilities, or choosing to realize gains or losses in a particular year. This will exacerbate the arbitrary and distortionary effects noted above.

4. Imputing Income on the Basis of Annual or Short-term Differences in Earnings

The section 809 mechanism for computing the imputed addition to mutual company income is based in part on the theory that both segments of the life insurance industry will earn comparable rates of return over the long term. Nevertheless, section 809 generally measures the annual difference between stock and mutual company earnings rates.

Numerous factors may in the short term lead to significant variations in the rates of return of the two segments. If, for example, one segment first introduces a new product, its rate of return may change substantially for a temporary period, increasing (or decreasing) significantly the additional income imputed to mutual companies in comparison to the income that would be imputed if earnings rate differences were accounted for over a longer period.

The yearly measurement of the differential earnings rate under section 809 also means that the rate of tax applicable to mutual companies is not known in advance of business decisions that it will affect. Furthermore, since the business and tax planning of other companies in the industry affects the differential earnings rate, mutual companies may be subject to wide and capricious yearly variations in their rate of tax.

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[19] The socialization in the measurement of the mutual sector's average earnings rate causes the taxes attributable to section 809 for small companies to depend largely on the economic performance of large mutual companies. Analysis of earnings rates based on 1986 tax return data shows that small companies benefited from socialization in 1986. See Appendix C.

Section 809 makes some compensation for swings in the stock segment earnings rate by computing the current stock earnings rate on the basis of a three-year average. No comparable averaging mechanism applies to the determination of the mutual company earnings rate. Thus, the earnings rate of the mutual segment and, hence, the imputation rate, may change dramatically because of one year's swing in the earnings rate of large mutual companies.

5. Mismatching of Earnings Rate Years

Section 809 determines the differential earnings rate by comparing the average of the stock earnings rates for the three years preceding the taxable year with the mutual earnings rate for the current taxable year (after the recomputation under section 809(f)). This mismatching of years increases the likelihood that the differential earnings rate under section 809 will be inappropriate.

Furthermore, the mismatching is more likely to deny to mutual companies full credit for their earnings in a year in which both segments have unusually high earnings, and the high mutual earnings rate is compared with the lower stock rates of the preceding years. The Internal Revenue Service has ruled that the average mutual earnings rate for any year cannot exceed the imputed stock earnings rate for that year.[20] As a result, part of the mutual company earnings for a high earnings rate year may never be included in the formula of section 809. For example, in 1986 the mutual company earnings rate was 17.980 percent and the stock company rate was 20.279 percent. Under section 809, however, the mutual rate is compared with the imputed 1986 stock earnings rate, which is 90.55 percent of the average of the prior three year's stock earnings rates. Since that rate of 16.285 percent was less than the mutual earnings rate of 17.980 percent, the differential earnings rate under section 809 was zero. In other words, a significant portion of mutual company earnings in 1986 will never be taken into account under section 809.

6. Recomputation of the Differential Earnings Rate in Later Tax Years.

The differential earnings rate under section 809 for the current tax year is recomputed in the subsequent tax year to take account of the actual mutual company earnings rate in the current tax year. Before this recomputation is made, the rate for the current tax year is based on the mutual company earnings rate for the second year preceding the current tax year. The recomputed rate is then multiplied by the mutual company equity base for the current tax year and the difference between that result and the result based on the original rate is added to (or subtracted from) mutual company income in the subsequent tax year.

[20] Notice 88-106, 1988-2 C.B. 444.

This recomputation provision adds a layer of complexity to the computation of the addition to mutual company income, and exacerbates the problem that mutual companies cannot predict the applicable rate of tax in advance of the current tax year. Moreover, such a recomputation appears unnecessary because the actual mutual company earnings rate for a given tax year is given effect under section 809 in the second year following the current tax year. The current recomputation provision merely changes the year in which mutual company earnings are taken into account. Absent systematic changes in the equity base, this should not alter the mutual segment's tax liability viewed over a period of years.

E. Conclusions

The tax treatment of stock and mutual life insurance companies should not confer an advantage on one form of organization over the other, i.e., competing businesses should have the same effective tax rate. The difficulty in applying this principle to life insurance taxation has always been of finding a sound method for identifying and measuring profits, or returns to equity, in an industry where customers (policyholders) are owners or part owners of the business.

Section 809 is cumbersome and arbitrary in its attempt to identify and measure equity returns to mutual policyholders and it ignores entirely the fact that equity-like returns are also paid to stock company participating policyholders. Moreover, the prepayment analysis calls into serious question the reasons offered in 1984 for imposing on mutual companies an imputed amount of taxable income. While there remains some uncertainty regarding certain assumptions of the prepayment analysis, this analysis generally demonstrates that equity returns to participating policyholders bear an appropriate tax at the corporate level.

The prepayment analysis does not, however, address the problem that income of participating policyholders, both stock and mutual, enjoys an individual tax advantage when compared to income of shareholders and bondholders. Unless some adjustment is made for the fact that shareholders of stock life insurance companies are subject to both corporate and individual-level tax on equity returns, whereas equity returns to all mutual company owners are taxed only once, stock life insurance companies could be at a competitive disadvantage. It is also important to point out that when comparing the tax exemption of participating life insurance policyholders' income and the taxation of stock life insurance companies' shareholder dividends at the individual level, the relative tax treatment of total income flowing through life insurance companies and competing financial institutions should be considered.

CHAPTER 5

POLICY OPTIONS FOR IMPROVING LIFE INSURANCE COMPANY TAXATION

As discussed in Chapter 4, section 809 poses serious practical and conceptual problems. The principal problem is that the "prepayment" analysis generally demonstrates that equity-like returns to mutual company policyholders bear a corporate level tax. As a result, apart from untaxed equity concerns, a provision such as section 809 is inappropriate. Thus, the Department of the Treasury recommends its repeal and proposes an alternative that would address the three issues described below.

First, equity returns to participating policyholders, both mutual and stock, are not sufficiently taxed at the individual level. More equity returns are attributable to the policyholders of mutual companies than to policyholders of stock companies, and, consequently, this advantage accrues more to mutual companies than to stock companies. It is, however, available to both segments of the industry. In contrast, returns to stock company shareholders are subject to double taxation, because the returns are taxed at both the corporate and individual levels.

The tax treatment of equity returns to investors in mutual and stock life insurance companies could be made equal either by imposing an individual-level tax on the returns to participating policyholders or by removing the double taxation of shareholder dividends and thereby imposing tax at one level only. An additional tax on returns to participating policyholders could be imposed at the corporate level which would serve as a proxy tax that accounts for the absence of taxation of returns to participating policyholders at the individual level. Alternatively, the corporate and individual-level taxes could be integrated by providing a shareholder dividends-paid credit at the corporate level that accounts for the individual-level tax on shareholder dividends. We believe that the dividends-paid credit is preferable to a proxy tax imposed at the corporate level because of the difficulty in identifying and measuring returns to participating policyholders, particularly with regard to stock company participating policyholders. This approach also is preferable because it reduces double taxation by providing partial integration of corporate and individual-level taxes.

A second concern is that income flowing through other financial institutions generally bears at least one level of tax whereas a considerable portion of total returns flowing through life insurance companies is subject to no Federal tax liability at either the corporate or individual level. A tax based on net investment earnings imposed at the corporate level would ensure one level of tax on income flowing through life insurance companies and would make more consistent the taxation of financial products offered by different financial institutions.

Third, any solution chosen should not result in loss of revenue. The Treasury Department is prepared to work with Congress in addressing these issues.

This chapter presents for Congressional consideration several options for improving the taxation of life insurance companies. We believe that the first option, an investment earnings tax with a shareholder dividends-paid credit is preferable because it integrates the corporate and individual taxation of returns to equity owners and avoids the problem of identifying equity-like returns to participating policyholders, both stock and mutual.

The next three options are designed to address only the corporate-level tax issues discussed in this report. The final option is a proxy tax imposed at the corporate level to address the tax exemption of policyholder returns at the individual level. The proxy tax could be combined with any of the preceding three options.

A. Life Insurance Company Investment Earnings Tax With Shareholder Dividends-Paid Credit

The Treasury Department recommends that section 809 be repealed and replaced with a tax based on net investment income that applies to all life insurance companies (including life insurance company subsidiaries of non-life insurance corporations). Under this proposal, life insurance companies would pay a tax equal to 1.0 percent of net investment income of life insurance contracts. This rate (combined with the shareholder dividends-paid credit discussed below) would raise approximately the same revenue from life insurance companies for the period FY 1990-91 as is expected to be raised under section 809. The rate would have to be increased to slightly more than 2.0 percent in later years to maintain revenue neutrality. This tax would be payable in addition to and separately from the tax payable on gain from operations after policyholder dividends. This tax would not be subject to reduction by net operating losses or tax credits.

Investment income would be broadly defined to include all interest, dividends, and net capital gains from all life insurance subgroup assets. So as to apply the tax only on investment income of life insurance contracts, however, investment income would be reduced by prorating investment income according to the ratio of life insurance reserves to total reserves. Net investment income would be a statutorily set percentage of investment income. Furthermore, a deduction against investment income for dividends received from affiliated companies would be allowed.

Stock life insurance companies would be allowed a dividends-paid credit for shareholder dividends paid which are attributable to life insurance companies. This credit would be allowed only against the new investment earnings tax. The credit would be equal to 15 percent of shareholder dividends paid to account for lower effective tax rates of shareholders. This rate assumes that approximately 70 percent of dividends are directly taxable to individuals, and the average marginal tax rate of these individuals is approximately 22 percent.

An investment earnings tax on all life insurance companies, with a shareholder dividends-paid credit, would have several advantages over the current system of life insurance company taxation. First, the taxation of total returns on participating policies would apply equally to mutual and stock companies, and the conceptually and practically flawed section 809 would be repealed. Second, the double taxation of equity returns of stock company shareholders would be eliminated with the dividends-paid credit to put them on a par with the current individual tax treatment of participating policyholders. Third, the tax treatment of financial products across different financial institutions would be made more consistent by ensuring that investment income flowing through life insurance companies is taxed at least once at either the corporate or individual levels.

B. Other Options

Congress may wish to consider the following options in addition to the investment earnings tax and shareholder dividends-paid credit described above. The first three alternatives address only the corporate-level tax; a corporate proxy for the individual-level tax on policyholder returns is also presented.

1. Repeal of Section 809

Congress may wish to repeal section 809 in light of its conceptual and practical problems. The repeal should be accomplished over two years so that the tax owed (or refund due) from the "true-up" under section 809 for the last year in which section 809 is in effect would not be eliminated. Repeal of section 809 alone would reduce Federal tax receipts by $2.1 billion during the FY 1990-94 period. An appropriate revenue offset would be required for implementation of this alternative.

2. Alternative Add-On Tax For Corporate-Level Tax

Congress could repeal section 809 and replace it with an imputation to taxable income based on the rate of stock company shareholder dividend payments. Such payments could provide an income adjustment without relying on annual comparisons of stock and mutual company earnings. This approach would be less complex and more predictable than section 809. For mutual companies, this imputation to income could be 4.5 percent of the section 809 equity base.[1] Because there is an equity-like return in participating policies of stock companies, an add-on tax could be applied to the equity of stock companies at a lower rate, such as 0.9 percent.[2] The equity base of each stock company would be the amount attributable to participating policies based upon the ratio of participating policy reserves to total reserves.

3. <u>Modification of Section 809</u>

If Congress believes that section 809 is conceptually sound, and that the prepayment analysis is invalid, section 809 could be modified to tax more accurately equity returns to mutual policyholders and to simplify its operation.

As explained in Chapter 4, section 809 has a number of practical shortcomings. Several of these shortcomings could be eliminated by adopting a two-year averaging method for the earnings rates of both stock and mutual companies and the equity base of mutual companies. This option would eliminate the mismatching of earnings rate years, provide some averaging of yearly fluctuations in mutual company earnings rates, and eliminate the complex true-up mechanism of section 809.

Under this option, the differential earnings rate would be the excess of the two-year average of the stock earnings rates for the preceding two years over the two-year average of the mutual earnings rates for the same two preceding years. The equity base would be the average equity base for the two preceding years. As under current law, mutual company deductions for policyholder dividends would be reduced by the amount of the section 809 adjustment. There would be no recomputation of the differential earnings rate.

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[1] Analysis of industry data indicates that, on average, payment of stock company shareholder dividends represents approximately 4.5 percent of the current section 809 equity base. Assuming that the payment of equity returns to participating policyholders is the same fraction of equity, the imputation to taxable income for mutual companies would be 4.5 percent of the section 809 equity base.

[2] Determination of the equity-like return for participating policyholders in stock life insurance companies requires an estimate of the relative risk borne by shareholders and participating policyholders in those companies. There are no data available upon which to make this estimate. Therefore, for purposes of illustration, a necessarily arbitrary assumption was made that 20 percent of the equity-like risk was borne by participating policyholders in stock life insurance companies.

4. <u>Proxy Tax at the Company Level for Lack of Individual Tax on Participating Policyholders' Equity Income</u>.

Should Congress conclude that one of the three alternatives described above is the appropriate method to tax life insurance equity returns at the corporate level, a proxy tax could be imposed at the corporate level to address the tax exemption at the individual level of equity-like returns to participating policyholders. A proxy tax could be imposed alone or in combination with the other alternatives.

The design of a corporate proxy tax would involve several issues, including the determination of the appropriate tax rate and tax base. For example, a proxy tax for mutual companies could be imposed at the rate of 0.625 percent of a company's section 809 equity base. This rate assumes that shareholder-like dividend payments by mutual life insurance companies are 4.5 percent of the section 809 equity base,[3] that the average marginal tax rate of individual taxpayers is approximately 20 percent, and that the percentage of policyholder dividends received by taxable individuals is approximately 70 percent. A corresponding (but lower rate) proxy tax for stock companies would be 0.0125 percent to account for the amount of equity-like returns to stock company participating policyholders.[4] The equity base for each stock company would be the amount attributable to participating policies. Since the tax on both mutual and stock companies would be intended as a proxy for the taxation of income at the individual level, it would be separate from the regular corporate income tax and not subject to reduction by corporate income tax losses or credits.

C. Revenue Implications

Preliminary estimates of the change in Federal income tax revenue as a result of enactment of each of the options discussed in this chapter are presented in Table 5.1. These estimates compare the revenue expected under current law with the revenue expected if each option were enacted.

Table 5.1 shows that repeal of section 809 would reduce receipts by $2.1 billion for FY 1990-94. The proposed replacement of section 809 with the investment earnings tax and a shareholder dividends-paid credit is estimated to be approximately revenue neutral with respect to current law if the investment earnings tax rate were 1.0 percent in 1990 and 1991 and slightly more than 2.0 percent thereafter. Table 5.2 shows that for mutual life insurance companies the reduction in

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[3] See footnote 1 above for a discussion of this assumption.

[4] The proxy tax rate for stock companies necessarily contains arbitrary assumptions because empirical data from which to determine an appropriate tax rate does not exist. See footnote 2 above.

Table 5.1

Revenue Effects of Selected Options to Reform
Life Insurance Company Taxation:
All Life Insurance Companies
($ billions)

	FY90	FY91	FY92	FY93	FY94	Total FY90-94
Repeal Section 809:	*	-0.4	-0.6	-0.5	-0.6	-2.1
with investment earnings tax and shareholder dividends paid credit	0.1	-0.1	-0.1	*	0.1	*
with proxy tax	0.2	-0.1	-0.3	-0.3	-0.3	-0.7
with add-on tax based on shareholder dividends	0.4	0.2	*	0.1	0.1	0.8
Modify Section 809	0.3	0.2	0.1	0.2	0.2	1.0
Proxy tax	0.2	0.3	0.3	0.3	0.3	1.3

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Note: Details may not add to totals because of rounding.

* Less than $50 million.

Table 5.2

Revenue Effects of Selected Options to Reform
Life Insurance Company Taxation:
Mutual and Stock Life Insurance Companies
($ billions)

	FY90	FY91	FY92	FY93	FY94	Total FY90-94
MUTUAL LIFE INSURANCE COMPANIES						
Repeal Section 809:	*	-0.4	-0.6	-0.5	-0.6	-2.1
with investment earnings tax and shareholder dividends-paid credit	0.1	-0.1	-0.1	*	0.1	-0.1
with proxy tax	0.2	-0.1	-0.3	-0.3	-0.3	-0.8
with add-on tax based on shareholder dividends:	0.3	0.2	*	*	*	0.5
Modify Section 809:	0.3	0.2	0.1	0.2	0.2	1.0
Proxy tax	0.2	0.3	0.3	0.3	0.3	1.2
STOCK LIFE INSURANCE COMPANIES						
Repeal Section 809:	0	0	0	0	0	0
with investment earnings tax and shareholder dividends paid credit	*	*	*	*	*	*
with proxy tax	*	*	*	*	*	0.1
with add-on tax based on shareholder dividends:	*	0.1	0.1	0.1	0.1	0.3
Modify Section 809	0	0	0	0	0	0
Proxy tax	*	*	*	*	*	0.1

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Note: Details may not add to totals because of rounding.

* Less than $50 million.

receipts from repeal of section 809 would be largely offset by the increase in receipts from the investment earnings tax. The increase in receipts from stock companies would be less than $50 million because the investment earnings tax would be largely offset by the dividends-paid credit.

If repeal of section 809 were combined with a proxy tax at the corporate level to address the tax exemption of equity returns at the individual level, receipts would be $0.7 billion lower than current law for FY 1990-94. Although the proxy tax would increase receipts by $1.3 billion, repeal of section 809 would reduce receipts by $2.1 billion. All of the tax reduction would be attributable to mutual life insurance companies, since stock life insurance companies are not taxed under section 809 (Table 5.2). Receipts from stock life insurance companies would increase slightly because stock companies would pay a proxy tax on the equity-like returns of their participating policyholders.

If repeal of section 809 were combined with the alternative add-on tax based on shareholder dividends, receipts from the life insurance industry would increase by $0.8 billion for FY 1990-94 (Table 5.1). The add-on tax would increase receipts from mutual companies by $2.6 billion, for a net increase of $0.5 billion. The add-on tax would increase receipts from stock life insurance companies by $0.3 billion. The add-on tax increases receipts from mutual life insurance companies more than from stock life insurace companies primarily because the add-on tax rate for mutual companies is higher than the rate for stock companies. The stock company tax rate is lower because the level of equity participation for stock company policyholders is smaller than for mutual company policyholders.

Simplifications of section 809 would increase receipts by $1.0 billion for FY 1990-94, although such simplification could be made revenue neutral by reducing the stock earnings rate in a manner similar to current law. Receipts from mutual life insurance companies would account for all revenue under the simplified income imputation proposed if section 809 is retained because the provision would continue to apply only to mutual companies.

D. Summary

Consideration of the appropriateness of section 809 offers an opportunity to improve the taxation of income flowing through life insurance companies. Section 809 applies a conceptually and practically flawed income imputation to mutual life insurance companies. Moreover, current law does not tax the equity-income of participating policyholders at the individual level although it taxes equity income of stock company shareholders twice. In addition, current law allows a significant portion of investment income flowing through life insurance companies to escape completely Federal income tax, which is inconsistent with the tax treatment of income flowing through other financial institutions.

An investment earnings tax on all life insurance companies with a dividends-paid credit, in combination with repeal of section 809, would represent a significant improvement in the taxation of income flowing through life insurance companies. The tax rules governing mutual and stock companies would be the same, and equity income of shareholders and policyholders would be taxed only once. The current competitive advantage of the life insurance industry relative to other financial institutions would be addressed by the investment earnings tax by ensuring that income flowing through life insurance companies is subject to at least one level of Federal income tax.

APPENDIX A

DATA SOURCE AND METHODOLOGY

A. Data Source

The data were obtained from a sample of life insurance company tax returns included in the 1986 IRS Statistics of Income (SOI) sample of corporate income tax returns. This sample includes information on all life insurance tax returns included in the regular SOI corporate sample, including life insurance company tax returns that were filed with life/nonlife consolidated tax returns. The sample, which contained 1986 data from 1,415 life insurance company tax returns, included data from 1,271 stock companies and 144 mutual life or mutual life subsidiary companies. The sample included information from 1,237 separate life or life/life consolidated returns and 178 life/nonlife consolidated tax returns. The SOI division uses statistical procedures to assign weights to the data from which the sample is taken so that industry totals can be estimated from sample results.

The data from this sample are not comparable to the data on life insurance taxes published by the SOI program. The SOI industry classification procedures for consolidated returns exclude some life insurance companies from the life insurance industry and attribute some non-insurance income to the life insurance industry in the published SOI statistics. In addition, since the sample data provide separate information for the life and nonlife subgroups of life insurance companies that file life/nonlife consolidated returns, it was used to disentangle the tax effect of consolidation.

B. Data Checking and Error Resolution

The internal consistency of data items required for the computation of taxable income were tested and data errors corrected. For example, in some cases the small and special life insurance deductions were incorrectly transcribed, which caused discrepancies between taxable income and tax before credits. Examination of data from the life/nonlife consolidated returns revealed some tax returns with discrepancies between reported and computed tax. In these cases, copies of the original tax returns were used to correct the underlying data transcription problems. For some companies, corrections of the stock-mutual company designation were made using 1986 information obtained from the A.M. Best Co. The data reported in this report reflect such corrections.

C. Calculation Procedures

This report presents data on life insurance company taxes before and after nonlife losses. Life insurance taxes before nonlife losses are computed based on the taxable income of all life insurance companies in the special sample before any nonlife losses are used. For life/nonlife consolidated companies, the life subgroup's share of consolidated tax and credits was determined by applying the proportional tax allocation method. According to this method, if 25 percent of the life/nonlife consolidated taxable income was attributable to life insurance business activities, 25 percent of the consolidated tax and credits would be allocated to the life insurance industry.

APPENDIX B

CALCULATION OF TRUE-UP UNDER SECTION 809

Under section 809, the deduction for policyholder dividends for a mutual company is reduced by the company's "differential earnings amount." The differential earnings amount for the current taxable year (in this example, 1986) is equal to the product of the mutual company's average equity base and the "differential earnings rate." The differential earnings rate, in turn, is equal to the excess of the imputed earnings rate (90.55 percent of the average of the earnings rates of each of the largest 50 stock company groups in the preceding three years) over the average earnings rate of all mutual company groups two years earlier (1984). The differential earnings amount is then "recomputed" in the subsequent taxable year (1987). The recomputed differential earnings amount is computed like the differential earnings amount except that the average mutual earnings rate for the current taxable year is used in place of the average mutual earnings rate for two years earlier. The difference between the recomputed differential earnings amount and the differential earnings amount (the "true-up") is included in (or deducted from) mutual company income in the subsequent taxable year. Table 2.1 shows the figures used in the calculation of the differential earnings rate.

Mutual segment taxes will be reduced by approximately $1.4 billion in 1987 due to the recomputation of the 1986 differential earnings rate. In 1986, the differential earnings rate was 10.539 percent computed from the imputed 1986 stock earnings rate of 16.285 percent minus the intial 1986 average mutual earnings rate of 5.746 percent (the average mutual earnings rate in 1984). Although the actual mutual earnings rate for 1986 was 17.980 percent, the Internal Revenue Service ruled that the average mutual earnings rate for any year could not exceed the imputed stock earnings rate for the year, which limited the recomputed differential earnings rate for 1986 to zero. The $3.7 billion difference between the 1986 differential earnings amount ($35 billion equity base times 10.539 percent) and the recomputed differential earnings amount of zero will reduce mutual company taxable income by approximately $3.7 billion in 1987.

The actual stock earnings rate in 1986 (20.279 percent), exceeded the average mutual earnings rate for 1986 (17.890 percent), but a negative "true-up" adjustment nevertheless occurs in 1986 because of a statutory feature of Section 809 whereby each year's stock earnings rate influences the amount of income imputed to the mutual segment over the succeeding three tax years, and not in the current tax year. Thus, the high stock earnings rate in 1986 will contribute to higher than average income imputations to mutual companies in 1987-89 under Section 809.

APPENDIX C

MUTUAL AND STOCK SEGMENT EARNINGS RATES

Under section 809, income is imputed to each mutual company in an amount equal to its equity base multiplied by the differential earnings rate (the difference between an imputed earnings rate based on an average of the stock company earnings rates for the preceding three years and the average earnings rate for mutual companies). If the average earnings rate for mutual companies is high, the differential earnings rate is low, which results in a smaller amount of additional taxes attributable to the income imputation under section 809. Conversely, if the average mutual earnings rate is low, the additional taxes attributable to section 809 would be high.

The formula for determining the average earnings rate of mutual companies gives relatively more weight to the earnings rates of larger mutual companies. Thus, if large mutual companies have lower earnings rates, this would have a greater effect on the average mutual earnings rate and taxes attributable to section 809 than if small companies had low earnings rates.

Table C-1 shows earnings rates for 1986 by equity-size class. It shows that the large mutuals generally had higher unweighted earnings rates than the smaller mutual companies. The higher earning rates of the large mutual companies increased the weighted average mutual earnings rate and reduced taxes attributable to section 809. Smaller mutual companies benefitted from the weighted average mutual earnings rate formula because the additional taxes attributable to section 809 were lower in 1986 than they would have been if the average earnings rate were unweighted.

Table C.1

Average Earnings Rates by Size of Equity Base: 1986
(percent)

Equity base class	Weighted 1/ Earnings rate		Unweighted 2/ Earnings rate	
	Mutuals	Stocks 3/	Mutuals	Stocks 3/
Over $1.0 billion	18.813	20.370	20.084	21.515
$500 million to $1.0 billion	18.092	23.428	18.321	23.319
$250 to $500 million	14.724	12.514	15.164	13.568
$100 to $250 million	16.998	21.340	16.797	20.891
$ 50 to $100 million	7.212	n.a.	7.253	n.a.
$ 35 to $ 50 million	13.029	n.a.	13.282	n.a.
$ 25 to $ 35 million	16.605	n.a.	16.799	n.a.
$ 15 to $ 25 million	9.901	n.a.	10.781	n.a.
$ 5 to $ 15 million	8.610	n.a.	7.490	n.a.
Under $5 million	7.293	n.a.	5.295	n.a.
All classes	17.980	21.090	11.927	20.279
All classes (without realized capital gains) 4/	-0.076	13.333	3.404	10.560

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Source: Data files with Internal Revenue Service on Form 8390.

n.a. = not available.

1/ Weighted average earnings rates are the ratio of the sum of gains from operations and the sum of average equity base for all companies in the class.

2/ Unweighted average earnings rates are the arithmetic average of all earnings rates in the class.

3/ Only the largest 50 stock companies are required to file Form 8390.

4/ For these computations, gain from operations excludes the realized capital gains shown on Form 8390.

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POLICIES FOR RTC ESTABLISHED AT FIRST OVERSIGHT BOARD MEETING
August 9, 1989

1. Establishment of joint Oversight Board-RTC policy development task force.

2. Procedures and documentation for approving RTC funding requests and the use of notes and guarantees.

3. Priorities for initial case resolutions.

4. Interim ethics and conflicts of interests standards.

5. Utilization of private sector.

6. Restructuring 1988 FSLIC deals to save taxpayer costs.

7. Disposition of Federal Asset Disposition Association (FADA).

8. Adoption of existing FDIC policies for RTC in other areas until the Oversight Board establishes appropriate general policies.

POLICY 1

ESTABLISHMENT OF JOINT POLICY DEVELOPMENT TASK FORCE

To augment the policies adopted at this Oversight Board meeting, a joint policy development task force will be established immediately with personnel from both the Oversight Board and the RTC. This task force will make specific recommendations to the Oversight Board concerning overall strategies, policies and goals for the RTC and concerning the strategic plan that the Oversight Board must develop and submit to Congress by December 31, 1989. The policy areas to be addressed will include: (1) least cost case resolution methods; (2) asset disposition, including procedures concerning the right of first refusal granted to certain qualified buyers; (3) sources and uses of funds for RTC activities; (4) Oversight Board audit, review, and monitoring of RTC activities; (5) other policy areas specifically mentioned in the statute concerning the strategic plan; and (6) such other areas as deemed appropriate. The task force will provide an initial draft of recommended policies in each of these areas to the Oversight Board by September 15, 1989.

The Oversight Board staff will review these recommended policies and consult further with the RTC, if necessary, before the Oversight Board establishes additional policies.

POLICY 2

PROCEDURES AND DOCUMENTATION FOR APPROVING RTC FINANCING REQUESTS

A. <u>RTC Case Resolutions</u> (includes Asset Liquidations)

The following documentation from RTC will be required, in advance, to support the authorization of disbursements of funds by the Oversight Board for case resolutions:

a) projected dates of the transactions (initiation and completion)

b) face amount and estimated fair market value of assets and liabilities (including contingent liabilities) at latest available valuation date, for each institution

c) projected cost of case resolutions

d) method of resolution chosen (such as liquidation, "clean bank" or "whole bank")

e) estimated amount and nature of assets and liabilities expected to be retained

f) amount of funding requested to cover expected cost (and explanation of any overage funds sought beyond expected cost)

B. <u>RTC Working Capital</u> (notes, guarantees, and other obligations)

The following documentation from RTC will be required, in advance, to support working capital requests:

a) projected dates of the transactions

b) face amount and estimated fair market value of assets and liabilities (including contingent liabilities) at latest available valuation dates

c) projected net amount of working capital required

d) amount of funding or guarantee to cover expected working capital needs (and explanation of any overage funds or guarantee sought beyond expected amount)

e) nature and source of working capital (such as notes, guarantees or other obligations). If guarantee is sought, nature of entity whose financial obligations are guaranteed and its intended source of funds, if any.

f) collateral behind financing, if any.

C. <u>RTC Operation Costs and Disbursements</u>

The following documentation from RTC will be required to support projected operating expenditures and internal disbursements for which Oversight Board funding approval is requested:

-- personnel salaries and benefits

-- cost of outside contractors (asset management, asset disposition, etc.)

-- office overhead

-- other

In all cases, documentation shall be submitted with appropriate detail and categorization, as determined by the Oversight Board. In addition, documentation shall be submitted within an appropriate timeframe as determined by the Oversight Board.

POLICY 3

PRIORITIES FOR INITIAL CASE RESOLUTIONS

Until such time as the Oversight Board establishes policies governing more complex transactions, the RTC shall resolve cases that are relatively simple in that they do not involve complex asset disposition and financing techniques, such as long-term asset guarantees; yield maintenance agreements; and substantial RTC equity interests.

Modifications to this policy will be made in ongoing consultation with the RTC.

POLICY 4

INTERIM ETHICS AND CONFLICTS OF INTERESTS STANDARDS

The Oversight Board and RTC are required to promulgate, within 180 days, regulations governing conflicts of interests, ethical responsibilities, and post-employment restrictions applicable to their members, officers, and employees, that are no less stringent than those applicable to the FDIC. The Oversight Board must also promulgate, together with RTC, regulations applicable to independent contractors governing conflicts of interests, ethical responsibilities, and the use of confidential information consistent with the goals of titles 18 and 41 of the U.S. Code. Finally, regulations must be promulgated by the Oversight Board that establish procedures for ensuring that any individual who is performing any function or service on behalf of RTC meets minimum standards of competence, experience, integrity and fitness.

Since the Oversight Board and the RTC must begin their operations immediately, it is necessary to establish interim policies and standards for ethics and conflicts of interests pending the promulgation of the necessary regulations.

Accordingly, pending the promulgation of these regulations, the members, officers, and employees of the Oversight Board who are subject to the standards of conduct regulations of another Federal agency shall be subject to the regulations of their respective agencies with regard to Oversight Board activities. In addition, during this interim period the regulations governing the responsibilities of the FDIC shall apply to those members, officers, and employees of the Board who are not subject to the standards of conduct regulations of any other Federal agency. Finally, the Oversight Board staff shall analyze the respective agency regulations applying to its members, officers, and employees in relation to the FDIC's regulations and submit to the Board proposed regulations that meet the relevant provisions of the FIRRE Act.

With respect to the RTC, pending the promulgation of regulations pursuant to the FIRRE Act, members, officers and employees shall be subject to existing regulations governing the responsibilities and conduct of the FDIC's members, officers and employees.

In addition, the RTC shall take immediate steps to ensure that all actions taken, and contractual or other arrangements entered into to carry out the purposes of section 21A of the Federal Home Loan Bank Act (which establishes the RTC and the Oversight Board), are generally consistent with the conflicts of interests and ethics provisions of that section. The RTC shall advise the Oversight Board in 10 days, or sooner if practicable, of the steps it intends to take or the procedures it has adopted. Finally, pending the promulgation of regulations, any individual performing a function or service for RTC must abide by the specifications set forth in section 21A to meet minimum standards of competence, experience, integrity, and fitness.

POLICY 5

UTILIZATION OF PRIVATE SECTOR

The statute requires the RTC to utilize the services of the private sector if the services are available and if the RTC determines that it would be practicable and efficient to use them. The specific services mentioned are real estate and loan portfolio asset management, property management, auction marketing, and brokerage services.

This policy applies to the RTC immediately. Even during the initial period of action pursuant to an interim operating plan, the RTC must seek to use private sector services pursuant to the statutory standard. At the same time, the Oversight Board should develop more explicit standards for using private sector services, including:

-- A standard for determining the availability of such services;

-- A standard for determining whether the use of available services would be practicable and efficient; and

-- A standard for choosing among competing private sector firms.

An initial draft of these suggested standards shall be provided by the joint policy task force to the Oversight Board no later than September 30, 1989.

POLICY 6

RESTRUCTURING 1988 FSLIC DEALS TO SAVE TAXPAYER COSTS

The Oversight Board has the duty and authority to develop and establish overall strategies, policies, and goals for the RTC, in consultation with the RTC, for restructuring the insolvent institution cases resolved through agreements by FSLIC between January 1, 1988, and the date of enactment of the FIRRE Act. The goal of any restructuring is to achieve cost savings that will in turn reduce taxpayer costs.

Accordingly, the RTC should provide to the Oversight Board, by September 30, 1989, an initial draft of the general methodology to be used by the RTC in reviewing and analyzing such cases in order to determine whether restructuring would achieve savings. This methodology shall include an evaluation and review of costs under the FSLIC agreements with respect to capital loss coverage, yield maintenance guarantees, forbearance, tax consequences, and any other relevant and ascertainable cost considerations (including reasonable provision for contingencies), and shall further include a review of the bidding procedures used in resolving such cases in order to determine whether the bidding and negotiating processes were sufficiently competitive.

The Oversight Board will thereafter review the analytical methodology in consultation with the RTC and will develop and establish such strategies, policies, and goals as are necessary to achieve savings by RTC under such agreements.

POLICY 7

DISPOSITION OF FADA

The statute requires the RTC to liquidate the Federal Asset Disposition Association (FADA) within 180 days after enactment. Accordingly, the RTC shall provide a proposal to the Oversight Board by September 30 for the appropriate disposition of FADA and the handling of FADA's personnel.

POLICY 8

EXISTING FDIC POLICIES TO BE USED BY RTC DURING TRANSITION

It is the intention of the Oversight Board that the RTC will carry out its responsibilities under basic strategies, policies, and goals adopted by the Oversight Board. However, during the initial transition period, as the Oversight Board develops and establishes strategies, policies, and goals for the RTC, the RTC may carry out its responsibilities in accordance with the strategies, policies, goals, regulations, rules, operating principles, procedures, and guidelines of the FDIC existing at this time. As soon as practicable, but no later than August 15, 1989, the RTC shall provide the Oversight Board for its review, such FDIC strategies, policies, goals, regulations, rules, operating principles, procedures, and guidelines under which it is operating, and the Oversight Board will take such actions to develop, establish or modify such items as authorized and appropriate.

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
August 14, 1989

CONTACT: LARRY BATDORF
(202) 566-2041

RECIPROCAL TAX EXEMPTIONS OF SHIPPING AND AIRCRAFT INCOME

The Treasury Department today announced further agreements with Pakistan and Hong Kong for the reciprocal tax exemption of income from international shipping. The exchanges of notes are in accordance with sections 872 and 883 of the Internal Revenue Code. The exemptions apply for taxable years beginning on or after January 1, 1987.

In addition, an exchange of notes which will provide for reciprocal tax exemption of income from international shipping and aviation has been signed with Malaysia, but is subject to ratification by the Malaysian Government before taking effect. Reciprocal tax exemption of international shipping and aviation income has been confirmed with the Virgin Islands under the "mirror" Code provisions applicable there; and Portugal has confirmed that it provides an equivalent exemption with respect to shipping companies under its domestic law on the same terms applicable to aviation companies, as described in Revenue Ruling 89-42.

Revenue ruling 89-42 and Treasury News Release NB-292 of May 23, 1989 summarized reciprocal tax exemptions of income from international shipping and/or aviation with other countries.

Copies of the notes with Pakistan and Hong Kong will be made available when they arrive in Washington and have been processed by the Department of State.

The exchange of notes with Pakistan provides exemption from tax of income from the international operation of ships, including income from the leasing of ships on a full (time or voyage) basis operated in international transport. The exemption does not extend to income from the leasing of ships on a bareboat basis, income from the incidental leasing of containers, or incidental gain on the disposition of ships.

The exchange of notes with Hong Kong provides exemption from tax of income from the international operation of ships, including income from the leasing on a full or bareboat basis of ships operated in international transport, income from the incidental leasing of containers and related equipment used in international transport, and incidental gain on the disposition of ships.

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NB-420

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

CONTACT: Office of Financing
202/ 376-4350

FOR IMMEDIATE RELEASE
August 14, 1989

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,237 million of 13-week bills and for $7,207 million of 26-week bills, both to be issued on August 17, 1989, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing November 16, 1989			:	26-week bills maturing February 15, 1990		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	8.00% a/	8.28%	97.978	:	7.78% b/	8.21%	96.067
High	8.02%	8.30%	97.973	:	7.85%	8.29%	96.031
Average	8.01%	8.29%	97.975	:	7.83%	8.26%	96.042

a/ Excepting 2 tenders totaling $4,510,000.
b/ Excepting 2 tenders totaling $2,000,000.
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 56%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 35,675	$ 35,675	:	$ 29,195	$ 29,195
New York	25,568,270	6,214.300	:	18,329,110	5,959,790
Philadelphia	23,795	23,795	:	19,855	19,855
Cleveland	47,990	47,990	:	38,655	38,655
Richmond	58,990	58,990	:	51,020	51,020
Atlanta	40,130	39,065	:	32,710	32,710
Chicago	1,056,575	51,575	:	927,500	105,500
St. Louis	30,320	29,320	:	22,910	22,910
Minneapolis	9,280	9,280	:	7,445	7,445
Kansas City	48,265	48,265	:	37,335	37,335
Dallas	30,415	20,415	:	30,500	30,500
San Francisco	824,090	78,140	:	762,980	286,980
Treasury	579,960	579,960	:	585,105	585,105
TOTALS	$28,353,755	$7,236,770	:	$20,874,320	$7,207,000
Type					
Competitive	$24,780,450	$3,663,465	:	$15,886,525	$2,219,205
Noncompetitive	1,324,895	1,324,895	:	1,166,595	1,166,595
Subtotal, Public	$26,105,345	$4,988,360	:	$17,053,120	$3,385,800
Federal Reserve	2,183,110	2,183,110	:	1,900,000	1,900,000
Foreign Official Institutions	65,300	65,300	:	1,921,200	1,921,200
TOTALS	$28,353,755	$7,236,770	:	$20,874,320	$7,207,000

1/ Equivalent coupon-issue yield.

NB-421

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.
August 15, 1989

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 August 24, 1989. This offering will provide about $525 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,887 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, August 21, 1989. The two series offered are as follows:

92-day bills (to maturity date) for approximately $7,200 million, representing an additional amount of bills dated November 25, 1988, and to mature November 24, 1989 (CUSIP No. 912794 SN 5), currently outstanding in the amount of $15,768 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,200 million, to be dated August 24, 1989, and to mature February 22, 1990 (CUSIP No. 912794 TS 3).

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 August 24, 1989. 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 $1,363 million as agents for foreign and international monetary authorities, and $4,176 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

NB-422

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 one-half hour prior to the closing time for receipt of tenders 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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
August 16, 1989

Contact: Bob Levine
(202)566-2041

Brady Comment on the Philippine Debt Agreement

Following a meeting with Philippine Central Bank Governor Jose Fernandez and Under Secretary of Finance Ernest Leung, Treasury Secretary Nicholas F. Brady issued the following statement:

"The new financing package agreed between the Philippine Governor and its commercial bank creditors demonstrates the versatility of the strengthened debt strategy. Its ability to resolve financing needs on a case-by-case basis responds to the needs and circumstances of individual debtor countries. The Philippine arrangement is expected to promote significant debt reduction, while also providing new money. Thus, it meets the important objectives of the government of the Philippines and will create a framework for further support for the Philippines economic reform and restructuring program."

NB-423

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

FOR RELEASE AT 4:00 P.M.
August 16, 1989

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION 2-YEAR AND 5-YEAR 2-MONTH NOTES TOTALING $17,250 MILLION

The Treasury will raise about $6,625 million of new cash by issuing $9,500 million of 2-year notes and $7,750 million of 5-year 2-month notes. This offering will also refund $10,619 million of 2-year notes maturing August 31, 1989. The $10,619 million of maturing 2-year notes are those held by the public, including $1,004 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $17,250 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, Federal Reserve Banks for their own accounts hold $892 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 each of the new securities are given in the attached highlights of the offerings and in the official offering circulars.

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Attachment

NB-424

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC
OF 2-YEAR AND 5-YEAR 2-MONTH NOTES

August 16, 1989

Amount Offered to the Public ...	$9,500 million	$7,750 million
Description of Security:		
Term and type of security	2-year notes	5-year 2-month notes
Series and CUSIP designation ...	Series AD-1991 (CUSIP No. 912827 XX 5)	Series L-1994 (CUSIP No. 912827 XY 3)
Issue date	August 31, 1989	September 1, 1989
Maturity date	August 31, 1991	November 15, 1994
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	February 28 and August 31	May 15 and November 15 (first payment on May 15, 1990)
Minimum denomination available .	$5,000	$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 Terms:		
Payment by non-institutional investors	Full payment to be submitted with tender	Full payment to be submitted with tender
Payment through Treasury Tax and Loan (TT&L) Note Accounts ..	Acceptable for TT&L Note Option Depositaries	Acceptable for TT&L Note Option Depositaries
Deposit guarantee by designated institutions	Acceptable	Acceptable
Key Dates:		
Receipt of tenders	Tuesday, August 22, 1989, prior to 1:00 p.m., EDST	Wednesday, August 23, 1989, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):		
a) funds immediately available to the Treasury ...	Thursday, August 31, 1989	Friday, September 1, 1989
b) readily-collectible check ...	Tuesday, August 29, 1989	Wednesday, August 30, 1989

TREASURY NEWS

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

Contact: Office of Financing
202/376-4350

FOR RELEASE AT 12:00 NOON

August 18, 1989

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 August 31, 1989, and to mature August 30, 1990 (CUSIP No. 912794 UP 7). This issue will provide about $50 million of new cash for the Treasury, as the maturing 52-week bill is outstanding in the amount of $ 9,211 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, August 24, 1989.

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 August 31, 1989. In addition to the maturing 52-week bills, there are $ 13,904 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 $ 3,702 million as agents for foreign and international monetary authorities, and $6,660 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 $280 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 5176-3.

NB-425

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 one-half hour prior to the closing time for receipt of tenders 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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

August 18, 1989

Monthly Release of U.S. Reserve Assets

The Treasury Department today released U.S. reserve assets data for the month of July 1989.

As indicated in this table, U.S. reserve assets amounted to $63,462 million at the end of July, up from $60,502 million in June.

U.S. Reserve Assets
(in millions of dollars)

End of Month	Total Reserve Assets	Gold Stock 1/	Special Drawing Rights 2/3/	Foreign Currencies 4/	Reserve Position in IMF 2/
1989					
June	60,502	11,063	9,034	31,517	8,888
July	63,462	11,066	9,340	34,001	9,055

1/ Valued at $42.2222 per fine troy ounce.

2/ Beginning July 1974, the IMF adopted a technique for valuing the SDR based on a weighted average of exchange rates for the currencies of selected member countries. The U.S. SDR holdings and reserve position in the IMF also are valued on this basis beginning July 1974.

3/ Includes allocations of SDRs by the IMF plus transactions in SDRs.

4/ Valued at current market exchange rates.

NB-426

AP Policy - 566-5282
1-800-336-0439

file

Report to Congress
on the

Depreciation of Clothing Held For Rental

Department of the Treasury
August 1989

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

AUG 18 1989

Dear Mr. Chairman:

Section 201(a) of Public Law 99-514, the Tax Reform Act of 1986, required the Treasury to establish an office to study the depreciation of all depreciable assets, and when appropriate, to assign or modify the existing class lives of assets. Treasury's authority to promulgate changes in class lives was repealed by Section 6253 of Public Law 100-647, the Technical and Miscellaneous Revenue Act of 1988. Treasury was instead requested to submit reports on the findings of its studies to the Congress. This report discusses the depreciation of clothing held for rental. The General Explanation of the Tax Reform Act of 1986 indicates that such study was to be among the first conducted by Treasury. This is thus the first depreciation report submitted to the Congress.

I am sending a similar letter to the Chairman of the Senate Finance Committee.

Sincerely,

Kenneth W. Gideon

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
House of Representatives
Washington, DC 20515

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

AUG 18 1989

Dear Mr. Chairman:

Section 201(a) of Public Law 99-514, the Tax Reform Act of 1986, required the Treasury to establish an office to study the depreciation of all depreciable assets, and when appropriate, to assign or modify the existing class lives of assets. Treasury's authority to promulgate changes in class lives was repealed by Section 6253 of Public Law 100-647, the Technical and Miscellaneous Revenue Act of 1988. Treasury was instead requested to submit reports on the findings of its studies to the Congress. This report discusses the depreciation of clothing held for rental. The General Explanation of the Tax Reform Act of 1986 indicates that such study was to be among the first conducted by Treasury. This is thus the first depreciation report submitted to the Congress.

I am sending a similar letter to the Chairman of the House Ways and Means Committee.

Sincerely,

Kenneth W. Gideon

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

The Honorable Lloyd Bentsen
Chairman
Committee on Senate Finance
United States Senate
Washington, DC 20510

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Chapter 1. Introduction and Summary of Findings

A. Mandate for Depreciation Studies

This study of the depreciation of rental clothing has been prepared by the Depreciation Analysis Division of the Office of Tax Analysis as part of its Congressional mandate to study the depreciation of all depreciable assets. This mandate was incorporated in Section 168(i)(1)(B) of the Internal Revenue Code as modified by the Tax Reform Act of 1986 (see Exhibit 1 of Appendix A). This provision directed the Secretary of the Treasury to establish an office that "shall monitor and analyze actual experience with respect to all depreciable assets", and granted the Secretary the authority to change the classification and class lives of assets. The Depreciation Analysis Division was established to carry out this Congressional mandate. The Technical and Miscellaneous Revenue Act of 1988 repealed Treasury's authority to alter class lives or asset classes, but the revised Section 168(i) continued Treasury's responsibility to "study the actual experience of depreciable assets and report to the Congress on its findings" (see Exhibit 2 of Appendix A).

The General Explanation of the 1986 Act (the "Blue Book") indicates that the class life of a set of assets should reflect the anticipated useful life and the anticipated decline in value over time of the assets. The concept of useful life suggested by the General Explanation distinctly differs from the useful life concept under prior law. Under the 1986 Act, the useful life is intended to reflect the economic life span of the property over all users combined, whereas under prior law the useful life was intended to reflect the typical period over which individual taxpayers retained their assets.[1]

Resale price data may be used to measure the decline in value, and if such data are used, the data should be adjusted to remove the effects of historical inflation. The General Explanation notes that the class life derived from such data (which, to avoid possible confusion, is referred to hereafter as the "equivalent economic" life) should be determined so that the present value of straight-line depreciation deductions over the equivalent economic life (discounted at an appropriate real rate of interest) equals the present value of the estimated decline in value of the assets. In order to resolve the ambiguity associated with the choice of straight-line method to be used as a standard, the equivalent economic life in this report shall be obtained by equating the present value of the decline in value to the present value of the depreciation allowances which may be claimed under the Alternative Depreciation System (with a recovery period equal to the equivalent economic life). This standard differs from the simple straight-line method which ignores the application of the half-year convention, as well as the timing of the depreciation tax benefits.

[1] In addition, there is no reference ot the use of the 30th percentile (rather than the mean value) in the legislative history of the 1986 Act, whereas the legislative history of the Tax Revenue Act of 1971, which codified the Asset Depreciation Guideline System, specifically allowed such an approach.

The General Explanation also indicates that other evidence of the assets' useful life, such as the depreciation method used for financial reporting, the period of financing or leasing arrangements under which the assets are acquired, and the period over which the assets are serviced under contract be obtained. Pursuant to this guidance, such evidence as is applicable to tuxedos has been collected, together with information relating to the frequency of rental of tuxedos with age from which their useful life and decline in value ("economic depreciation") may be inferred. Treasury believes that economic depreciation was intended to be the primary measure of depreciation in determining class lives. Thus, although each of the observed life measures are reported in this study, primary attention is given to the estimation of the equivalent economic life of tuxedos.

During the debate over the Tax Reform Act of 1986, the formal wear rental industry expressed its concern that the proposed depreciation of tuxedos would inadequately reflect the actual economics of these assets. As noted in the General Explanation, Congress responded by requesting that clothing held for rental be among the first assets studied by Treasury (see Exhibit 3 of Appendix A). This report is submitted to the Congress pursuant to both this request, and the general mandate for studies of taxpayer's actual experience with depreciable assets.

B. Principal Findings

The principal findings of this study are that the equivalent economic life of tuxedos held for rental is 1.9 years, while their useful life, which measures the period over which they provide service, is 3.7 years. If Congress were to establish a separate asset class for tuxedos, Treasury would suggest that a 2.0 year life be assigned to such class. Treasury recommends, however, that Congress carefully consider the implications of dividing existing asset classes into sub-classes to which shorter (or longer) class lives are assigned.

C. Organization of the Report

The report is organized into five chapters and three appendices. The second chapter provides a brief description of the rental clothing industry in general, and the formal wear industry in particular. The third chapter describes the efforts taken by the Depreciation Analysis Division to work with this industry on the design of an appropriate survey instrument. It also includes a description of the sample selection process and provides descriptive statistics on the responses to the survey questionnaire. The fourth chapter describes the methods used to estimate measures of the economic life of tuxedos. Chapter five summarizes the results of the study, and discusses some of the implications of changing the class life of tuxedos to reflect their economic life. Appendix A includes material from various public documents which relate to the Congressional mandate under which this study was performed. A copy of the survey questionnaire and follow-up material is included in Appendix B. Appendix C describes the technical details involved in applying the Alternative Depreciation System as the standard against which the equivalent economic life is to be measured, as well as in taking the actual dates the tuxedos were placed in service into account.

Chapter 2. A Brief Description of the Rental Clothing Industry

A. The Scope of The Study.

The major types of clothing held for rental include formal wear (both men's and women's), costumes, and industrial and commercial clothing. The rental of tuxedos and costumes are both a part of Standard Industrial Classification (SIC) industry 7299, Miscellaneous Personal Services, Not Elsewhere Classified. The rental of industrial and commercial clothing is classified as part of either SIC 7213, Linen Supply, or SIC 7218, Industrial Launderers. For tax purposes, tuxedos belong in Asset Class 57.0, Distributive Trades and Services, which is a very broad class that includes assets used in wholesale and retail trade, and in the provision of personal and professional services. The current class life of assets in Asset Class 57.0 is 9 years. This implies a recovery period of 5 years for regular depreciation (MACRS), and a recovery period of 9 years under the Alternative Depreciation System (ADS).

Table 1 shows some of the activities conducted by establishments whose assets fall into Asset Class 57.0, and the relative levels of 1982 investment by such establishments. About one seventh of all equipment acquired in 1982 belongs in Asset Class 57.0, and about one-half of the total investment in assets in this class was made by the service sector. Investment by establishments providing personal services was not a major component of total service sector investment, however, and total investment in tuxedos by formal wear rental firms was itself only a very small (about one-twentieth) portion of the personal service sector investment. The Depreciation Analysis Division (which was initially referred to as the Office of Depreciation Analysis) announced its intent to study the depreciation of rental clothing in the Federal Register on October 2, 1987, and in that notice also announced its intention to hold a public meeting with all interested parties. In addition, the Depreciation Analysis Division sent copies of this notice to various trade associations which it believed might have an interest in the study. At the initial public meeting, which was held on October 26, 1987 at the Treasury building, the proposed scope of the study was discussed.

Representatives from the Textile Rental Services Association of America strongly voiced their objection to rental uniforms and other garments rented by their members being included in this study. They indicated that industrial and commercial clothing frequently lasts less than one year, and provided the Depreciation Analysis Division with statistical information that had been collected by the industry to support their contention. They also noted that for tax purposes the cost of such clothing is often expensed, rather than capitalized and depreciated, and that the rental of uniforms was generally only a portion of their total rental business.

Although the Depreciation Analysis Division did not seek to independently confirm these arguments, both the material presented and considerations of administrative convenience suggested that it would make more sense to study the depreciation of the assets of industrial and commercial launderers (which generally also includes the laundering equipment) as part of a more general study of the personal services industry. Thus, no attempt was made to obtain information regarding the depreciation of rental uniforms, and the conclusions of this study of the depreciation of tuxedos do not apply to such assets.

Table 1. 1982 Investment in Equipment by All Industries, Industries in Asset Class 57.0, and Investment in Rental Tuxedos (in millions of dollars)

Industry	Investment in Equipment [2]
All Industries	361,260
Asset Class 57.0	53,073
Wholesale Trade	12,924
Retail Trade	13,098
Service Industries	27,051
Business Services	10,033
Personal Services	1,024
Rental Tuxedos	60
All Other Services	15,994

[2] The investment values (except the value for tuxedos) are from: U.S.Department of Commerce, Bureau of Economic Analysis, *Fixed Reproducible Tangible Wealth in the United States, 1925-1985*. Washington DC: U.S. Government Printing Office, June 1987. These values include all investment in equipment by the listed industries including investment in computers, furniture and fixtures and other types of equipment that would not ordinarily be depreciated using the life for asset class 57.0. The value for investment in rental tuxedos was provided by the tuxedo manufacturing industry.

Renters of tuxedos have more recently begun to rent formal gowns. Since this is a relatively recent phenomenon, there are very few data on which to base estimates of class lives. An attempt was made to collect data for formal gowns, but little information on gowns was received. Discussions were also held with representatives of the American Costumers Association, as well as individual costumers. These discussions revealed that a large majority of firms in this industry did not keep records that could be used to determine class lives. In general, these industry experts suggested that the rental pattern of costumes was similar to that of tuxedos, but as in the case of formal gowns, very little information regarding the depreciation of rental costumes was obtained. This study is intended to cover only clothes held for rental, other depreciable assets held by rental clothing firms are specifically excluded from the study.

B. Characteristics of the Formal Wear Industry

The formal wear rental industry is made up of mostly small firms. The International Formal Wear Association (IFWA) estimates that there are some 1,300 firms in the industry that own some 6,000 retail outlets. These outlets for the most part both rent and sell formal wear. As shown in Table 1, the total 1982 investment in tuxedos is estimated to be about 60 million dollars. Rented tuxedos are purchased almost entirely from three domestic manufacturers, although the tuxedos themselves may carry a variety of designer labels.

Most rental firms either own or lease the formal wear which they rent. There are some formal wear firms that own no stock of rental formal wear, but instead themselves rent formal wear from a wholesaler on an individual order basis, and some of these firms even rent the formal wear held for display on their showroom floor. Firms with multiple outlets usually keep their formal wear in a single warehouse, which often is in a separate location from the rental outlets. For firms operating in this manner, good inventory control is a necessity. Firms without computerized inventory control keep track of their inventory on large spreadsheets that account for as many as 12 weeks of rentals. The size and the style of the formal wear and the date of the rental are recorded on the spreadsheet, thus insuring that a given tuxedo is scheduled to be rented only once on a given date. Firms with computerized inventory control keep similar worksheets on their computers. Several firms now specialize in customizing software packages to provide inventory control for the formal wear industry. Some formal wear manufacturers are producing rental formal wear with bar codes that identify the style, size and date of purchase of the tuxedo. Prior to 1985 there were very few firms with computerized inventory control; since 1985 many firms in the industry have been moving towards computerized inventory control. As mentioned above, this study is based upon data for tuxedos, which is used as the generic term for all men's formal wear. The basic unit of input is the tuxedo jacket. The average rental includes the jacket, pants, cummerbund, shirt, tie, and studs. Studs, ties, shirts, and cummerbunds are generally treated as noncapital items for tax purposes by the formal wear firms. Pants are usually purchased at the same time as the jacket, although the manufacturer may price and sell pants separately. Since pants usually wear out faster than jackets, approximately one and a third pairs of pants are purchased for each jacket.

It was clear from initial discussions with industry representatives that firms are not usually concerned about the number of times a specific tuxedo is rented, but rather focus on the rental of the entire set of tuxedos that represents a single style. Depending upon the number of tuxedos ordered by the firm, a style may contain from 25 to 2,500 individual tuxedos. This is because the set typically contains tuxedos in a wide range of sizes, some of which may rent very frequently and others of which may rent hardly at all. The latter are nevertheless needed, because rentals are often made to entire wedding parties and it is necessary to fit the entire party in order to rent even a single tuxedo. Records are frequently maintained such that rentals for a given style of tuxedo can be determined, but not rentals for any single tuxedo within that style.

Likewise, the fact that an entire set of tuxedos constituting a given style is generally acquired in a single purchase also suggests that a given style of tuxedo should be viewed as the basic asset studied. Thus, in this study, the entire set of tuxedo jackets and pants of various sizes in a given style acquired by a firm at a single time (and thus representing a given vintage) is considered a single asset (and referred to hereafter simply as a "style"); data on individual tuxedos were not sought or obtained.

C. Characteristics of Tuxedos

There are two major types of tuxedos: basic black tuxedos and fashion tuxedos. Basic black tuxedos generally do not change in style, while fashion tuxedos generally change in style from year to year. The basic black tuxedo ceases to rent either because it is worn out as a result of the multiple process of wearing and cleaning, or because it is rendered permanently unserviceable as a result of a cigarette burn or some other unrepairable damage. Fashion tuxedos are also susceptible to sudden unrepairable damage, but usually go out of style (or become obsolete) before they physically wear out. Repairs to tuxedos are generally minor and are never capitalized.

Formal wear rental firms infrequently sell used tuxedos. Industry representatives noted that before the used tuxedos are discarded, they may be spray painted, shredded, or their sleeves may be cut off to prevent the tuxedos from being worn when their appearance would no longer suggest elegance. There is thus little or no salvage value for retired tuxedos. As a result, the depreciation of a style of tuxedo must largely be inferred from the pattern of rentals over the style's economic life. The ability of formal wear rental firms to supply such information is related to the way purchases of rental tuxedos are made and inventory is controlled.

A given style of fashion tuxedo is generally purchased for delivery at a single point in time. The number of rentals of a given style is dependent upon the rental fee, the location of the establishment, the level of advertising, and other factors having to do with the popularity of the style. Since different styles are introduced each year, and the popularity of each style tends to decrease with the passage of time since its introduction, additional (or replacement) tuxedos of the same style are seldom ordered. This allows a given fashion style to be associated with a given year of acquisition (or vintage). Thus, if a firm keeps either its rental receipts or its spreadsheet identifying the styles that are rented each year, it should be able to associate the number of rentals of each style for each year of that style's life (although the ease of extracting this information depends on the firm's method of recordkeeping).

The style of basic black tuxedos does not change much over time. Purchases of basic black tuxedos are thus repeatedly made, either to replace worn out stock or to expand the rental stock. The inventory information contained in a spreadsheet or a rental receipt may thus not be enough to identify the specific vintage of the tuxedo that is rented. Thus, although many firms know how many basic black tuxedos they rented in a given year, not all of these firms are able to determine the distribution of the tuxedo rentals by year of tuxedo purchase (vintage). However, as discussed more fully in the next chapter, a number of firms keep their books or inventory records in such manner that they are able to identify rentals by vintage for basic black tuxedos as well as for fashion tuxedos.

Chapter 3. The Results of the Survey Questionnaire

There are no published statistics documenting the pattern of tuxedo rentals as a function of the age of the tuxedo, or even statistics regarding the levels of tuxedo investments and dispositions. The Depreciation Analysis Division thus decided to collect the necessary information through the use of a mail survey to be sent to a random sample of firms in the industry.

A. Design of the Survey Questionnaire

The design of the survey questionnaire was developed over several months, during which time the Depreciation Analysis Division held several meetings with representatives of the formal wear rental industry, and engaged in numerous phone conversations with industry representatives. Because many issues regarding the design of the survey remained unresolved at the conclusion of the initial public meeting, a second public meeting with all interested parties was held on January 20, 1988.

As successive proposed drafts of the survey were prepared, copies were sent to the participants of the public meetings for their review (as well as to members of the tax press). Through this iterative process, a survey questionnaire was developed which sought to minimize the burden on the potential respondents as well as to meet the requirements of this study. (The survey questionnaire is included in Appendix B). The final survey form, together with the corresponding Survey Justification Form, was sent to the Office of Management and Budget for their review on June 9, 1988, and approval to conduct the survey was received on September 4, 1988.

B. The Survey Sample and Response Rates

An initial sample of 240 clothing rental firms was randomly drawn from the Dun's National Business List (obtained from the Dun & Bradstreet Corporation) for establishments noted as being in Dun's industry 7299B, which includes only formal wear rental firms. Although the sample was chosen so as to provide information on a cross section of firms in this industry, the primary intent of the sampling procedure was to obtain information in an economical manner on a representative sample of tuxedos, rather than a representative sample of firms. For this reason, as well as for ease of administration, the Depreciation Analysis Division obtained a listing of the "ultimate parent" for each of the randomly chosen establishments (if different from the individual establishment chosen). The survey forms were sent to the "ultimate parent" (or establishment, if the same), and these forms requested limited information on the firm's entire inventory of tuxedos (even if kept at several locations). In particular, each firm was asked to provide information on the number of rentals per year ("turns"), by age, for 6 separate styles of tuxedo (see Question 6 of the survey questionnaire in Appendix B).

This sample size (240 firms with 6 styles each) was based on an estimate that information on the rental of 180 styles of tuxedos would be needed to provide an estimate of the equivalent economic life of tuxedos accurate to within 0.1 year at a 95 percent confidence level, and that this information could be obtained from 240 firms.[3] Although it was expected that the overall response rate to the survey would be high, not all respondents were expected to be able to provide information concerning the number of turns by age of various styles of tuxedos. It was, however, expected that each of the firms able to do so would provide information on six different styles.

The level of tuxedo rental information obtained from the initial survey of the 240 firms was less than expected. In order to obtain more turns data, 67 additional firms were added to the sample. In October 1988, the International Formal Wear Association held its biannual conference in California, at which time 26 members volunteered to respond to the survey. In addition, a major franchiser in the industry, provided the names of 41 franchisees which were added to the sample.

Table 2 displays the response rates for both the initial sample and the additional sample of firms, disaggregated by response status. It should be noted that only 174 of the 240 firms in the initial sample were able to respond to the questionnaire. Many of the firms in the initial sample were no longer in the business of renting tuxedos, or were in business for too short a period to provide useful information, or did not in fact represent independent firms (i.e., they were affiliated with another firm that was already included in the sample), or were classified incorrectly by Dun's into the tuxedo rental industry. Of the 174 firms which were able to provide some useful information, 142 (or 82 percent) ultimately did so.

The overall response rate for the 67 additional firms added to the sample (65 of which were able to respond) is much lower than that for the initial sample, due mainly to the fact that the significant follow-up effort which was undertaken with respect to firms in the initial sample was not repeated for these additional firms. This follow-up effort was initiated by the mailing of a letter to all firms in the initial sample that did not respond during the 60 day period which was allowed. Those firms that did not respond to the follow-up letter were contacted via telephone. (A copy of the follow-up letter is included in Appendix B).

In total, out of the 307 firms to whom questionnaires were sent, 239 firms were able to provide useful information, and 161 (or 67 percent) of these firms did so. These 239 firms represent approximately 20 percent of the total universe of formal wear firms that are estimated to currently own and actively rent tuxedos. Despite this relatively high overall response rate, only 38 firms provided useful information about the rental frequency of tuxedos (while the remaining 123 firms

[3] As discussed below, the final data set used to estimate the equivalent economic life included 199 styles of tuxedos. It is estimated that this sample provides an estimate of the economic life of tuxedos accurate to within 0.1 year at a 95% confidence interval.

responded to some part of the survey other than Question 6). These 38 firms, which are estimated to own about one-third of all rental tuxedos, provided information on the number of turns by age for 199 different styles of tuxedos.

Table 2. Response Status of Surveyed Firms

Survey Status	Initial Sample	Additional Sample	Total Sample
Surveys Mailed	240	67	307
Unable to Respond	66	2	68
No Longer in Business	41	-	41
New Business With No Turns History	8	-	8
Affiliate of Company Already in the Sample	11	2	13
Incorrectly Classified as Tuxedo Rental Business	6	-	6
Able to Respond	174	65	239
Surveys Received	142	19	161
Surveys Providing Turns Information	30	8	38
Number of Styles Provided	157	42	199

Because the turns data are the primary source of information regarding the depreciation of tuxedos, and this information was obtained from only a fraction of the firms able to provide some information, the possibility of self-selection bias (i.e., the tendency for only those firms which have data supporting a short class life to respond) must be addressed.[4] As will be discussed more fully in the next section, the recordkeeping practice of the firm appears to be an important factor in the relatively low response rate with regard to turns information (i.e., to Question 6 of the survey questionnaire). Specifically, firms that are likely to be better able to provide turns information (because they reported using a computerized system, or had multiple retail outlets, or stored tuxedos in a warehouse) were much more frequent providers of turns information. While some degree of self-selection bias cannot be ruled out, it appears that for most of the firms that did not provide turns information, the difficulty (though not necessarily the impossibility) of compiling this information was the primary reason.[5]

C. Summary of Responses

Table 3 contains a summary of the responses to the survey questions. Information concerning the method of depreciation used by the firm for financial accounting purposes and typical lease and loan periods was sought in accordance with the guidelines suggested in the General Explanation. Other questions were asked in order to obtain some understanding of the nature of the respondent's activities. The implications of the information collected with regard to the life measures of tuxedos will be discussed in the following chapter. Table 3 shows that the majority of firms participating in the survey are retail renters of men's formal wear. Although seven responding firms are involved in the rental of women's gowns, only one of them was able to provide data concerning turns.Question 3 was designed to allow firms that rent tuxedos but do not own any stock (and thus are not an intended recipient of the survey questionnaire) to note that fact without having to complete the balance of the survey. As discussed in Appendix C, the ending date of the firm's fiscal year as provided in the response to Question 4, combined with the delivery date of each style of tuxedo reported in Question 6, is useful in determining that part of the firm's first year for which the style was available for rental. About two-thirds of the firms that responded to this question are calendar-year taxpayers.

[4] One possible source of self-selection bias is the sample of 67 additional firms who volunteered to participate in the survey. The equivalent economic life obtained from the turns information provided by these additional 67 firms is slightly shorter (but not significantly so) than that obtained from the turns information provided by the initial sample of firms. Sample statistics for the initial value-in-use and the cost of styles for both the initial and additional sample are shown in Table 7.

[5] Indeed, through subsequent telephone contact with firms whose response appeared questionable, it was noted that some firms, in their desire to respond, provided turns data that were not based on actual records, or provided data for styles of a more recent vintage so that only an incomplete life history could be obtained; these responses were dropped and treated as non-responses in Table 2.

Table 3. Summary of Survey Responses

Firms Responding to:	Number Responding
Total Survey Forms Returned	161
Question 2a: In What Types of Rental Activities is the Firm Engaged?	
Total Number of Responses	152
Retail Men's Formal Wear	112
Wholesale Men's Formal Wear	44
Women's Gowns	7
Costumes	1
Question 2b: Does the Firm Own More than One Retail Outlet?	
Total Number of Responses	109
Yes	67
No	42
Question 2c: Does the Firm Stock Rental Clothes in a Warehouse?	
Total Number of Responses	109
Yes	61
No	48
Question 3: If the Firm Maintains No Stock of Rental Clothes, Check the Box Below	
Total Number of Responses	24
Question 4: What is The Date on Which The Firm's Fiscal Year Ends? (Responses are tabulated by month of fiscal year end.)	
Total Number of Responses	
January - March	94
April - June	11
July - September	8
October - November	9
December	8
	58

Table 3. Summary of Survey Responses (Continued)

Firms Responding to:	Number Responding
Question 5: Does the Firm Use a Computerized System for Inventory Control or to Keep its Accounting Records.	
Total Number of Responses	96
Yes	40
No	56
Question 6: Enter turns information for six styles of tuxedos purchased between 1981 and 1985.	
Total Number of Firms Responding	38
Average Number of Turns Per Tuxedo by Age:	

Age (in years)	1	2	3	4	5	6	7
Turns	7.1	7.1	4.5	2.0	.6	.1	.0

Firms Responding to:	Number Responding
Question 7 and 8: What is the value and the number of units of tuxedos in year end inventory for the years 1981-1987, and what is the value and number of units of tuxedos purchased for the years 1981-1987?	
Total Number of Responses	16
Question 9: What is the Life and Method the Firm Uses to Depreciate Rental Clothes for Financial Statements?	
Total Number of Responses for Life:	57
Life in Months:	
12	2
20	1
36	27
44	1
48	3
50	1
60	17
84	5

Table 3. Summary of Survey Responses (Continued)	
Firms Responding to:	**Number Responding**
Question 9: What is the Life and Method the Firm Uses to Depreciate Rental Clothes for Financial Statements? (Continued)	
Total Number of Responses for Method:	68
Depreciation Method:	
Double Declining Balance	18
150% Declining Balance	2
Unit of Production	1
Sum of Years Digits	2
Staight Line	35
Other	10
Question 10: What is the Average Loan Period Over Which the Firm Finances Its Rental Clothes?	
Total Number of Responses:	23
Loan Period in Months:	
3-6	10
9	2
12	6
24	1
36	1
60	2
90	1
Question 11: What is the Average Lease Period Over Which the Firm Leases its Rental Clothes?	
Total Number of Responses (One Year Lease):	2

About half of the firms that responded to Question 9 used a 36-month period to depreciate tuxedos for financial accounting purposes, and about half of the responding firms used the straight-line method of depreciation. As discussed in the following chapter, this is consistent with both the estimated two year economic life and the roughly four year useful life obtained from analysis of the turns data. There are also a significant number of firms (about one-fourth of those responding to Question 9) that use a 60-month useful life, and a comparable fraction use a declining-balance method of depreciation.

The average loan period for most of those who responded to Question 9 is 12 months or less. While this is consistent with the contention of industry representatives that tuxedos lose their market value relatively quickly, and have almost no resale value, it may also simply represent general trade practice. The average loan period should thus be viewed as a lower limit to the economic life of tuxedos.

Table 4. Response to Question 6 (Turns Information) Cross-Classified by Responses to Questions 2b, 2c, and 5

	Number of Responses by Firms Not Providing Turns Information			Number of Responses by Firms Providing Turns Information		
Question:	No Response	No	Yes	No Response	No	Yes
2b. Does the Firm Own More Than One Retail Outlet?	48	36	37	2	6	30
2c. Does the Firm Stock Rental Clothes in a Warehouse?	48	41	32	2	7	29
5. Does the Firm Use a Computerized System For Inventory Control or to Keep its Accounting Records?	62	38	21	1	18	19

In order to examine whether the lack of rental frequency information was due to the difficulty of compiling the requested information, an examination was made of the relationship between a firm's response to Question 6 and various firm-specific attributes which suggest that the requested information is more readily available, such as its having multiple retail outlets, its storage of tuxedos in a warehouse, and its use of a computerized record system. The results of this examination are shown in Table 4. It may be noted that although a few firms lacking these attributes provided turns information (e.g., 14 percent of the firms reporting that they had no warehouse responded to Question 6), the likelihood of obtaining turns information was much greater if these attributes were present.

Thus, 30 out of the 67 firms which reported storing their tuxedos in a warehouse (or 45 percent) provided turns information. Likewise, 48 percent of the firms reporting the use of multiple retail outlets, and 48 percent of the firms using a computer, provided turns information.

Table 5. Depreciation Method Used For Financial Accounting Purposes Cross-Classified by Service Life Used

	Number of Firms Using Depreciation Method and Life					
Life in Months	Double Declining Balance	150% Declining Balance	Sum of Years Digits	Straight Line	All Other Methods	Total, All Methods
12	-	-	1	1	-	2
20	-	-	-	1	-	1
36	6	1	-	15	5	27
44	1	-	-	-	-	1
48	-	1	-	1	1	3
50	1	-	-	-	-	1
60	4	-	1	10	2	17
84	5	-	-	-	-	5
Total, All Lives	17	2	2	28	8	57

Because the rapidity with which tuxedos are written off for financial accounting purposes depends on both the tuxedo service life and the method of depreciation used by the firm, it is of some interest to examine the correlation (if any) which may exist between the choice of these two factors. Table 5 presents the distribution of methods chosen by service life. Since the write-offs resulting from the use of shorter service lives with a slower method of depreciation can be similar (at least in the initial years) to those resulting from the use of longer lives with a more accelerated method, both of these combinations were expected. As shown in Table 5, however, the straight-line method seemed to be preferred both by firms using a three year service life and by firms using a five year service life.

Chapter 4. The Measurement of the Class Life of Tuxedos

As noted in Chapter 1, the legislative history of the 1986 Act suggests that the class life of depreciable assets be based on their anticipated decline in economic value, and that consideration also be given to their anticipated useful life. In this chapter, the survey data is used to obtain the useful life of tuxedos from their period of rental, and the equivalent economic life of tuxedos from their inferred decline in value with age. In Appendix C, an analysis leading to a shorter equivalent economic life is presented which takes into account the actual date of acquisition of the tuxedos and the timing of the tax benefits received by the taxpayer under the Alternative Depreciation System.

Figure 1: Distribution of Useful Lives (For 199 Styles of Tuxedos)

A. The Useful Life of Tuxedos

The turns data obtained from the survey allow determination of the useful life of each style of tuxedo, which is taken to be the period between the date of delivery and the end of the last fiscal year for which rentals of that style are reported. While firms may not actually dispose of the tuxedos at that time, if they no longer rent the tuxedos, that is the point at which the economic life of the style of tuxedo may be considered to have terminated. Data for the more recent vintages that clearly appeared to provide an incomplete history were expressly excluded. Fig. 1 presents the distribution of useful lives based on the rental patterns reported for all 199 styles for which complete turns data were obtained. (Fig. 1 should be interpreted in the following way: 1.5 percent of the styles have a useful life greater than one year and less than or equal to two years, 26.1 percent have a useful life greater than 2 years and less than or equal to 3 years, etc.) Most styles (182 out of 199) had a useful life of approximately three to five years. If the useful life of each style is weighted by the cost of the style (i.e., the cost per tuxedo times the number of tuxedos acquired), a weighted average useful life of 3.7 years is obtained.

Although equivalent economic lives are more indicative of the actual depreciation of the assets examined than are useful lives, useful life information may nevertheless be helpful. Measures of useful life may provide a test of the reasonableness of the class lives as determined from the estimated decline in value.

B. The Productivity Method

When available, resale prices (adjusted for the fact that retired assets no longer appear in the resale market) may generally be expected to provide the best evidence of the decline in value of an asset group. Such approach has been used by a number of academic researchers to estimate the economic depreciation of a variety of different assets, with the most comprehensive and careful work done by Hulten and Wykoff [1981].[6] Frequently, however, resale prices may not be available, and this is the case for tuxedos.

An alternative method of inferring the decline in value of an asset is based on an examination of the pattern of the income flow which it generates.[7] The economic value of any asset to its owner may generally be expressed as the discounted present value of the expected future cash flow generated by its use. This value has been referred to as the "value-in-use" of the asset, and it is a standard assumption of investment theory that the market price of the asset (if such price could be measured) would equal the value-in-use of the asset to a marginal purchaser of the asset.[8] It is generally recognized that, because many different assets may be used to produce a single product, the direct measurement of the value-in-use of any individual asset can be very difficult, and thus reliance on resale prices, if possible, is much to be preferred. The current study of tuxedos appears to be a case where economic depreciation may, however, be readily estimated from the pattern of income generated from their rental.

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[6] See also Ackerman [1973], Biedleman [1973], Ohata and Griliches [1976], Ramm [1970], and Wykoff [1970].

[7] This method has been used by Taubman and Rasche (1969) to estimate the depreciation of office buildings.

[8] This fundamental assumption has been used by Hotelling [1925] in his classic paper on the theory of depreciation, and by Samuelson [1964] in his paper on the invariance of asset prices to the tax rate in a system in which economic depreciation is used for tax purposes.

Discussions with industry representatives revealed that the rental price of a given style of tuxedo rarely depends upon the age of the tuxedo. In addition, many of the costs incurred by the rental firm which are either directly associated with the rental of the tuxedos (such as the cost of cleaning), or may reasonably be allocated to individual styles of tuxedos on the basis of such rentals (such as the cost of advertising), also do not vary with the age of the tuxedo. These are conditions which suggest that the decline in the value-in-use of each style of tuxedo can be estimated directly from rental information.

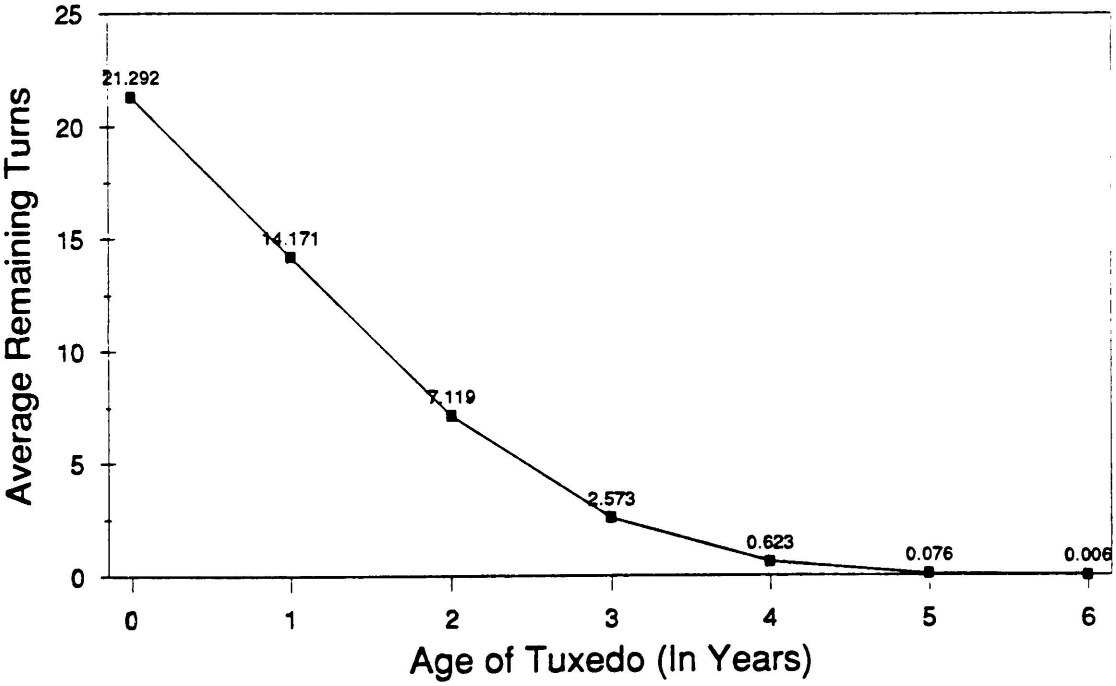
The method used in this study to estimate the class life of tuxedos may be characterized as the "productivity" method. As mentioned in Chapter 2 data concerning the number of times that a style of tuxedo rents (turns) for each year of its life has been collected for 199 different styles. The productivity method for measuring economic depreciation is based on the assumption that the number of turns of a given style in a given year is an adequate surrogate (up to an unknown proportionality constant) for the net cash flow generated by the ownership and use of the tuxedos of that style for the year.

This assumption cannot be completely valid if some of the costs incurred by the firm are period costs (i.e., costs associated with the passage of time, such as rent or insurance, that are independent of the number of rentals of a given style of tuxedo). It is likely that these costs, which should more properly be allocated to the individual styles of tuxedos on the basis of the number of tuxedos, are independent of the age of the tuxedos. By assuming that these costs are proportional to the number of turns, the profitability of each style tends to be understated in the earlier years (when there are more rentals) and overstated in the later years (when there are fewer rentals). The decline in value of the tuxedos over time is thus somewhat underestimated, and the resulting economic life somewhat overestimated.

Some industry representatives have suggested that owners frequently retain tuxedos even if the rental of the particular style is rather infrequent. This suggests that for such firms, period costs may not be very significant. In contrast, the turns data suggest that for some styles, the tuxedos are retired even though the number of turns in the last year of rental is still a significant fraction of the number of first-year turns. This suggests that for these styles rent and other costs which are independent of the age of the tuxedos may be far more significant. However, the fact that the number of turns reported for these styles does not decline appreciably over their useful life reduces the potential error made by assuming that these costs decline with age in tandem with the number of turns.

Assuming that for any individual style the future annual net cash flow generated by the rental of the tuxedos is proportional to the number of turns reported each year, the value-in-use of the style for each year of its economic life can be determined.[9] By examining the annual decline in the value-in-use, the economic depreciation of the specific style can be inferred. Because a number of factors complicate the process of obtaining the equivalent economic life of tuxedos from the productivity method, it is helpful to first illustrate the application of this method using a simplified analysis. The more complex analysis, which takes account of these factors (the proper weighting of the information obtained from the individual styles, the fact that the tuxedos are not generally placed in service at the beginning of the year, the timing of the tax benefits under the Alternative Depreciation System, etc.), will be discussed in Appendix C.

Figure 2: Average Remaining Turns Per Tuxedo By Age

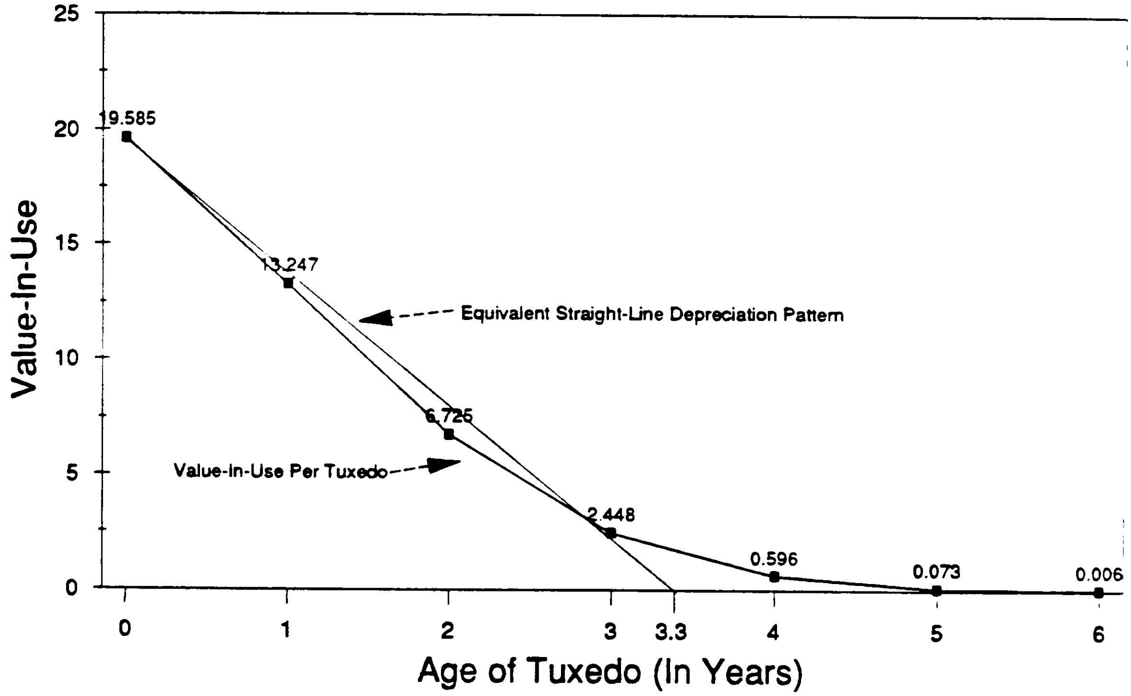


[9] If discounts were offered for rental of older tuxedos or premiums charged for rental of newer tuxedos, and costs remained constant, this assumption would be incorrect. Industry representatives however, have reported that the rental price of a given style of tuxedo rarely depends upon the age of the tuxedo.

C. Illustration of The Measurement of The Economic Life of Tuxedos Using the Productivity Method

The application of the productivity method can be illustrated by treating the average number of turns per tuxedo reported at each age for all styles combined (noted in Table 3 under the response to Question 6) as the number of turns at each age of a single "generic" style of tuxedo. The remaining average number of turns per tuxedo at each age, as obtained from the survey data, is shown in Fig. 2.[10]

Figure 3: Value-In-Use Per Tuxedo By Age (In Units of Turns)



For this illustration, it is assumed that tuxedos are placed in service in the beginning of the year, and the cash flow generated by their rental is received at the end of the year. The value-in-use per tuxedo is thus proportional to the discounted sum of the remaining number of turns. From the pattern of turns shown in Fig. 2, a pattern of decline in value may be obtained by setting the constant

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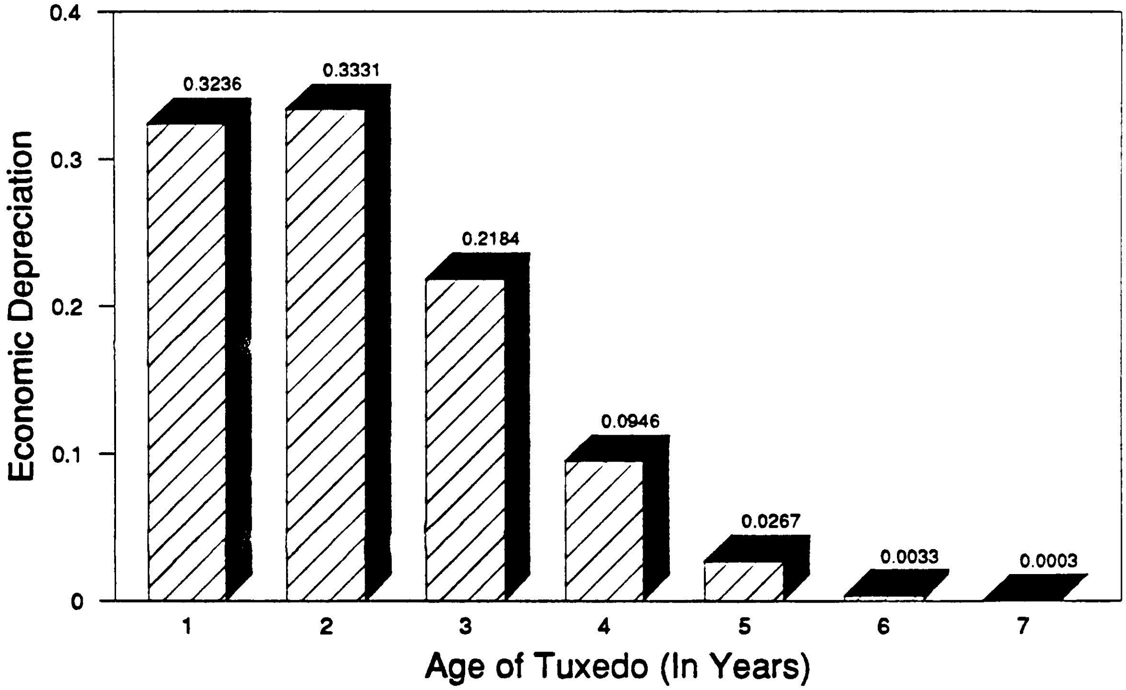
[10]The values in Fig. 2 are obtained by dividing the number of turns reported for each age of the style, aggregated over all styles, by the total number of tuxedos acquired, also aggregated over all styles. On average, each tuxedo "turned" about 21 times over its useful life.

of proportionality equal to unity, and using a 4% discount rate. The resulting value-in-use per tuxedo (as shown in Fig. 3), is somewhat less (due to discounting) than the average remaining number of turns per tuxedo for each year of their useful life (shown in Fig. 2).

The economic depreciation per tuxedo is given by the annual decline in the average value-in-use per tuxedo. To obtain the equivalent economic life, only the pattern of economic depreciation, and not its absolute level, is relevant. Thus, the unknown constant of proportionality may be eliminated by dividing each year's value-in-use by the initial year's value-in-use. The result may be viewed as the economic depreciation per dollar of investment, and is shown in Fig. 4.

Figure 4: Economic Depreciation By Age Per Dollar of Investment



Assuming again for this illustration that the tax benefits associated with each year's depreciation allowance are recognized at the end of the year, the present value of economic depreciation per dollar of investment can be calculated by simply discounting and summing the values for depreciation shown in Fig. 4. The result is a present value of depreciation of 0.919.

The equivalent economic life can now be determined from economic depreciation as measured by the productivity method. If the present value of straight-line depreciation is calculated under the same assumptions noted above (i.e., tuxedos are placed in service at the beginning of the year, and the depreciation tax benefits are recognized at the end of the year), the resulting equivalent economic life of 3.3 years is obtained. The straight-line decline in value corresponding to this class life is shown in Fig. 3.

Table 6. Measures of Useful and Equivalent Economic Lives

Measure of Life	Life (In Years)
Useful Life	3.7
Equivalent Economic Life - Without the half-year convention and without the adjustments for delivery date and realization of tax benefits.	3.2[11]
Equivalent Economic Life - With the half-year convention and without the adjustments for delivery date and realization of tax benefits.	2.7
Equivalent Economic Life - With the half-year convention and with adjustments for delivery date and realization of tax benefits.	
All Tuxedos	1.9[12]
Fashion Tuxedos	2.0
Basic Black Tuxedos	1.8

Because the calculated value-in-use falls during the first few years of useful life of this "generic" tuxedo, the 3.3 year equivalent economic life is shorter than the average useful life of 3.7 years noted in the previous section. In Appendix C, the simplifying assumptions of this illustration are replaced by somewhat more realistic assumptions. In particular, the fact that the tuxedos are generally available for rental for only a portion of the first year has a significant impact on the estimated economic life. Moreover, the method of translating the estimated decline in value into an economic life is modified to reflect the half-year convention allowed under the Alternative

[11] Based on a weighted average using the cost of tuxedos as weights. When weighted by initial value-in-use, the equivalent economic life is 3.3 years.

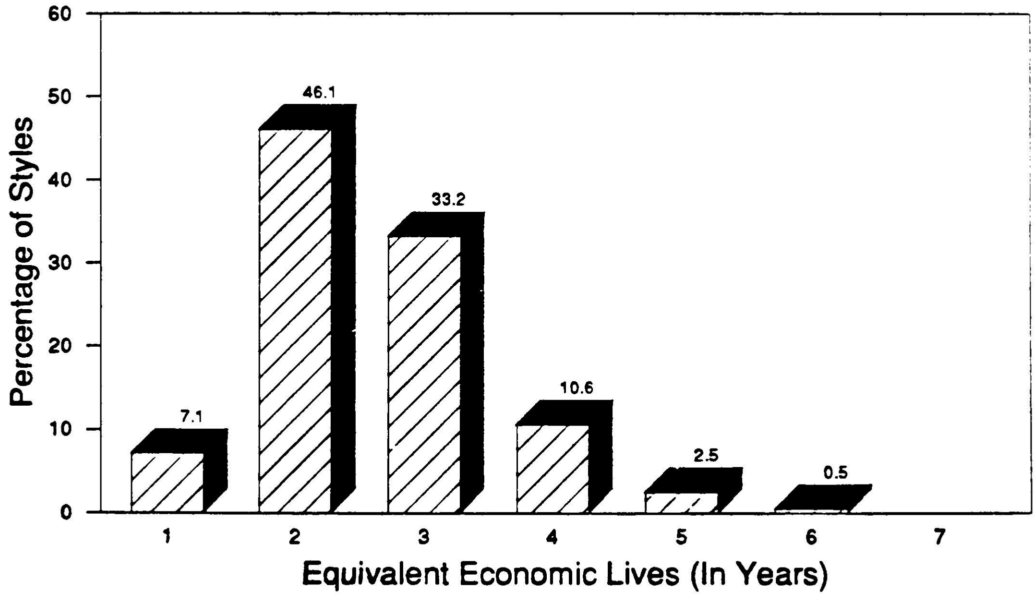
[12] Based on a weighted average using the cost of tuxedos as weights. When weighted by the intial value-in-use, the equivalent economic life is 2.1 years.

Depreciation System and the timing of the tax benefits. The information provided on tuxedo delivery dates and the fiscal years of tuxedo rental firms suggests that a mid-quarter convention would seldom be used.

Table 6 summarizes the several measures of the economic life of rental tuxedos which are noted in both this chapter and in Appendix C. This table shows that, as the additional calculational refinements described in Appendix C are introduced, the resulting estimate of equivalent economic life is reduced.After all refinements are made, an equivalent economic life of 1.9 years is obtained if the information from the turns data is weighted by cost (and 2.1 years if weighted by initial value-in-use).

Just as the individual styles have differing useful lives, so also do they have differing equivalent economic lives. Fig. 5 shows the distribution of the individual equivalent economic lives for each style of tuxedo obtained when all of the refinements noted in Table 6 have been taken into account. (Fig. 5 should be interpreted in the following way: 46.1 percent of the styles have an equivalent economic life greater than one year and less than or equal to two years, 33.2 percent have an equivalent economic life greater than 2 years and less than or equal to 3 years, etc.)

Figure 5: Distribution of Equivalent Economic Lives (For 199 Styles of Tuxedos)



When this figure is compared to Fig. 1, it is apparent that although the equivalent economic lives are generally much shorter than the useful lives, the variability in these two measures are comparable.

Treating all of the turns information as if it refers to a single type of "generic" tuxedo, as was done in the illustrative analysis above, is one way of obtaining an average class life. This approach effectively weights the individual styles by their initial value-in-use. Because there is some reason to believe that the proportionality constant differs across styles in an unknown manner, the decline in value of the individual styles should more properly be weighted by their cost. The choice of the different weighting methods (which have a very modest impact on the final results) is also discussed at greater length in Appendix C.

Chapter 5. Conclusions

A. The Class Life of Tuxedos

The empirical results of this study of the depreciation of tuxedos are readily summarized. The useful life of tuxedos, which in the context of this study is essentially the average period over which tuxedos are rented, is 3.7 years. The equivalent economic life of tuxedos, which in the context of this study is that recovery period under the Alternative Depreciation System which generates depreciation allowances whose present value equals the average present value of the economic depreciation of tuxedos, is 1.9 years (2.1 years if the results for the individual styles of tuxedos are weighted by initial value-in-use, rather than cost). Treasury believes the equivalent economic life is more indicative of the actual depreciation of tuxedos, and if a separate asset class for tuxedos is to be established, recommends that it be assigned a class life of 2.0 years.

The General Explanation notes that a change in the class life of an asset group is to reflect the anticipated useful life and the anticipated decline in value over time of the assets in the group. Although the results noted above are based on historical information about assets acquired a number of years ago, industry representatives did not anticipate changes in the economics of tuxedo rental which might cause the depreciation of tuxedos acquired in the future to differ from the observed depreciation.

The disparity between the estimated useful life and the much shorter equivalent economic life of rental tuxedos is an important result of this study. Treasury believes that when, as in the present case, adequate information is available to reliably estimate the decline in economic value with age of the asset studied, such information should be used to determine the asset's class life. For assets whose productivity tends to decrease with age (as is true for rental tuxedos when productivity is measured by the number of turns), the equivalent economic life will usually be shorter than the useful life, and the faster the decline in productivity with age, the greater the disparity between the equivalent economic life and the useful life.

In general, focusing on the useful life tends to bias the analysis towards an excessively long class life. By contrast, reliance on the equivalent economic life does not give undue weight to the latter year's of an asset's life, when it may be retained primarily to perform an infrequently needed task. Although these considerations do not appear to be relevant in this study of tuxedos for which actual rentals, rather than retention, was reported, the decline in the frequency of rental of a given style of tuxedo with age leads to an average economic life for tuxedos which is much shorter than their average useful life. This may, in part, reflect the rapidity with which the attractiveness of any style of fashion tuxedo may change, or the increasing impact of wear and tear with age on the firm's ability to rent a complete set of basic black tuxedos. Regardless of the reasons for the relatively rapid decline with age in the imputed value-in-use of rental tuxedos, this decline is not reflected in their useful life, which is simply a measure of the period over which they provide some service to the firm, however small.

A similar disparity between the useful life and the equivalent economic life is expected to be observed in the case of many, but not all, depreciable assets. Although resale price data should be available to estimate the decline in value of many assets, the productivity method can also be used. If the productivity method were used, the focus of the analysis would very likely have to change. Rather than focusing on individual assets (as would be natural under the resale method), it would generally be necessary to focus on the entire collection of assets which are typically acquired as part of a major investment project. By studying how the output and cost of operation of the acquired facility changes over time, the decline in value of the entire set of assets can be inferred, whereas it may be impossible to disentangle the net income contributed by any single machine.

B. Structure of the Asset Classification System

The ultimate structure of the asset classification system is a difficult issue. In particular, the number and scope of the separate asset categories which characterize the system should be considered by Congress. The Treasury Department does not wish to imply that the current Asset Depreciation Range (ADR) classification system is perfect, nor is the Treasury Department reluctant to recommend changes in class lives if the evidence suggests that such changes are merited. Treasury is concerned, however, that if Congress were to continually subdivide existing asset classes so that those assets that happen to have somewhat shorter (or longer) class lives than the average for all assets in the class were placed in separate subclasses, the resulting asset classification system would soon become far too complex.[13]

A change in the class life of rental tuxedos results in a shift in recovery period under the regular depreciation system from five years to three. While equity and efficiency considerations might thus favor the establishment of a new asset class for rental tuxedos, investment in rental tuxedos is a very small portion of total investment in all business equipment, as noted in Table 1. There is currently no asset class that encompasses such a small amount of investment. The establishment of a special asset class for rental tuxedos may thus be taken as a precedent for the establishment of asset classes of very small size. A classification system that distinguishes among the assets owned by sectors of the economy each as small as the tuxedo rental industry would be an extremely detailed and complex system. Such a system would be much more difficult to administer than a system with broader asset classes.

[13] Moreover, if one subset of assets is given a shorter (or longer) class life, the class life for the remaining assets in the class would have to be lengthened (or shortened), assuming that the existing class life approximately reflects the average economic life of all the assets.

In principle, a classification system with very detailed asset classes can allow for a neutral tax treatment of assets. There are, however, only a few recovery periods for regular depreciation, each encompassing a range of class lives, so that assets with different class lives falling within the same recovery period have different effective tax rates. Some degree of non-neutrality is thus a feature of the current depreciation system. Conversely, unless the taxpayer is subject to the Alternative Depreciation System, "fine tuning" of the asset classification system generally need not have any tax consequence.

Eventually, Congress will have to determine where the line should be drawn between a complex and more neutral system, and a less complex, but also less neutral, classification system. The establishment of a separate asset class for tuxedos may be inconsistent with the structure ultimately desired.

Appendix A. Exhibits Related to the Congressional Mandate

Exhibit 1. Section 168(i)(1)(B) of the Internal Revenue Code as Revised by the Tax Reform Act of 1986

Code Sec. 168 (i) **Definitions and Special Rules.**

For purposes of this section--

(1) **Class Life.**

(B) Secretarial authority. The Secretary, through an office established in the Treasury--

(i) shall monitor and analyze actual experience with respect to all depreciable assets, and

(ii) except in the case of residential rental property or nonresidential real property--

(I) may prescribe a new class life for any property,

(II) in the case of assigned property, may modify any assigned item, or

(III) may prescribe a class life for any property which does not have a class life within the meaning of subparagraph (A).

Any class life or assigned item prescribed or modified under the preceding sentence shall reasonably reflect the anticipated useful life, and the anticipated decline in value over time, of the property to the industry or other group.

Exhibit 2. Section 168(i)(1) of the Internal Revenue Code as Revised by the Technical and Miscellaneous Revenue Act of 1988:

Code Sec. 168(i) **Definitions and Special Rules.**

For purposes of this section--

(1) **Class Life.** Except as provided in this section, the term "class life" means the class life (if any) which would be applicable with respect to any property as of January 1, 1986, under subsection (m) of section 167 (determined without regard to paragraph (4) and as if the taxpayer had made an election under such subsection). The Secretary, through an office established in the Treasury, shall monitor and analyze actual experience with respect to all depreciable assets.

Exhibit 3. Provisions for Changes in Classification from The General Explanation of the Tax Reform Act of 1986

The Secretary, through an office established in theTreasury Department is authorized to monitor and analyze actual experience with all tangible depreciable assets, to prescribe a new class life for any property or class of property (other than real property) when appropriate, and to prescribe a class life for any property that does not have aclass life. If the Secretary prescribes a new class life for property, such life will be used in determining the classification of property. The prescription of a new class life for property will not change the ACRS class structure, but will affect the ACRS class in which the property falls. Any classification or reclassification would be prospective.

Any class life prescribed under the Secretary's authority must reflect the anticipated useful life, and the anticipated decline in value over time, of an asset to the industry or other group. Useful life means the economic life span of property over all users combined and not, as under prior law,the typical period over which a taxpayer holds the property. Evidence indicative of the useful life of property, which the Secretary is expected to take into account in prescribing aclass life, includes the depreciation practices followed by taxpayers for book purposes with respect to the property, and useful lives experienced by taxpayers, according to their reports. It further includes independent evidence of minimal useful life -- the terms for which new property is leased, used under a service contract, or financed -- and independent evidence of the decline in value of an asset over time, such as is afforded by resale price data. If resale price data is used to prescribe class lives, such resale price data should be adjusted downward to remove the effects of historical inflation. This adjustment provides a larger measure of depreciation than in the absence of such an adjustment. Class lives using this data would be determined such that the present value of straight-line depreciation deductions over the class life, discounted at an appropriate real rate of interest, is equal to the present value of what the estimated decline in value of the asset would be in the absence of inflation.

Initial studies are expected to concentrate on property that now has no ADR midpoint. Additionally, clothing held for rental and scientific instruments (especially those used in connection with a computer) should be studied to determine whether a change in class life is appropriate.

Certain other assets specifically assigned a recovery period (including horses in the three-year class, qualified technological equipment, computer-based central office switching equipment, research and experimentation property,certain renewable energy and biomass properties, semi-conductor manufacturing equipment, railroad track, single-purpose agricultural or horticultural structures, telephone distribution plant and comparable equipment, municipal waste-water treatment plants, and municipal sewers) may not be assigned a longer class life by the Treasury Department if placed in service before January 1, 1992. Additionally,automobiles and light trucks may not be reclassified by the Treasury Department during this five-year period. Such property placed in service after December 31, 1991, and before July 1, 1992, may be prescribed a different class lifeif the Secretary has notified the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate of the proposed change at least 6 months before the date on which such change is to take effect.

Appendix B. The Survey Questionnaire and the Follow-Up Letter

DEPARTMENT OF THE TREASURY
WASHINGTON

Dear Sir or Madam:

The Depreciation Analysis Division of the Treasury Department's Office of Tax Analysis has randomly selected your firm to participate in its survey of the depreciation of rental clothing. As mandated by the Tax Reform Act of 1986, this office has the responsibility for studying the depreciation of all assets. At the request of Congress, rental clothing is one of the first assets to be studied.

The information obtained in this survey will enable Treasury to recommend a class life for tax depreciation purposes for rental clothing. The International Formal Wear Association has endorsed this survey, and encourages your response. The design of the attached survey form reflects the many comments and suggestions made by rental clothing industry representatives at a series of meetings held during the last several months.

This survey is designed for firms that rent men's or women's formal wear or costumes. The questions refer to tuxedos because the rental of tuxedos is the largest component of the rental clothing industry. If you rent women's formal wear or costumes, please provide separate responses for such rental clothing, as noted on the first page of the form.

All data collected in this survey will be treated as strictly confidential. We will, therefore, not report the names of the firms included in this survey, nor the firm-specific information obtained, to the Internal Revenue Service or any other agency, enterprise, or individual. Any report on the results of this study will contain only aggregate statistical measures, or information which cannot be identified as to source.

Please return the completed form in the enclosed postage paid return envelope by October 14, 1988. If you have any question regarding the survey, please write or call the persons responsible for administering the survey, as noted on the first page of the survey form.

Sincerely,

Lowell Dworin

Lowell Dworin
Director for Depreciation Analysis

Enclosure

OMB Approval No.:
1505 0114
Expires 12/31/88

Survey of Depreciation of Rental Clothing

General Instructions

- The responses to the questions in this survey should be based on information relating to all of the wholesale and retail outlets owned by or affiliated with the firm identified in question 1.
- In responding to the questions asked, please refer to the information in your accounting or property records. If these records are not adequate to allow you to respond to a specific question, enter the letters "NA" (for "not available") in the space provided for the response.
- The responses should not include information relating to clothing which you lease on a long-term basis to other firms, but should include information relating to clothing which you have obtained through a long-term lease.
- The responses should include only information relating to clothing that is a permanent part of your inventory. Information relating to clothing that you obtained temporarily to meet a specific customer's needs should be excluded.
- Firms that rent women's gowns in addition to tuxedos should submit separate survey forms for tuxedos and women's gowns. The responses for tuxedos should be entered on this form, and the responses for women's gowns should be entered on a copy of questions 6, 7, and 8 of this form. Please label the copy "women's gowns".
- Firms that rent costumes in addition to tuxedos should submit separate survey forms for tuxedos and costumes. The responses for tuxedos should be entered on this form, and the responses for costumes should be entered on a copy of questions 6, 7, and 8 of this form. Please label the copy "costumes".
- Please return the completed form in the enclosed postage paid envelope by ~~October 14~~ November 21, 1988.

If you have any question regarding the survey, please write or call the persons responsible for administering the survey:

Gerald Silverstein
Depreciation Analysis Division
Room 4217, Main Treasury Building
Washington DC 20220

(202) 786-8373

Michael J. Walsh
Depreciation Analysis Division
Room 4217, Main Treasury Building
Washington DC 20220

(202) 535-6992

U S Department of the Treasury | Office of Tax Policy | Office of Tax Analysis | Depreciation Analysis Division

TD F 90-21.3 (06-88)

Control No.:

Section I: General Information

Question 1: Please enter the name and the address of your firm, and the name and telephone number of the person to be contacted regarding the responses entered on this survey form. This will allow us to contact you in the unlikely event that questions arise regarding the information provided on this form.

Firm Name: ______________________

Firm Address: ______________________

____

____

Contact Person's Name: ______________________

Contact Person's Phone Number: ______________________

Question 2a: Please check the boxes next to each type of rental activity in which the firm is engaged.

Retail rental of men's formal wear [ ]

Wholesale rental of men's formal wear [ ]

Retail rental of women's gowns [ ]

Rental of costumes [ ]

If you are engaged in retail rental activity, please answer questions 2b and 2c below, otherwise continue with question 3.

Question 2b: Do you own more than one retail outlet?

Yes [ ]

No [ ]

Question 2c: Do you stock rental tuxedos in a warehouse?

Yes [ ]

No [ ]

Control No.:

Section I Continued: General Information

Question 3: If your firm maintains no stock of rental clothes, please check the box below, but do not respond to questions 4-11. Simply return the form in the enclosed postage paid envelope.

This firm maintains no stock of rental clothes [ ]

Question 4: What is the date on which your fiscal year ends?

Month ________ Day __________

Question 5: Do you use a computerized system for inventory control or to keep your accounting records?

Yes [ ]

No [ ]

Control No.:

Section II: Number of Turns By Age of Tuxedo

Question 6: Starting with those styles purchased in 1981 (or for the earliest year after 1980 for which you have such information) and continuing until you have listed no more than 6 distinct styles, please enter the style of tuxedo acquired, the season and year the style was purchased (that is, the season and year the style was delivered), the number of units purchased, and the number of rentals ("turns") in each year of the style's life. The number of units is equal to the number of jackets even if you purchase more than one pair of pants for each jacket. Exclude styles purchased in 1986, 1987, and 1988. Make one entry for all "basic black" tuxedos purchased at a single date, regardless of slight differences in style. If you have purchased the same style at two different dates, report the purchases separately, only if you have information on the number of turns for each purchase. Treat the time between the purchase of the style and the end of your fiscal year as the first year of the style's life (even if the delivery took place late in the fiscal year). Every succeeding year should coincide with your fiscal year. **Before responding to this question, please refer to the example and the sample responses that are shown on the last two pages of this survey form.**

Style of Tuxedo	Season and Year of Purchase	Number of Units	Number of Turns						
			1st Year	2nd Year	3rd Year	4th Year	5th Year	6th Year	7th Year
1.									
2.									
3.									
4.									
5.									
6.									

Control No.:

Section III: Purchases and End of Year Stock of Tuxedos.

Question 7: Please enter the number of units and total cost of tuxedos purchased for each of the years listed below. The number of units is equal to the number of jackets even if you purchase more than one pair of pants for each jacket. (Number of units should be entered in units, so that 10 units would be entered as 10. Dollar amounts should be entered in dollars, so that $700.00 would be entered as 700.) Use the "total" columns only if you do not have separate information for "basic black" and "all other" tuxedos.

Year of Purchase	Basic Black		All Other		Total	
	Number of Units (units)	Total Cost of Units (dollars)	Number of Units (units)	Total Cost of Units (dollars)	Number of Units (units)	Total Cost of Units (dollars)
1981						
1982						
1983						
1984						
1985						
1986						
1987						

Question 8: Please enter the number of units and total cost of tuxedos in inventory at the end of the years listed below. Number of units is equal ot the number of jackets even if you purchase more than one pair of pants for each jacket. (Number of units should be entered in units, so that 10 units would be entered as 10. Dollar amounts should be entered in dollars, so that $700.00 would be entered as 700.) Use the "total" columns only if you do not have separate information for "basic black" and "all other" tuxedos.

Year of Inventory	Basic Black		All Other		Total	
	Number of Units (units)	Total Cost of Units (dollars)	Number of Units (units)	Total Cost of Units (dollars)	Number of Units (units)	Total Cost of Units (dollars)
1981						
1982						
1983						
1984						
1985						
1986						
1987						

Control No.:

Section IV: Additional Information

Question 9: If you prepare financial statements for stockholders, creditors, etc., what is the life and method you use to depreciate rental clothing for those statements?

Life (in months) _________

Method:

Double Declining Balance.......... [ ]

150% Declining Balance............ [ ]

Unit of Production...................... [ ]

Sum of Years Digits......... [ ]

Straight Line.................... [ ]

Other.............................. [ ]

If other, specify ____________________

Question 10: If your rental clothes have been financed, what is the average loan period?

Loan Period (in months) _________

Question 11: If you lease your rental clothes, what is the average term of your lease?

Lease Term (in months) _________

Control No.:

- 42 -

Example for Question 6

Question 6:

Starting with those styles purchased in 1981 (or for the earliest year after 1980 for which you have such information) and continuing until you have listed no more than 6 distinct styles, enter the style of tuxedo acquired, the season and year the style was purchased (that is, the season and year the style was delivered), the number of units purchased, and the number of rentals ("turns") in each year of the style's life. The number of units is equal to the number of jackets even if you purchase more than one pair of pants for each jacket. Exclude styles purchased in 1986, 1987, and 1988. Make one entry for all "basic black" tuxedos purchased at a single date, regardless of slight differences in style. If you have purchased the same style at two different dates, report the entries separately only if you have information on the number of turns for each purchase. Treat the time between the purchase of the style and the end of the fiscal year as the first year of a style's life (even if the delivery took place late in the fiscal year). Every succeeding year should coincide with your fiscal year.

Example:

Your fiscal year ends on January 31. In Spring, 1981 you purchased 100 Bill Blass Pearl Gray tuxedos, 80 After Six Gray Baron tuxedos, and 30 Basic Black tuxedos. In Fall, 1981 you purchased an additional 40 Basic Black tuxedos. Your records indicate the following history of rentals:

The **100 Bill Blass Pearl Gray** tuxedos purchased in the Spring of 1981:

Turned	**400**	times between the Spring of **1981** and January 31, **1982**.
Turned	**200**	times between February 1, **1982** and January 31, **1983**.
Turned	**100**	times between February 1, **1983** and January 31, **1984**.
Turned	**50**	times between February 1, **1984** and January 31, **1985**.
Turned	**5**	times between February 1, **1985** and January 31, **1986**.

The **80 After Six Gray Baron** tuxedos purchased in the Spring of 1981:

Turned	**320**	times between the Spring of **1981** and January 31, **1982**.
Turned	**80**	times between February 1, **1982** and January 31, **1983**.
Turned	**20**	times between February 1, **1983** and January 31, **1984**.
.Turned	**5**	times between February 1, **1984** and January 31, **1985**.

The **30 Basic Black** tuxedos purchased in the Spring of 1981:

Turned	**150**	times between the Spring of **1981** and January 31, **1982**.
Turned	**110**	times between February 1, **1982** and January 31, **1983**.
Turned	**90**	times between February 1, **1983** and January 31, **1984**.
Turned	**80**	times between February 1, **1984** and January 31, **1985**.
Turned	**70**	times between February 1, **1985** and January 31, **1986**.
Turned	**50**	times between February 1, **1986** and January 31, **1987**.

The **40 Basic Black** tuxedos purchased in the Fall of 1981:

Turned	**77**	times between the Fall of **1981** and January 31, **1982**.
Turned	**208**	times between February 1, **1982** and January 31, **1983**.
Turned	**165**	times between February 1, **1983** and January 31, **1984**.
Turned	**154**	times between February 1, **1984** and January 31, **1985**.
Turned	**123**	times between February 1, **1985** and January 31, **1986**.
Turned	**46**	times between February 1, **1986** and January 31, **1987**.

You would enter this information as shown on the sample form on the following page. Additional information for other purchases would be entered in the same way until no more than 6 entries were made.

Sample Question 6 With Responses For The Example Shown On The Previous Page

Question 6: Starting with those styles purchased in 1981 (or for the earliest year after 1980 for which you have such information) and continuing until you have listed no more than 6 distinct styles, enter the style of tuxedo acquired, the season and year the style was purchased (that is, the season and year the style was delivered), the number of units purchased, and the number of rentals ("turns") in each year of the style's life. The number of units is equal to the number of jackets even if you purchase more than one pair of pants for each jacket. Exclude styles purchased in 1986, 1987, and 1988. Make one entry for all "basic black" tuxedos purchased at a single date, regardless of slight differences in style. If you have purchased the same style at two different dates, report the purchases seprately only if you have information on the number of turns for each purchase. Treat the time between the purchase of a style and the end of the fiscal year as the first year of the style's life (even if the delivery took place late in your fiscal year). Every succeeding year should coincide with your fiscal year.

Style of Tuxedo	Season and Year of Purchase	Number of Units	Number of Turns						
			1st Year	2nd Year	3rd Year	4th Year	5th Year	6th Year	7th Year
1. Bill Blass Pearl Gray	Spring '81	100	400	200	100	50	5		
2. After Six Gray Baron	Spring '81	80	320	80	20	5			
3. Basic Black	Spring '81	30	150	110	90	80	70	50	
4. Basic Black	Fall '81	40	77	208	165	154	123	46	
5.									
6.									

DEPARTMENT OF THE TREASURY
WASHINGTON

October 19,1988

Dear Sir or Madam:

This notice is to inform you that the Treasury Department's Office of Tax Analysis has not yet received your response to the survey of depreciation of rental clothing that was sent to you last month. It is important that you respond to this survey in order that estimates of the depreciation of rental clothing be as accurate as possible. The International Formal Wear Association has endorsed this survey, and encourages your response.

Enclosed is another copy of the survey material, including a cover letter which provides additional information regarding this survey. **Please return the completed form before November 21, 1988.** If you have any questions regarding the survey, please call the individuals listed in the cover letter.

If your survey form was mailed within the past several days, we thank you, and ask that you disregard this notice.

Sincerely,

Lowell Dworin

Lowell Dworin
Director for Depreciation Analysis
Office of Tax Analysis

Enclosures

Appendix C. Technical Issues in the Application of the Productivity Method

In this appendix, an algebraic framework for estimating the equivalent economic life for tuxedos from productivity data is developed, and several technical issues are discussed. The technical issues discussed include: the choice of weighting factors to be used to obtain a single average life measure from the information obtained for each individual style of tuxedo; the utilization of the information collected on the period within the first year during which each style of tuxedo is available for service; the actual timing of the depreciation tax benefits; and the implications of using the Alternative Depreciation System, with its required half-year convention, as the standard against which the equivalent economic life is measured.

Section 1. Weighting the Results for the Different Styles

As noted in Table 7, when the initial value-in-use per tuxedo for each style of tuxedo for which turns data have been obtained is examined, it is found that these individual values differ. Under the standard assumption of investment analysis, the expected value-in-use per tuxedo should equal the cost per tuxedo. If the calculated value-in-use differs from the true value-in-use by the same factor for each style, the coefficient of variation of the calculated values-in-use per tuxedo would be comparable to the coefficient of variation observed for the cost of tuxedos. These coefficients of variation are noted in Table 7, and it is seen that the two values are not comparable.[14] The disparity between the coefficient of variation for the cost per tuxedo (about 13%) and that for the initial value-in-use per tuxedo (about 62%) may be explained in several ways.

First, the measured value-in-use per tuxedo for a given style may be in error. In particular, although the profitability of any style may be directly related to the number of times that style "turns", not all firms may charge the same rental fee, or incur the same operating costs, or benefit from the same level of imputed managerial services. If the constant of proportionality linking the net income generated by a style to the number of times it is rented is not likely to be the same for each style, and cannot be adequately measured, it is useful to reduce the importance of these factors by normalizing the calculated value-in-use per tuxedo for each style. More specifically, by dividing the calculated value-in-use per tuxedo at each age by its initial value, a pattern of economic decline which is independent of the proportionality factors may be obtained. Since the normalized values-in-use per tuxedo no longer reflect the relative importance of the various styles to the industry, it is appropriate to weight the present value of the decline in the normalized value-in-use for each style by the cost of the tuxedos acquired (i.e., the product of the cost per tuxedo for the style and the number of tuxedos in the style).

[14] The cost of tuxedos was obtained from the manufacturers of tuxedos, rather than from the survey respondents, and converted to constant dollars.

Table 7. Sample Statistics for Value-In-Use Per Tuxedo and Cost Per Tuxedo, for the Total, Initial, and Additional Samples and for Fashion and Basic Black Styles

Value-In-Use Per Tuxedo (Measured by Turns/Tuxedos)	Mean	Variance	Coefficient of Variation (Percent)
Total Sample of 199 Styles (from 307 firms)	19	141	62
Initial Sample of 157 Styles (from 240 firms)	20	156	62
Additional Sample of 42 Styles (from 67 firms)	15	59	53
Basic Black Tuxedos (25 styles)	28	159	44
Fashion Tuxedos (174 styles)	17	125	63
Cost Per Tuxedo (In Dollars)	**Mean**	**Variance**	**Coefficient of Variation (Percent)**
Total Sample of 199 Styles (from 307 firms)	113	211	13
Initial Sample of 157 Styles (from 240 firms)	113	207	13
Additional Sample of 42 Styles (from 67 firms)	109	216	13
Basic Black Tuxedos (25 styles)	118	344	16
Fashion Tuxedos (174 styles)	112	188	12

Second, the measured value-in-use may differ from the true value by a constant which is the same for all styles, but the variance in value-in-use per tuxedo may be attributable to random differences in demand for the individual styles. That is, although the anticipated demand for tuxedos may be nearly the same for all styles (as reflected in the relatively low coefficient of variance for the cost of tuxedos), the actual demand for tuxedos of different styles may be quite different. Some styles may prove to be "winners", while others may be "losers", but the winning styles may not be easily distinguished from the losers at the time the orders are placed. If this feature is the source of the disparity, the observed disparities in value-in-use per tuxedo convey useful information. If, it is assumed that the turns data contain a representative sample of "winners" and "losers", and that this distribution of winners and losers is stable over time, the average decline in economic value may in this case more properly be obtained by simply averaging these realized values. By not normalizing the values-in-use per tuxedo, but by simply aggregating the turns data (as in chapter 4), the individual styles are effectively weighted by their initial value-in-use.

From the coefficients of variation shown in Table 7, it is seen that the dispersion in initial value-in-use per tuxedo is somewhat less for basic black tuxedos (where the distinction between "winners" and "losers" may be expected to be much less pronounced) than for fashion tuxedos. However, it is still much greater than the dispersion in the cost per tuxedo. This suggests that both sources of dispersion are present. Both weighting methods have thus been used, leading to the results shown in Table 6 (these results will be discussed more fully in the following section). As shown in Table 6, the fully adjusted equivalent economic lives are not very different: 1.9 years when the average decline in economic value is based on the decline in the normalized value-in-use per tuxedo weighted by the cost of the tuxedos, and 2.1 years when the average decline in economic value is based on the decline in value-in-use per tuxedo weighted by the initial value-in-use.

Section 2. The Algebra of the Class Life Estimate Using Turns Data Based on Delivery Dates

The starting point for estimating the class life for tuxedos by the productivity method is the turns data provided by the respondents to the survey questionnaire. In the analysis of Chapter 4, it was assumed that all tuxedos are equivalent, are placed in service at the beginning of the year, and all cash flows and depreciation deductions are recognized at the end of the year. In this section, the analysis will be revised to take account of the actual timing of these events and, as discussed in the previous section, to more properly combine the results for the individual styles into a single measure of the class life of tuxedos. The turns data for the first year of the style's life reflects the availability for rental for the period from the date of delivery of the style to the end of the firm's fiscal year. (The distribution of fiscal year ends are noted in Chapter 3.) The Depreciation Analysis Division was informed by industry representatives that most deliveries of fashion tuxedos are made in the spring in time for the wedding and prom season, while deliveries of basic black tuxedos may be made at any time of the year. It was anticipated that turns for the first year of the style's life might reflect the differing period of their availability during the first year, and therefore the survey respondents were asked to indicate the season of purchase for each style of tuxedo for which turns data was provided. To adjust for the fact that each style of tuxedo may be placed in service earlier or later in the acquiring firm's fiscal year, it is assumed that the first year's cash flow generated by the rental of the tuxedos is received in the middle of theperiod between the date of delivery and the end of the firm's fiscal year, whereas all future years' cash flows are assumed received in the middle of the fiscal year.[15] Likewise, the initial value-in-use is calculated with respect to the date the style is delivered, while the values-in-use for all subsequent years are calculated with respect to the beginning of the year. Therefore, in calculating the present value of the decline in the value-in-use (i.e., the present value of economic depreciation), the initial decline in value-in-use covers the period between the date of delivery and the end of the fiscal year, whereas all subsequent year's differences are for a full fiscal year. Algebraically, the discounted present value of the future cash flow taken to be directly proportional to the number of remaining turns for each style:

$$(1) \quad PV(t)_j = \sum_{a=t}^{T-1} \frac{N_j(a+1)}{(1+r)^{(a+L_j(t)G(a)-M(a))}} \quad , \qquad (t = 1, T-1)$$

where Nj(a+1) is the number of turns reported for style j in year a+1, T is the last year for which any turns are reported for this style, r is the discount rate, Lj(t) equals the period between the date of delivery and the end of the fiscal year for style j (expressed in fractions of a year) for t=0 and equals -(t-1) otherwise, G(a) = 1/2 for a = 0 and equals 1 otherwise, and M(a) = 0 for a = 0 and equals 1/2 otherwise.

The present value is calculated using an interest rate of four percent, which represents an estimate of the real rate of interest facing the formal wear rental industry. A real, rather than nominal, rate of interest is used because the turns data represent physical quantities of output which are not affected by overall changes in prices. Although in principle the real rate of interest used in equation (1) can have an impact on the calculated equivalent economic life, because most of the service provided by tuxedos occurs in the first few years, the choice of a real interest rate has very little impact.[16]

It is initially assumed that the disparities in the measured value-in-use per tuxedo are due to measurement error (i.e., the presence of different, and inadequately measured, constants of proportionality for each style). The calculated value-in-use per tuxedo for each style is thus normalized such that the initial value-in-use per tuxedo equals unity:

[15] The specific delivery date is assumed to be the middle of the quarter (season) in which delivery is made.

[16] Changing the discount rate from 4 percent to 8 percent reduces the resulting class life by 0.1 years.

(2) $$NPV_j(t) = \frac{PV(t)_j}{PV(0)_j} \quad ,$$

where NPVj(t) is the normalized present value in year t of the assets life. Economic depreciation for style j in year t, Dj(t), is calculated as the difference between consecutive normalized present values:

(3) $$D_j(t+1) = NPV_j(t) - NPV_j(t+1) \quad ,$$

where it should be noted that Dj(1) generally represents only a partial year's depreciation.

The depreciation flow is then discounted (also at a 4 percent real rate) to obtain PVDj, the present value of economic depreciation for style j:

(4) $$PVD_j = \sum_{a=0}^{T-1} \frac{D_j(a+1)}{(1+r)^{(a+L_j(0)G(a)-M(a))}} \quad .$$

The real interest rate r chosen to discount the calculated economic depreciation has even less impact on the resulting class life than does the rate used in equation (1), since the same real rate of interest is used (in equations (7) and (8)) to determine the present value of the straight-line depreciation from which the class life may be inferred. For any reasonable real rate of interest, the actual rate used has very little impact on the calculated class life.

The present values of depreciation for each style of tuxedo are then averaged to obtain a present value of economic depreciation for the entire sample using as weights CSj, the cost of tuxedos of style j (which in turn is equal to the product of the number of tuxedos of style j and the cost per tuxedo for style j):

(5) $$AVGPVD = \sum_{J=1}^{N} CS_j \frac{PVD_j}{CTOT} \quad ,$$

where

(6) $$CTOT = \sum_{j=1}^{N} CS_j \quad .$$

Section 3. Translating Economic Depreciation Into Equivalent Economic Lives

The General Explanation provides a formula for translating economic depreciation as obtained from resale data into a class life. In general, the translation consists of determining that period L such that the discounted present value of economic depreciation (per dollar of investment) equals the discounted present value of straight-line depreciation over period L. This period is the specified class life (which, in order to indicate that it is only one of the measures of depreciation which we have examined, is referred to in this report as the equivalent economic life).

While it may be assumed that Congress intended this formula to be used to translate economic depreciation into equivalent economic lives even when economic depreciation is inferred, as in the productivity method, rather than obtained from direct examination of the decline in resale prices, the application of this formula requires more detailed specification. Treasury believes that it was the intent of Congress in proposing this formula that a taxpayer using the Alternative Depreciation System (ADS), which requires the use of a straight-line method of depreciation, obtain the same present value of depreciation allowances that he would obtain if economic depreciation were allowed for tax purposes. The present value of economic depreciation (discounted to the date the asset is placed in service) is thus to be equated to the discounted present value (discounted to the same date) of straight line depreciation over the class life, using the required ADS half-year convention, and taking note of the actual realization of benefits resulting from depreciation deductions. For a calendar-year taxpayer who anticipates the acquisition of the tuxedos, and earns sufficient income from operations during the year to take full advantage of the depreciation deductions, the benefits of these deductions are realized by the taxpayer on average (through their effect on estimated tax payments) on August 9 of each year.

Thus, the initial year's straight-line allowance will be taken to be one-half of a full year's allowance and will be discounted for the portion of the year between the date of delivery and August 9. This implies the following equation for the class life L:

(7)
$$L = \frac{\dfrac{1-(1/(1+r)^{Y-1})}{r} + \dfrac{1}{2} + \dfrac{0.5+X}{(1+r)^{(Y)}}}{AVGPVD} ,$$

if X<1/2, and

(8)
$$L = \frac{\dfrac{1-(1/(1+r)^{Y})}{r} + \dfrac{1}{2} + \dfrac{X-0.5}{(1+r)^{(Y+1)}}}{AVGPVD} ,$$

if X>1/2, where Y is the integer part of the equivalent economic life and X is the decimal part (L=Y+X). The resulting class life (1.9 years) is noted in Table 6. Also noted in Table 6 is the equivalent economic life calculated from equations (7) or (8), without the adjustments for delivery date and realization of tax benefits. The fact that this equivalent economic life is approximately one-half year shorter than the equivalent economic life obtained in Chapter 4 may be attributed to the use of the half-year convention required under the Alternative Depreciation System.

The cost of each style was used in the above calculation on the premise that the calculated differences in value-in-use per tuxedo reflect measurement error. If it is instead assumed that measurement error is not present, so that the observed differences represent useful information on the ex-post demand factors for each style of tuxedo, the average present value of economic depreciation should be obtained from the decline in the aggregate value-in-use per tuxedo for all styles. Substituting this average present value (AVGPVD) into equation (8) yields an equivalent economic life (as noted in Table 6) of 3.3 years without the adjustments for the half-year convention and delivery date, and 2.1 years with those adjustments.

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FOR IMMEDIATE RELEASE

August 21, 1989

FEDERAL FINANCING BANK ACTIVITY

Charles D. Haworth, Secretary, Federal Financing Bank (FFB), announced the following activity for the month of July 1989.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $138.8 billion on July 31, 1989, posting a decrease of $753.4 million from the level on June 30, 1989. This net change was the result of an increase in holdings of agency debt of $25.9 million, and decreases in holdings of agency assets of $685.9 million and in agency-guaranteed debt of $93.5 million. FFB made 34 disbursements during July.

Attached to this release are tables presenting FFB July loan activity and FFB holdings as of July 31, 1989.

NB-427

FEDERAL FINANCING BANK

JULY 1989 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
AGENCY DEBT					
NATIONAL CREDIT UNION ADMINISTRATION					
Central Liquidity Facility					
+Note #496	7/5	$ 1,000,000.00	10/3/89	8.351%	
+Note #497	7/5	2,300,000.00	10/3/89	8.351%	
+Note #498	7/11	18,060,000.00	10/10/89	8.121%	
TENNESSEE VALLEY AUTHORITY					
Advance #1050	7/5	282,000,000.00	7/10/89	8.361%	
Advance #1051	7/7	318,000,000.00	7/12/89	8.159%	
Advance #1052	7/10	292,000,000.00	7/17/89	8.112%	
Advance #1053	7/12	309,000,000.00	7/19/89	8.150%	
Advance #1054	7/17	7,000,000.00	7/20/89	8.227%	
Advance #1055	7/17	24,000,000.00	7/21/89	8.227%	
Advance #1056	7/17	226,000,000.00	7/24/89	8.227%	
Advance #1057	7/19	301,000,000.00	7/26/89	8.308%	
Advance #1058	7/24	179,000,000.00	7/31/89	8.523%	
Advance #1059	7/26	58,000,000.00	8/1/89	8.435%	
Advance #1060	7/26	226,000,000.00	8/4/89	8.435%	
Advance #1061	7/28	16,000,000.00	8/4/89	8.296%	
Advance #1062	7/31	100,000,000.00	8/4/89	8.248%	
Advance #1063	7/31	237,000,000.00	8/7/89	8.248%	
GOVERNMENT - GUARANTEED LOANS					
DEPARTMENT OF DEFENSE					
Foreign Military Sales					
Greece 17	7/19	5,905,692.81	2/25/14	8.291%	
Morocco 13	7/19	158,213.49	5/31/95	8.124%	
Philippines 11	7/20	443.20	9/12/90	8.055%	
Greece 16	7/27	2,193,472.56	9/3/13	8.224%	
Morocco 13	7/27	324,673.97	5/31/95	7.967%	
Greece 17	7/31	1,425,565.71	2/25/14	8.105%	
DEPARTMENT OF HOUSING & URBAN DEVELOPMENT					
Community Development					
*Niagara Falls, NY	7/3	4,223,077.00	7/3/95	8.178%	8.345% ann.

+rollover
*maturity extension

FEDERAL FINANCING BANK

JULY 1989 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
RURAL ELECTRIFICATION ADMINISTRATION					
*Wabash Valley Power #206	7/3	$ 10,571,000.00	1/2/18	8.191%	8.109% qtr.
Arizona Electric #242	7/5	3,300,000.00	12/31/20	8.200%	8.118% qtr.
Oglethorpe Power #320	7/6	3,017,000.00	9/30/91	8.108%	8.027% qtr.
Alabama Electric #287	7/7	5,868,000.00	12/31/15	8.209%	8.126% qtr.
*Colorado-Ute Electric #168A	7/13	130,295.00	12/31/15	8.125%	8.044% qtr.
*Wabash Valley Power #206	7/13	8,665,000.00	1/2/18	8.139%	8.058% qtr.
Central Iowa Power #295	7/17	4,975,000.00	1/2/18	8.189%	8.107% qtr.
Oglethorpe Power #246	7/21	1,022,000.00	1/2/24	8.217%	8.134% qtr.
Corn Belt Power Coop. #292	7/24	2,009,000.00	1/2/18	8.218%	8.135% qtr.
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
Note A-89-10	7/31	658,992,783.91	10/31/89	8.282%	

*maturity extension

FEDERAL FINANCING BANK HOLDINGS
(in millions)

Program	July 31, 1989	June 30, 1989	Net Change 7/1/89-7/31/89	FY '89 Net Change 10/1/88-7/31/89
Agency Debt:				
Export-Import Bank	$ 11,007.6	$ 11,007.6	$ 0.0	$ 50.0
NCUA-Central Liquidity Facility	117.9	114.0	3.9	-0.2
Tennessee Valley Authority	17,362.0	17,340.0	22.0	231.0
U.S. Postal Service	6,195.0	6,195.0	-0-	602.8
sub-total*	34,682.6	34,656.6	25.9	883.6
Agency Assets:				
Farmers Home Administration	54,911.0	55,586.0	-675.0	-3,585.0
DHHS-Health Maintenance Org.	74.7	79.5	-4.8	-4.8
DHHS-Medical Facilities	88.1	93.8	-5.8	-8.3
Overseas Private Investment Corp.	-0-	-0-	-0-	-0-
Rural Electrification Admin.-CBO	4,076.0	4,076.0	-0-	-63.2
Small Business Administration	12.2	12.4	-0.3	-3.2
sub-total*	59,162.0	59,847.8	-685.9	-3,664.5
Government-Guaranteed Lending:				
DOD-Foreign Military Sales	11,472.4	11,552.3	-79.9	-4,539.3
DEd.-Student Loan Marketing Assn.	4,910.0	4,910.0	-0-	-0-
DOE-Geothermal Loan Guarantees	-0-	-0-	-0-	-50.0
DHUD-Community Dev. Block Grant	306.3	308.9	-2.6	-11.8
DHUD-New Communities	-0-	-0-	-0-	-0-
DHUD-Public Housing Notes +	1,995.3	1,995.3	-0-	-41.7
General Services Administration +	378.1	381.1	-0-	-9.4
DOI-Guam Power Authority	31.5	31.5	-0-	-0.6
DOI-Virgin Islands	25.9	25.9	-0-	-0.6
NASA-Space Communications Co. +	995.2	995.2	-0-	96.4
DON-Ship Lease Financing	1,720.5	1,720.5	-0-	-38.3
Rural Electrification Administration	19,256.6	19,236.4	20.2	51.3
SBA-Small Business Investment Cos.	574.5	582.2	-7.7	-58.2
SBA-State/Local Development Cos.	830.9	833.7	-2.8	-40.0
TVA-Seven States Energy Corp.	2,258.0	2,278.7	-20.7	95.6
DOT-Section 511	37.5	37.5	-0-	-8.7
DOT-WMATA	177.0	177.0	-0-	-0-
sub-total*	44,969.8	45,063.3	-93.5	-4,555.3
grand total*	$ 138,814.3	$ 139,567.7	$ -753.4	$ -7,336.2

*figures may not total due to rounding
+does not include capitalized interest

TREASURY NEWS

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

CONTACT: Office of Financing
202/ 376-4350

FOR IMMEDIATE RELEASE
August 21, 1989

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,202 million of 13-week bills and for $7,209 million of 26-week bills, both to be issued on August 24, 1989, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing November 24, 1989			:	26-week bills maturing February 22, 1990		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.93%a/	8.21%	97.973	:	7.83%	8.26%	96.042
High	8.00%	8.28%	97.956	:	7.86%	8.30%	96.026
Average	7.99%	8.27%	97.958	:	7.85%	8.29%	96.031

a/ Excepting 1 tender of $1,650,000.

Tenders at the high discount rate for the 13-week bills were allotted 98%.
Tenders at the high discount rate for the 26-week bills were allotted 86%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 32,265	$ 32,265	:	$ 30,605	$ 30,605
New York	18,688,020	5,989,520	:	21,171,710	5,978,885
Philadelphia	20,555	20,555	:	17,025	16,745
Cleveland	34,110	34,110	:	32,425	32,425
Richmond	45,335	45,335	:	46,695	46,695
Atlanta	31,230	31,230	:	33,790	33,090
Chicago	1,259,710	232,710	:	1,009,625	172,625
St. Louis	19,345	19,345	:	20,955	20,955
Minneapolis	6,350	6,250	:	8,345	8,345
Kansas City	37,440	37,440	:	38,140	38,095
Dallas	34,815	24,815	:	25,230	15,230
San Francisco	972,445	216,445	:	984,010	213,410
Treasury	512,075	512,075	:	601,830	601,830
TOTALS	$21,693,695	$7,202,095	:	$24.020,385	$7,208,935
Type					
Competitive	$18,381,020	$3,889,420	:	$19,827,045	$3,015,595
Noncompetitive	1,161,290	1,161,290	:	1,151,040	1,151,040
Subtotal, Public	$19,542,310	$5,050,710	:	$20,978,085	$4,166,635
Federal Reserve	2,100,985	2,100,985	:	2,075,000	2,075,000
Foreign Official Institutions	50,400	50,400	:	967,300	967,300
TOTALS	$21,693,695	$7,202,095	:	$24,020,385	$7,208,935

1/ Equivalent coupon-issue yield.

NB-428

TREASURY NEWS

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

ROOM 5310

FOR IMMEDIATE RELEASE
August 22, 1989

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $9,501 million of $24,016 million of tenders received from the public for the 2-year notes, Series AD-1991, auctioned today. The notes will be issued August 31, 1989, and mature August 31, 1991.

The interest rate on the notes will be 8-1/4%. The range of accepted competitive bids, and the corresponding prices at the 8-1/4% rate are as follows:

	Yield	Price
Low	8.35%	99.819
High	8.38%	99.765
Average	8.37%	99.783

Tenders at the high yield were allotted 46%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 37,250	$ 37,250
New York	20,993,600	8,110,400
Philadelphia	30,815	30,815
Cleveland	77,720	77,720
Richmond	79,610	70,970
Atlanta	38,615	35,915
Chicago	1,501,410	406,510
St. Louis	78,930	62,930
Minneapolis	38,420	38,150
Kansas City	88,570	88,570
Dallas	28,455	18,455
San Francisco	797,030	298,325
Treasury	225,225	225,225
Totals	$24,015,650	$9,501,235

The $9,501 million of accepted tenders includes $1,033 million of noncompetitive tenders and $8,468 million of competitive tenders from the public.

In addition to the $9,501 million of tenders accepted in the auction process, $650 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $892 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-429

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.
August 22, 1989

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 August 31, 1989. This offering will provide about $500 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,904 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, August 28, 1989. 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 June 1, 1989, and to mature November 30, 1989 (CUSIP No. 912794 TF 1), currently outstanding in the amount of $6,421 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,200 million, to be dated August 31, 1989, and to mature March 1, 1990 (CUSIP No. 912794 TT 1).

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 August 31, 1989. In addition to the maturing 13-week and 26-week bills, there are $9,211 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 $3,364 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $3,644 million as agents for foreign and international monetary authorities, and $6,660 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-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 one-half hour prior to the closing time for receipt of tenders 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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.

10/87

TREASURY NEWS

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

FOR IMMEDIATE RELEASE ROOM 5310 CONTACT: Office of Financing
August 23, 1989 202/376-4350

RESULTS OF AUCTION OF 5-YEAR 2-MONTH NOTES

The Department of the Treasury has accepted $7,800 million of $26,150 million of tenders received from the public for the 5-year 2-month notes, Series L-1994, auctioned today. The notes will be issued September 1, 1989, and mature November 15, 1994.

The interest rate on the notes will be 8-1/4%. The range of accepted competitive bids, and the corresponding prices at the 8-1/4% rate are as follows:

	Yield	Price
Low	8.24%	99.976
High	8.26%	99.893
Average	8.26%	99.893

Tenders at the high yield were allotted 60%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 16,739	$ 16,739
New York	24,112,377	7,462,777
Philadelphia	6,776	6,776
Cleveland	20,797	20,797
Richmond	168,983	46,983
Atlanta	9,713	9,713
Chicago	897,435	150,435
St. Louis	37,257	20,257
Minneapolis	23,192	8,192
Kansas City	18,841	18,841
Dallas	12,220	8,020
San Francisco	824,292	29,292
Treasury	945	945
Totals	$26,149,567	$7,799,767

The $7,800 million of accepted tenders includes $341 million of noncompetitive tenders and $7,459 million of competitive tenders from the public.

In addition to the $7,800 million of tenders accepted in the auction process, $450 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities.

NB-431

THE SECRETARY OF THE TREASURY
WASHINGTON

August 23, 1989

GUEST COLUMN BY
NICHOLAS F. BRADY

One of the best ways to preserve America's economic leadership and our standard of living is to create incentives for investment in the long-term productive capacity of American industry and increase the national rate of savings.

If we can do that, we'll lower the cost of capital in the U.S. and make ourselves more successful in the increasingly competitive international marketplace. That means more jobs and better living standards for Americans.

Before leaving for the August Congressional recess, members of both parties were giving serious consideration to President Bush's call for a lower tax rate for capital gains as a way to lower the cost of capital, make American firms more competitive internationally, and create new job opportunities.

Capital gains is a bipartisan issue because of one fundamental fact: reduced capital gains taxation benefits the entire nation, and therefore all Americans.

Unfortunately, since the enactment of the Tax Reform Act of 1986, the United States has taxed capital gains at the same rate as other income -- the first time we have done so in more than half a century. With powerful competitors emerging abroad, this is not a good time to disadvantage Americans internationally by saddling them with high capital costs.

Taxes are an essential component of capital costs, and the cost of capital for new plant and equipment, as well as working capital, is important to any nation's ability to compete in world markets. Today, the United States is burdened with a higher capital gains tax than almost all our industrialized country competitors.

By lowering our capital gains tax rate, we can see our capital resources put to more efficient use, increasing our nation's productivity -- the key to our competitive position in the world economy.

A lower capital gains tax rate also helps small businesses, which create most of our new jobs. Because new ventures often have difficulty raising start-up capital, lower rates can create incentives for the kind of risk-taking that can keep America in the lead with the emerging technologies of the 21st century. New ideas and new businesses keep the economy vibrant and growing.

Some have expressed the concern that we can't afford a tax cut in this era of tight budgets. But the capital gains proposal is fiscally responsible. In fact, the Treasury estimates that a lower capital gains rate proposed by the President would raise revenue both now and in the long run, based on estimates of additional taxes paid because the lower rates encourage the turnover of investment assets. If the dynamic feedback effects of a growing economy were to be considered, the capital gains proposal would show even higher revenue increases.

Others have expressed the concern that the capital gains proposal is a tax cut for the rich. In fact, 44 percent of the capital gains are reported by people whose other income is less than $50,000. More to the point, lowering the cost of capital will benefit all Americans by making our economy stronger and more competitive, and creating new and better job opportunities.

The underlying issue in the capital gains debate is the fundamental problem of how we will preserve and improve our standard of living. How we will increase the rate of national saving and investment. How we will encourage Americans to take the long-term view in their economic thinking. And how we will improve our international competitiveness.

Jobs and opportunity are the most important results of a lower tax rate for capital gains. A new factory built, a new medical cure, better quality products at lower prices -- that's what the President's capital gains proposal is all about. When the Congress returns in September to consider this issue, we hope there will be a bipartisan majority for this important investment in America's future.

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

 CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
August 24, 1989

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $9,264 million of 52-week bills to be issued August 31, 1989, and to mature August 30, 1990, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	7.67%	8.26%	92.245
High -	7.69%	8.28%	92.225
Average -	7.68%	8.27%	92.235

Tenders at the high discount rate were allotted 27%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 16,520	$ 16,270
New York	24,878,750	8,760,250
Philadelphia	11,290	11,290
Cleveland	18,635	18,625
Richmond	23,115	23,115
Atlanta	13,410	13,410
Chicago	1,516,140	118,890
St. Louis	19,270	15,270
Minneapolis	10,285	10,285
Kansas City	29,515	27,515
Dallas	18,005	8,005
San Francisco	778,340	28,340
Treasury	212,565	212,565
TOTALS	$27,545,840	$9,263,830
Type		
Competitive	$24,130,760	$5,848,750
Noncompetitive	535,080	535,080
Subtotal, Public	$24,665,840	$6,383,830
Federal Reserve	2,600,000	2,600,000
Foreign Official Institutions	280,000	280,000
TOTALS	$27,545,840	$9,263,830

An additional $10,000 thousand of the bills will be issued to foreign official institutions for new cash.

NB-432

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

FOR IMMEDIATE RELEASE
August 28, 1989

CONTACT: LARRY BATDORF
(202) 566-2041

NEW INCOME TAX CONVENTION SIGNED WITH THE FEDERAL REPUBLIC OF GERMANY

The Treasury Department announced today the signing of a proposed new Income Tax Convention and accompanying Protocol ("the treaty") between the United States and the Federal Republic of Germany. The proposed treaty was signed in Bonn on August 29, 1989 by Ambassador Vernon Walters, for the United States; and Dr. Theo Waigel, Minister of Finance, and Dr. Hans-Werner Lautenschlager, State Secretary of the Foreign Office, for the Federal Republic of Germany. The proposed treaty will be submitted to the Senate for its advice and consent to ratification. Following ratification by both countries, the treaty will enter into force upon the exchange of instruments of ratification. In general, it will have effect as of January 1, 1990, although different effective dates are provided for certain provisions. The proposed treaty will replace the treaty currently in force which was signed in 1954, and was last amended in 1965.

The proposed treaty will make several significant changes in the taxation of income flowing between the United States and Germany. The rate of tax withheld at source on dividends paid by a subsidiary corporation in one country to its parent in the other will drop from the 15 percent rate applicable under the present treaty to 10 percent for dividends paid or credited between January 1, 1990 and December 31, 1991. For dividends paid or credited on or after January 1, 1992, the rate of withholding tax will become 5 percent. While the general rate of tax at source on portfolio dividends will remain at 15 percent, as a result of a special rule applicable to such dividends paid to U.S. shareholders by German corporations, the effective German rate will be reduced to 10 percent effective for dividends paid on or after January 1, 1990. The proposed treaty will retain the exemption at source in the present treaty for interest and royalties. The proposed treaty provides for the imposition of the U.S. branch profits tax, beginning in 1991, at a rate of 5 percent. Rules are provided in the treaty to limit the treaty's benefits to "non-treaty shoppers".

Copies of the proposed treaty are available from the Treasury's Office of Public Affairs, Room 2315, Treasury Department, Washington, D.C. 20220, telephone (202) 566-2041.

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NB-433

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

FOR IMMEDIATE RELEASE
August 28, 1989

CONTACT: Larry Batdorf
(202)566-2041

United States and Dominican Republic
Sign Agreement to Exchange Tax Information

The Treasury Department announced today that the United States and the Dominican Republic signed on August 7, 1989, an agreement to exchange tax information (the "Agreement") that satisfies the criteria set forth in the Caribbean Basin Economic Recovery Act of 1983. The Agreement will enter into force when the Dominican Republic legislature ratifies the Agreement.

Currently, similar agreements to exchange tax information are in effect with Jamaica, Barbados, Grenada, Dominica, and Bermuda. In addition, the United States signed agreements to exchange tax information with St. Lucia (January 30, 1987), Trinidad and Tobago (January 11, 1989) and Costa Rica (March 15, 1989). The agreements, however, are not in effect yet and will be effective when respective governments enact legislation that would bring the agreements in conformity with the criteria set forth in the Caribbean Basin Economic Recovery Act of 1983.

Copies of the Agreement are available from the Treasury Public Affairs Office, Treasury Department, Room 2315, Washington, D.C. 20220.

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NB-434

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
August 28, 1989

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,233 million of 13-week bills and for $7,201 million of 26-week bills, both to be issued on August 31, 1989, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing November 30, 1989			26-week bills maturing March 1, 1990		
	Discount Rate	Investment Rate 1/	Price	Discount Rate	Investment Rate 1/	Price
Low	7.92%	8.19%	97.998	7.86%	8.30%	96.026
High	7.94%	8.21%	97.993	7.90%	8.34%	96.006
Average	7.94%	8.21%	97.993	7.88%	8.32%	96.016

Tenders at the high discount rate for the 13-week bills were allotted 58%.
Tenders at the high discount rate for the 26-week bills were allotted 6%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	Received	Accepted
Boston	$ 34,375	$ 34,375	$ 33,945	$ 33,945
New York	19,018,845	5,973,575	18,643,415	5,964,015
Philadelphia	18,890	18,890	23,630	23,630
Cleveland	35,430	35,430	45,505	45,505
Richmond	44,675	44,675	43,310	43,310
Atlanta	32,440	32,440	34,870	34,870
Chicago	1,748,210	351,195	1,308,290	137,790
St. Louis	46,675	25,835	36,705	30,705
Minneapolis	4,680	4,680	17,795	17,795
Kansas City	40,875	40,035	49,325	49,325
Dallas	21,475	21,475	17,205	17,205
San Francisco	693,035	114,035	661,180	257,180
Treasury	536,165	536,165	546,135	546,135
TOTALS	$22,275,770	$7,232,805	$21,461,310	$7,201,410
Type				
Competitive	$18,922,165	$3,879,200	$16,089,160	$1,829,260
Noncompetitive	1,209,405	1,209,405	1,130,850	1,130,850
Subtotal, Public	$20,131,570	$5,088,605	$17,220,010	$2,960,110
Federal Reserve	2,060,400	2,060,400	2,000,000	2,000,000
Foreign Official Institutions	83,800	83,800	2,241,300	2,241,300
TOTALS	$22,275,770	$7,232,805	$21,461,310	$7,201,410

1/ Equivalent coupon-issue yield.

NB-435

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

5310

FOR RELEASE AT 4:00 P.M.
August 29, 1989

CONTACT: Office of Financing
202/376-4350

TREASURY DISCONTINUES USE OF TT&L ACCOUNTS
FOR SECURITIES PAYMENTS

The Department of the Treasury announced today that payment for Treasury securities by credit to Treasury Tax and Loan Note Accounts will no longer be accepted effective Thursday, September 7, 1989.

Effective September 7, settlement for accepted tenders for all Treasury marketable securities 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, maturing Treasury securities, or funds immediately available to the Treasury. Full payment must accompany all tenders for securities to be maintained on the book-entry records of the Treasury Department (TREASURY DIRECT).

Payment by credit to Treasury Tax and Loan Note Accounts will be accepted for the 13-, 26-, and 52-week bills and the 2-year notes to be issued Thursday, August 31, 1989; the 5-year 2-month notes to be issued Friday, September 1, 1989; and the 8-day cash management bills to be issued Wednesday, September 6, 1989.

Effective October 1, 1989, payment for United States Savings Bonds by credit to Treasury Tax and Loan Note Accounts will no longer be accepted. Payment for U. S. Savings Bonds by credit to Treasury Tax and Loan Note Accounts will be accepted through September 30, 1989.

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NB-436

TREASURY NEWS

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

3310

FOR RELEASE AT 4:00 P.M.
August 29, 1989

CONTACT: Office of Financing
202/376-4350

TREASURY OFFERS $4,000 MILLION
OF 8-DAY CASH MANAGEMENT BILLS

The Department of the Treasury, by this public notice, invites tenders for approximately $4,000 million of 8-day Treasury bills to be issued September 6, 1989, representing an additional amount of bills dated March 16, 1989, maturing September 14, 1989 (CUSIP No. 912794 SX 3).

Competitive tenders will be received at all Federal Reserve Banks and Branches prior to 1:00 p.m., Eastern Daylight Saving time, Thursday, August 31, 1989. 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 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, September 6, 1989. 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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

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 566-2041

FOR RELEASE AT 4:00 P.M.
August 29, 1989

CONTACT: Office of Financing
202/376-4350

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 September 7, 1989. This offering will provide about $350 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $14,058 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, prior to 1:00 p.m., Eastern Daylight Saving time, Tuesday, September 5, 1989. 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 June 8, 1989, and to mature December 7, 1989 (CUSIP No. 912794 TG 9), currently outstanding in the amount of $6,561 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,200 million, to be dated September 7, 1989, and to mature March 8, 1990 (CUSIP No. 912794 TU 8).

In a separate announcement made today the Treasury announced that payment for Treasury securities by credit to Treasury Tax and Loan Note Accounts will no longer be accepted. This change becomes effective with the weekly Treasury bills being offered in this announcement.

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 September 7, 1989. 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 $1,458 million as agents for foreign and international monetary authorities, and $4,482 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

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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 one-half hour prior to the closing time for receipt of tenders 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.

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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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.

8/89

TREASURY NEWS

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

ROOM 5310

FOR IMMEDIATE RELEASE
August 31, 1989

CONTACT: Office of Financing
202/376-4350

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DEPARTMENT

RESULTS OF TREASURY'S AUCTION OF 8-DAY CASH MANAGEMENT BILLS

Tenders for $4,011 million of 8-day Treasury bills to be issued on September 6, 1989, and to mature September 14, 1989, 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	8.17%	8.32%	99.818
High	8.30%	8.41%	99.816
Average	8.25%	8.36%	99.817

Tenders at the high discount rate were allotted 87%.

TOTAL TENDERS RECEIVED AND ACCEPTED
BY FEDERAL RESERVE DISTRICTS
(In Thousands)

Location	Received	Accepted
Boston	$ --	$ --
New York	22,230,000	3,517,100
Philadelphia	--	--
Cleveland	--	--
Richmond	--	--
Atlanta	--	--
Chicago	2,250,000	493,500
St. Louis	--	--
Minneapolis	--	--
Kansas City	--	--
Dallas	--	--
San Francisco	700,000	--
TOTALS	$25,180,000	$4,010,600

NB-439

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

ROOM 5310

FOR IMMEDIATE RELEASE
September 1, 1989

CONTACT: Larry Batdorf
Phone: (202) 566-2041

TREASURY ACTS AGAINST OFFICIALS IN PANAMANIAN REGIME

The Department of the Treasury today announced the publication of a new appendix to the Panamanian Transactions Regulations, listing the names of individuals whom the Director of the Office of Foreign Assets Control has determined are acting or purporting to act on behalf of the Noriega/Solis regime in Panama. The effect of this amendment is that no direct or indirect payments or transfers of funds or other financial or investment assets may be made to these individuals from the United States or by U.S. persons or their controlled Panamanian entities located in Panama.

The designations of these individual officials of the Noriega/Solis regime are being made pursuant to Executive Order 12635 of April 8, 1988, and the implementing Panamanian Transactions Regulations, which impose economic sanctions on the Noriega/Solis regime in Panama. The sanctions freeze all assets of the Government of Panama located in the United States, and prohibit all unlicensed payments or transfers to the Noriega/Solis regime, which is defined to include the individuals designated in this amendment.

The new appendix to the Panamanian Transactions Regulations was published in the August 31, 1989 Federal Register.

NB-440

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
September 5, 1989

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,213 million of 13-week bills and for $7,212 million of 26-week bills, both to be issued on September 7, 1989, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing December 7, 1989			:	26-week bills maturing March 8, 1990		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.86%a/	8.13%	98.013	:	7.83%	8.26%	96.042
High	7.89%	8.16%	98.006	:	7.88%	8.32%	96.016
Average	7.88%	8.15%	98.008	:	7.87%	8.31%	96.021

a/ Excepting 1 tender of $3,025,000.

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 40%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 27,830	$ 27,830	:	$ 34,825	$ 34,825
New York	22,923,020	6,315,240	:	20,484,260	6,131,260
Philadelphia	13,440	13,440	:	17,645	17,645
Cleveland	36,330	36,130	:	35,950	35,950
Richmond	46,460	46,460	:	41,490	40,290
Atlanta	28,225	28,225	:	21,125	21,125
Chicago	1,402,810	52,810	:	1,260,990	85,990
St. Louis	24,110	24,110	:	24,005	24,005
Minneapolis	6,870	6,870	:	8,590	8,590
Kansas City	30,020	30,020	:	40,265	40,265
Dallas	18,245	18,245	:	19,835	19,835
San Francisco	771,230	67,230	:	683,315	149,315
Treasury	545,895	545,895	:	602,505	602,505
TOTALS	$25,874,485	$7,212,505	:	$23,274,800	$7,211,600
Type					
Competitive	$22,230,480	$3,568,500	:	$18,821,420	$2,758,220
Noncompetitive	1,200,075	1,200,075	:	1,162,480	1,162,480
Subtotal, Public	$23,430,555	$4,768,575	:	$19,983,900	$3,920,700
Federal Reserve	2,381,730	2,381,730	:	2,100,000	2,100,000
Foreign Official Institutions	62,200	62,200	:	1,190,900	1,190,900
TOTALS	$25,874,485	$7,212,505	:	$23,274,800	$7,211,600

1/ Equivalent coupon-issue yield.

NB-441

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

FOR RELEASE AT 4:00 P.M.
September 5, 1989

CONTACT: Office of Financing
202/376-4350

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 September 14, 1989. This offering will result in a paydown for the Treasury of about $3,800 million, as the maturing bills total $18,189 million (including the 8-day cash management bills to be issued September 6, 1989, in the amount of $4,011 million). Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, September 11, 1989. 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 June 15, 1989, and to mature December 14, 1989 (CUSIP No. 912794 TH 7), currently outstanding in the amount of $6,648 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately $7,200 million, representing an additional amount of bills dated March 16, 1989, and to mature March 15, 1990 (CUSIP No. 912794 TV 6), currently outstanding in the amount of $9,056 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 September 14, 1989. 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 $1,833 million as agents for foreign and international monetary authorities, and $4,660 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-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 one-half hour prior to the closing time for receipt of tenders 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.

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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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.

8/89

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

ROOM 5310

FOR RELEASE AT 3:00 PM
September 7, 1989

SEP 9 AM

DEPARTMENT

Contact: Peter Hollenbach
(202) 376-4302

TREASURY ANNOUNCES ACTIVITY FOR
SECURITIES IN THE STRIPS PROGRAM FOR AUGUST 1989

The Department of the Treasury announced activity figures for the month of August 1989, of securities within the Separate Trading of Registered Interest and Principal of Securities program, (STRIPS).

Dollar Amounts in Thousands

Principal Outstanding (Eligible Securities)	$366,929,259
Held in Unstripped Form	$285,259,009
Held in Stripped Form	$81,670,250
Reconstituted in April	$3,490,840

The attached table gives a breakdown of STRIPS activity by individual loan description.

The Treasury now reports reconstitution activity for the month instead of the gross amount reconstituted to date. These monthly figures are included in Table VI of the Monthly Statement of the Public Debt, entitled "Holdings of Treasury Securities in Stripped Form." These can also be obtained through a recorded message on (202) 447-9873.

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NB-443

TABLE VI—HOLDINGS OF TREASURY SECURITIES IN STRIPPED FORM, AUGUST 31, 1989
(In thousands)

Loan Description	Maturity Date	Principal Amount Outstanding: Total	Principal Amount Outstanding: Portion Held in Unstripped Form	Principal Amount Outstanding: Portion Held in Stripped Form	Reconstituted This Month[1]
11-5/8% Note C-1994	11/15/94	$6,658,554	$5,320,954	$1,337,600	$30,400
11-1/4% Note A-1995	2/15/95	6,933,861	6,176,101	757,760	-0-
11-1/4% Note B-1995	5/15/95	7,127,086	5,363,726	1,763,360	73,920
10-1/2% Note C-1995	8/15/95	7,955,901	7,143,501	812,400	-0-
9-1/2% Note D-1995	11/15/95	7,318,550	6,477,750	840,800	3,200
8-7/8% Note A-1996	2/15/96	8,575,199	8,287,199	288,000	17,600
7-3/8% Note C-1996	5/15/96	20,085,643	19,848,843	236,800	59,200
7-1/4% Note D-1996	11/15/96	20,258,810	19,958,810	300,000	10,400
8-1/2% Note A-1997	5/15/97	9,921,237	9,852,037	69,200	76,000
8-5/8% Note B-1997	8/15/97	9,362,836	9,362,836	-0-	-0-
8-7/8% Note C-1997	11/15/97	9,808,329	9,793,929	14,400	-0-
8-1/8% Note A-1998	2/15/98	9,159,068	9,158,428	640	-0-
9% Note B-1998	5/15/98	9,165,387	9,135,387	30,000	-0-
9-1/4% Note C-1998	8/15/98	11,342,646	11,221,046	121,600	-0-
8-7/8% Note D-1998	11/15/98	9,902,875	9,902,875	-0-	-0-
8-7/8% Note A-1999	2/15/99	9,719,628	9,719,628	-0-	-0-
9-1/8% Note B-1999	5/15/99	10,047,103	9,770,303	276,800	20,800
8% Note C-1999	8/15/99	10,163,649	10,163,649	-0-	-0-
11-5/8% Bond 2004	11/15/04	8,301,806	3,511,406	4,790,400	64,000
12% Bond 2005	5/15/05	4,260,758	2,017,708	2,243,050	120,000
10-3/4% Bond 2005	8/15/05	9,269,713	7,286,513	1,983,200	230,400
9-3/8% Bond 2006	2/15/06	4,755,916	4,755,916	-0-	-0-
11-3/4% Bond 2009-14	11/15/14	6,005,584	2,179,184	3,826,400	602,400
11-1/4% Bond 2015	2/15/15	12,667,799	2,830,839	9,836,960	-0-
10-5/8% Bond 2015	8/15/15	7,149,916	1,895,836	5,254,080	48,320
9-7/8% Bond 2015	11/15/15	6,899,859	2,408,659	4,491,200	86,400
9-1/4% Bond 2016	2/15/16	7,266,854	5,296,454	1,970,400	100,000
7-1/4% Bond 2016	5/15/16	18,823,551	16,483,551	2,340,000	681,600
7-1/2% Bond 2016	11/15/16	18,864,448	10,517,568	8,346,880	721,600
8-3/4% Bond 2017	5/15/17	18,194,169	7,669,049	10,525,120	200,000
8-7/8% Bond 2017	8/15/17	14,016,858	9,340,058	4,676,800	91,200
9-1/8% Bond 2018	5/15/18	8,708,639	4,603,039	4,105,600	99,200
9% Bond 2018	11/15/18	9,032,870	3,573,270	5,459,600	55,000
8-7/8% Bond 2019	2/15/19	19,250,793	14,279,593	4,971,200	99,200
8-1/8% Bond 2019	8/15/19	9,953,364	9,953,364	-0-	-0-
Total		366,929,259	285,259,009	81,670,250	3,490,840

[1] Effective May 1, 1987, securities held in stripped form were eligible for reconstitution to their unstripped form.

Note: On the 4th workday of each month a recording of Table VI will be available after 3:00 pm. The telephone number is (202) 447-9873
The balances in this table are subject to audit and subsequent adjustments.

GPO 940-651

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

EMBARGOED UNTIL DELIVERY
EXPECTED AT 2:15 p.m.

Remarks by
Secretary of the Treasury
Nicholas F. Brady
at the Treasury Bicentennial Celebration
September 11, 1989

Mr. President, Members of Congress, Secretary Barr, Secretary Dillon, Secretary Fowler, Secretary Simon, Secretary Miller, Deputy Secretary Robson, distinguished guests and fellow Treasury employees, welcome to the Bicentennial celebration of the Department of the Treasury.

I'd like to offer special thanks to the Coast Guard Band for adding to our celebration with their first rate music. The Coast Guard played a major role in the proud history of this Department until the Transportation Department was created in 1967. We sure miss the Coast Guard. And we really miss having our own band!

Today, we mark 200 years of dedicated service to the nation by the men and women of the Treasury. This ceremony today is dedicated to you.

Following the ceremony, each of you is invited to tour the Treasury Building. I suggest you enter through the Pennsylvania Avenue entrance and stop to see the exhibits displayed by each of the Treasury bureaus in and around the Cash Room.

Then you can visit five other rooms of historical significance in this magnificent building, which, except for the Capitol and the White House, has been in use longer than any other government building in Washington. On your tour, be sure to visit the portrait of Hamilton which was unveiled just this morning in the hallway outside the Secretary's office.

Mr. President, earlier this year, you participated in a ceremony marking the 200th anniversary of the inauguration of George Washington as our first President. 200 years ago today, President Washington nominated Alexander Hamilton to be the first Secretary of the Treasury.

Hamilton was confirmed by the Senate and took the oath of office, all on the very same day, September 11, 1789 -- a record for speedy confirmation that we can safely assume will never be broken. The Treasury Department itself had been authorized by Congress only nine days earlier.

In the time of Washington and Hamilton, the Treasury had 30 employees, while the State Department had only six and the War Department just three. Today, the Treasury is 150,000-strong.

When Hamilton took office, the fledgling country was staggering under the burden of a huge war debt. Hamilton stunned the Congress by proposing that the federal government repay the debt in full and take on the outstanding debt of the states as well.

He said, "The debt of the United States...was the price of liberty.... The faith of America was pledged for it...." This commitment laid the foundation for the nation's financial health, which the Treasury and its employees have faithfully guarded ever since.

As the nation's history has unfolded, Treasury has responded to changing circumstances. When the secession of the Southern states caused a loss of Customs revenues, the printing of paper money was initiated. Five Treasury clerks worked in the attic of this building in 1862, affixing the Treasury seal to the first paper currency -- greenbacks -- because President Lincoln needed new money to finance the Civil War.

Today, Treasury continues to play a central role in ensuring the soundness of our domestic economy and encouraging growth in the world economy. We are preparing new initiatives designed to preserve our standard of living by encouraging savings and long-term investment. And we are battling on the front lines of the war against illegal drugs.

Treasury's 12 bureaus perform some of the most important tasks in our government -- managing our nation's finances, collecting our revenue, printing our currency and minting our coins, regulating our financial institutions, protecting our borders, monitoring the sale of guns and explosives, training our law enforcement agents, and protecting the President of the United States.

All Treasury employees can be proud of our history of service.

Mr. President, before closing I'd like to mention just one more historical note. I know how fond you are of Martin Van Buren. During the campaign, you often noted that he was the last sitting Vice President to be elected President. Well, I've developed a fondness for a former Treasury Secretary by the name of Levi Woodbury, who incidentally became the first Secretary to occupy this building in 1831.

Secretary Woodbury was appointed by President Jackson. But when Van Buren was elected, he asked Woodbury asked to stay on as his Secretary of the Treasury, and I'm told that in those days

President Van Buren and Secretary Woodbury spent a good deal of time worrying about a problem we wish we had: What to do with the budget surplus.

As we look back to 1789, we remember a national government that historian Joanne Freeman called "untried, untested, and unproven."

"Lines were not yet drawn," she wrote. "Processes were not yet established.... (But) Hamilton's bold policies for financial stability led to a sense of national pride and a national identity."

Today, as in Hamilton's day, our pride and identity as a nation depends on financial integrity. America counts on Treasury to continue its stewardship of the nation's resources. As we begin our third century, the men and women of the Treasury Department are prepared to take on the challenges of the future with renewed confidence, a sense of purpose, and the desire to build upon a strong legacy.

Now, I am pleased and proud to introduce a man whose leadership inspires us all. Mr. President, we are all deeply honored that you were able to join the Treasury for our 200th birthday party. Ladies and gentlemen, the President of the United States.

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

Contact: Cheryl Crispen
(202) 566-5252

THE UNITED STATES DEPARTMENT OF TREASURY

Even before Jefferson wrote the Declaration of Independence, America's leaders recognized the need for government to foster economic security and provide for the sound management of its money supply.

It was not surprising, then, when these duties were gathered into one of the earliest cabinet departments shortly after Washington's inauguration. The Department of the Treasury-- established September 11, 1789 -- celebrates its bicentennial as the foremost financial institution in the nation as well as a long-established senior agency in international financial affairs.

Most Americans think of the Treasury's mission as encompassing four main functions: revenue collection, money production, financial management, and economic policy formulation.

Perhaps less known are the incredibly varied tasks that are also an integral part of the Department's agenda. These include the training of law enforcement personnel from over 60 Federal organizations, monitoring the sale of guns and explosives, and providing security protection for the President of the United States. Treasury also comes into the lives of many American coin collectors, who have long associated it with the striking of commemorative medals.

The modern Treasury Department has organizationally been clustered around two major components: the Departmental Offices and the operating bureaus.

Primarily responsible for policy and overall management, the Departmental Offices are separated into divisions that include the Office of: Policy Management, International Affairs, Finance, Economic Policy, Enforcement, Tax Policy, Administration, Legislative Affairs, Public Affairs, General Council and the Inspector General.

The twelve operating bureaus carry out the specific operations assigned to the Department and total 98 percent of the Treasury work force. The Department's combined employment is now approximately 150,000 people. The twelve bureaus are:

Office of the United States Treasurer
United States Mint*
Bureau of Engraving and Printing*
United States Savings Bond Division*
Internal Revenue Service
United States Custom Service
Bureau of Alcohol, Tobacco, and Firearms
Federal Law Enforcement Training Center
United States Secret Service
Office of the Comptroller of the Currency
Financial Management Service
Bureau of Public Debt
Office of Thrift Supervision**

(*Report to the Office of the United States Treasurer)

(**The Office of Thrift Supervision was recently created by the Congress to supervise the Savings and Loan industry. Historical information is not available.)

For Additional Information Contact:
Department of the Treasury
Office of Public Affairs
(202) 566-2041

Office of Treasurer of the United States

Most Americans probably think that Secretary of the Treasury is the oldest financial position in the government. Yet there is another public office whose origins predate even the Declaration of Independence by nearly a year -- Treasurer of the United States.

United States Treasurers can be traced back fourteen years before creation of the Treasury Department to September 6, 1777. It was then that the office was established with the initial charge to oversee the receipt and custody of all government funds.

Even before the nation's birth, however, the Office of Treasurer was functioning through the efforts of Michael Hillegas and George Clymer. These gentlemen were jointly appointed Treasurer by the Second Continental Congress on July 29, 1775.

It was not until 175 years later, that a woman was chosen to serve as United States Treasurer. Georgia Neese Clark was selected by President Truman on June 21, 1949, thus becoming thus becoming the first woman to carry out those public duties. Nine other women followed in her footsteps in the years since.

It is also interesting to consider the signature of the Treasurer of the United States. It must be familiar to every American who handles paper money. Yet it was not until the early months of the Civil War -- August 5, 1861 -- that the Treasurer and the Register of the Treasury were designated as official signers of our currency.

The modern United States Treasurer has responsibility for three significant segments of the Treasury Department. These include the United States Mint, the Bureau of Engraving and Printing, and the U.S. Savings Bonds Division.

This means the Treasurer must effectively manage a wide array of tasks that directly impact the printing of currency and postage stamps; the minting of circulation and commemorative coinage; and the ongoing national Savings Bond campaign.

For Additional Information Contact:
The Office of the Treasurer
Office of Public Affairs
(202)566-2314

United States Mint

English shillings, French louis d'or, Spanish doubloons, various colonial monies -- these were among the currencies in common usage 200 years ago. With so many different currencies in use, the American public became confused. Consequently, trade and economic growth slowed.

The Constitution's framers recognized the urgent need for a unified monetary system, and Treasury Secretary Alexander Hamilton personally directed planning for a national Mint in the government's early years. Moving quickly, Congress gave its blessing to construction on April 2, 1792, and the first Mint building was located in the nation's temporary capital, Philadelphia. This was the first Federal Building erected by the new constitutional American Government.

Coinage was also authorized by Congress in the 1792 law, and President Washington picked a leading American scientist -- David Rittenhouse -- to start production as the first Director of the Mint. To help the cause, some of George Washington's own silver was apparently donated for melting.

Congress decided upon three basic metals for the new American currency. Gold was to be used in $2.50, $5 and $10 coins. Silver was the choice for half-dime, dime, quarter, half-dollar, and dollar pieces. The cent and half-cent were copper. The least was first, inasmuch as the less valuable copper penny coins were first put into circulation -- 11,178 of them, delivered in March 1793.

Of course, the passage of many generations has brought changes in our currency's denomination and content. Gone are the half-cent, 2-cent, 3-cent, and 20-cent pieces, as well as the silver half dimes. The nickel, dime, quarter and half-dollar are now made of a copper-nickel alloy, and the "copper penny" is now a "copper-plated zinc cent."

Organizationally, the Mint evolved through three stages in its first century. Initially, the Mint was part of Thomas Jefferson's State Department, where it briefly remained until a 1799 act declared the Mint an independent agency, directly reportable to President Adams.

Subsequent legislation created new branch mints and assay offices, and both were granted public depository functions. Finally, the Coinage Act of 1873 put all mint and assay office activities under the newly organized Bureau of the Mint in the Department of the Treasury. There it resides to this day, and a 1984 Secretarial order gave the bureau a new name: the United States Mint, which is headquartered in Washington, D.C.

For Additional Information Contact:
United States Mint
Office of Public Information
(202) 376-4968

Bureau of Engraving and Printing

If we could be transported back in time to a single room in the Treasury building's basement on August 29, 1862, we would find four women and two men, carefully separating and sealing privately-printed $1 and $2 United States notes. This modest little operation marked the beginning of the modern Bureau of Engraving and Printing.

A Civil War was raging at the time, and events moved briskly. By the fall of 1863, Treasury employees were actually printing currency notes for the first time. The next year, the Treasury Secretary successfully advocated establishment of the Bureau of Engraving and Printing.

The next decade continued to witness the new government printer's gradual absorption of functions long performed by the private bank note companies. By October 1, 1877, all United States currency was engraved and printed at the Bureau of Engraving and Printing.

In addition to paper money, twentieth century Americans also are accustomed to using postage stamps printed by their government. This was not always common practice, however. Private bank note engraving firms printed our stamps under government contract in the early decades of the nation.

It was not until March 3, 1847 that the use of U.S. postage stamps for the prepayment of delivery fees was legally authorized. Another half century passed -- July 1, 1894-- before the production of United States stamps was ultimately transferred from private concerns to the Bureau of Printing and Engraving. Since then, the Bureau has been continuously producing the majority of U.S. postage stamps.

On November 24, 1986, the Treasurer of the United States announced that the Bureau of Engraving and Printing would build a new currency manufacturing facility in Fort Worth, Texas. When completed, this facility will serve three Federal Reserve Districts and, remarkably, produce at least a quarter of our Nation's annual paper currency supply.

For Additional Information Contact:
Bureau of Engraving and Printing
Office of Public Affairs
(202) 447-0193

U.S. Savings Bonds

During the Great Depression, Treasury Secretary Henry Morgenthau, Jr. realized it was desirable to encourage broad public participation in government financing. At the same time, it would be socially beneficial to help the non-professional smaller investor who wanted to purchase federal bonds that were safe.

He also knew that Treasury Bonds had been periodically offered for individual purchase since 1776, but as marketable securities that fluctuated. This meant that some average American investors experienced painful losses when forced by personal circumstance to sell their bonds prior to maturity.

In 1935, Morgenthau introduced his solution: the savings bond. It was designed to eliminate the risk for even the most novice purchaser. All of the ingredients of safety were there for the bondholder: fixed redemption values; a short holding period; issuance in registered (non-negotiable) form; and guaranteed replacement in the event of loss.

Americans embraced the early "baby bonds," as they were called, and bought them in denominations from $25 to $1,000. They sold at 75 percent of face value and paid 2.9 percent interest when held to maturity. The last in the four initial series did not cease paying interest until April, 1951. Without doubt, savings bonds were a success, and total sales at issue price were an impressive $4 billion between March, 1935 and April, 1941.

World war was then imminent, and the Treasury again responded to much larger funding requirements brought on by heavy defense expenditures, a larger national debt and growing inflationary pressures.

Introduced May 1, 1941, the Series E Bond would popularly be best known as the "defense bond," the "war bond" of 1942-45 and, finally, the "Savings Bond" of today. During World War II, nearly $50 billion in Bonds were sold to help finance the Allied effort.

Today, modernized for the 1980s to pay competitive market-based rates, Series E and successor Series EE Bonds have become the most durable of all. Tens of millions of families own them. In fact, the dollar amount outstanding now exceeds $14 billion, the highest in the history of the program. Today, they are the world's most widely held security.

For Additional Information Contact:
U.S. Savings Bonds Division
Office of Public Affairs
(202)634-5377

Internal Revenue Service

The Internal Revenue Service has a unique place in the Treasury Department and the Federal government. The tax administration system of the United States is by far the most effective and efficient in the world -- this year collecting $1 trillion in revenues at a cost to taxpayers of only 54 cents for each $100 collected.

Taxes have always been important to Americans -- remember the Boston Tea Party! One of the earliest controversies facing the new country involved the taxing powers of the Federal government.

Early revenues came from tariffs but Alexander Hamilton prevailed upon the Congress to set up a system of excise taxes. These taxes proved unpopular and led to armed confrontation-- the Whiskey Rebellion of 1794.

On July 1, 1862, President Lincoln signed into law what was then the most sweeping revenue-producing measure in the nation's history, progressive tax levied on income. A 44-year-old Massachusetts lawyer, George S. Boutwell, was named the first Commissioner of Internal Revenue. First year collections were more than $20 million, but still the Union had to borrow more than 80 percent of the total costs to fight the war.

After the Civil War, the income tax was repealed again in 1872 but the issue continued to be debated until 1894 when the income tax was revived. However court challenges led to a 1895 Supreme Court decision declaring income tax law unconstitutional because it was a direct tax and not apportioned among the states on the basis of population. The issue was finally settled when the 16th Amendment was ratified by the new 36th state -- Wyoming -- and became part of the Constitution in February 1913.

The modern income tax came just in time to help pay the costs of World War I. By the time the war ended, the Bureau of Internal Revenue had collected more than the combined cost of all the other wars in our nation's history -- almost $9 billion. Just after the war came Prohibition which gave the Commissioner of the Internal Revenue primary responsibility to enforce the law. The Bureau provided much of the evidence used to convict Al Capone, the most notorious gangster of the era, for tax evasion and he was sentenced to 11 years in prison.

World War II brought significant investigations in 1951, the agency was reorganized, all political offices other than that of the Commissioner were abolished and replaced by career civil servants, and in 1953, the name was changed from "Bureau of Internal Revenue" to "Internal Revenue Service."

Today, the 120,000 employees of the IRS work throughout the US and in 14 countries around the world processing almost 200 million tax returns each year and providing informational and educational services to the public. Law enforcement remains a priority through 1 million tax audits annually, $23 billion in delinquent taxes collected and major criminal investigations resulting in a high rate of successful prosecutions.

For Additional Information Contact:
Internal Revenue Service
Office of Public Affairs
(202) 566-4743

U.S. Custom Service

The collection of revenue and the control of trade are almost as old as civilization itself. Levies and tariffs on imports were well known in America from the earliest colonial times.

After declaring independence in 1776, our young nation found itself on the brink of bankruptcy. Responding to the urgent need for revenue, the First Congress and President George Washington signed the Tariff Act of July 4, 1789, establishing a tariff and system for collection duties. Four weeks later, the original Customs districts and ports of entry were established by the Fifth Act of Congress.

For nearly 125 years, Customs remained virtually the only source of income for the Government. Customs revenue made possible a period of unprecedented growth and expansion. And by 1835, Customs had reduced the national debt to zero.

To this day, Customs is a growing, major source of income for the Federal Government. In the 1987 fiscal year, Customs collections were more than $16 billion -- four times greater than they were twenty years earlier.

Not only has Customs been a steady source of income for our government, it has also been the forerunner to a number of today's Federal agencies. Throughout the years, customs officers have: been designated as pension agents for military pensions-- which became the Veterans Administration; obtained statistics on imports and exports -- which became the Bureau of the Census; supervised revenue cutters -- which became the task of the U.S. Coast Guard; collected hospital dues for the relief of sick and disabled seamen -- which became the Public Health Service; and established standard weights and measures -- a function now performed by the National Bureau of Standards.

During these changes, the mission of the Custom Service has remained constant -- to assess and collect duties and tariffs on imported goods, to control carries of imports and exports, and to combat smuggling and revenue frauds.

For Additional Information Contact:
U.S. Customs
Office of Public Affairs
(202)566-5286

Bureau of Alcohol, Tobacco & Firearms

Few federal agencies can lay claim to an historical legacy more controversial, storied and publicized than the Bureau of Alcohol, Tobacco & Firearms (BATF).

Alcohol has been at the center of public debate since America's earliest days. When Congress imposed the first tax on distilled spirits in the spring of 1791 to pay Revolutionary War debts, it found itself faced three years later with violent resistance and the legendary Whiskey Rebellion.

Not sure how to react, Congress alternatively enacted and repealed taxes on distilled spirits for the next seventy years, depending on the revenue needs of the moment. The urgent need to finance the Civil War focused the Congressional mind, however, and it passed the Act of July 1, 1862. This law created the Office of the Internal Revenue and imposed a tax an distilled spirits that has become a permanent part of the federal revenue system.

Public controversy over alcohol reached its zenith with passage of the 18th Constitutional Amendment in 1919--Prohibition. Distillers were required to dispose of inventories which amounted to some 60 million gallons of beverage alcohol. Today's BATF special agents are descendants of Elliott Ness' "Untouchables" who were formed as special squads by the new Bureau of Prohibition to go after organized crime.

An unprecedented wave of criminal violence was one of the tragic byproducts of the Prohibition era. Public outcry resulted in the National Firearms Act (NFA), passed in 1934, and enactment of the Federal Firearms Act four years later. The latter afforded the first limited regulation of the firearms industry; it became a Federal crime for felons and fugitives to receive firearms in interstate commerce.

The Alcohol, Tobacco and Firearms Division remained part of the Internal Revenue Service in the decades that followed, but it duties were clearly distinguishable from the larger tax collection and accounting activities. On July 1, 1972, Alcohol, Tobacco and Firearms was given full Bureau status in the Treasury Department.

With a new name came additional responsibilities. In 1978, in response to the millions of dollars being lost to the States by cigarette smuggling from low tax to high tax states, ATF was charged with enforcing a new Contraband Cigarette Act. At the same time, the Bureau was developing an entirely new Federal effort against an emerging crime problem -- arson.

Today, the Bureau is involved in the annual collection of more than $10.1 billion in taxes.

For Additional Information Contact:
Bureau of Alcohol, Tobacco and Firearms
Office of Public Affairs
(202) 566-7135

Federal Law Enforcement Training Center

In 1967, the Bureau of the Budget (now the Office of Management and Budget) warned that most federal law enforcement officers were not sufficiently trained due to inadequate educational staffs and support facilities. Other senior government studies in the late sixties revealed the need for a training facility for criminal investigators, uniformed officers and other federal agency personnel lacking instruction in advanced law enforcement procedures. The Federal Law Enforcement Center was created in 1970 as a result of these studies and increased public concern.

The former Glynco Naval Air Station, near Brunswick, Georgia, has served as the headquarters for the Federal Law Enforcement Training Center since 1975. The facility is a remarkable one -- it often trains 2,000 people a day to be Federal law enforcement officers and agents.

At Glynco, personnel from more than 60 law enforcement organizations from across the nation and its territories attend basic law enforcement training programs, as well as advanced or specialized programs.

In addition, state and local law enforcement officers participate in some 30 specialized training programs at Glynco. These classes meet educational needs not generally available to State and local agencies. Enhanced networking and cooperation throughout the law enforcement community are a natural byproduct.

Most important is the enhanced, quality law enforcement that is being achieved in America's diverse communities as a result of better training. Between 20,000 and 30,000 students enter FLETC classrooms each year, and more than 160,000 law enforcement personnel have graduated in the past two decades.

For Additional Information Contact:
Federal Law Enforcement Training Center
Office of Public Affairs
(912) 267-2447

The United States Secret Service

The United States Secret Service was born in response to an impending financial crisis. Later, its mission would be broadened to halt perhaps the gravest challenge to the nation's political leadership.

By the end of the Civil War, it was estimated that nearly one-half of all currency in circulation was counterfeit. To meet this large scale assault on the our economic system's integrity, the Secret Service was created on July 5, 1865, as a division of the Treasury Department. Its resources were modest: a Chief and ten "operatives" comprised the entire Service organization. Its sole purpose was to suppress counterfeiting.

The Service's reputation grew rapidly, however, and soon it was conducting investigations involving other Federal interests as well. These have included smuggling, mail robbery, espionage cases, and the fraudulent use of Government land.

The assassination of President McKinley resulted in new responsibilities for the Secret Service. Incredibly, the President's death in 1901 marked the third murder of a President -- Lincoln and Garfield were the others -- in just 36 years.

Authorization was quickly granted for the Secret Service to provide protection for all succeeding American Presidents. That mandate was expanded repeatedly over the years. Finally, legislation was enacted in 1951 that delineated the Service's investigative and protective duties.

Secret Service protection is now afforded to the President and Vice President, their immediate families; the President-elect, Vice President-elect and their families; former Presidents, their spouses and minor children; major Presidential and Vice Presidential candidates; and visiting foreign leaders. The President may also direct protection for other distinguished foreign visitors and official American representatives who are performing special missions abroad.

The modern Secret Service employs approximately 4,300 people. These include special agents, uniformed officers, technical experts, specialists and support personnel.

For Additional Information Contact:
U.S. Secret Service
Office of Public Affairs
(202) 535-5708

<u>Comptroller of the Currency</u>

American banking originated in the colonial period and developed as a source of short-term credit to shippers and merchants in the post-Revolutionary War period. In those days, banks issued their own notes when making loans, with an expressed or implied requirement that the notes be repaid in gold and silver. This led to the appearance of currency as varied as the banks which issues it.

In 1863, public concern with the state of the currency and the press of financing the Civil War led to the first system of federally charted national banks. The National Currency Act of 1863 created the position of the Comptroller of the Currency and the National Bank Act of 1864 more clearly defined the Comptroller's responsibilities. The Comptroller was given the authority to examine national banks, regulate their lending and investing activities, and when necessary, declare them insolvent.

Although the Comptroller's office is designated as a bureau of the Treasury Department and the Comptroller operates under the general supervision of the Treasury Secretary, the National Bank Act gave the Comptroller considerable independence. The Comptroller is appointed by the President for a five-year term, and supervisory decisions for the 4400 national banks are made independently.

The Office of the Comptroller of the Currency's primary responsibility is to ensure that the national banking system operates in a safe and sound manner to meet the public's need for financial services. The Comptroller is the only federal bank regulator with the authority to both charter and close commercial banks. Through the exercise of this authority, as well as the Office's supervisory and regulatory responsibilities, the Comptroller plays a unique role in shaping the course of American banking.

For Additional Information Contact:
Comptroller of the Currency
Office of Public Affairs
(202) 287-4279

The Bureau of the Public Debt

Managing the nation's $2.8 trillion public debt has become a great deal more sophisticated than it was two centuries ago when Congress first addressed the issue. Today's modern, highly skilled work force at the Bureau of the Public Debt is utilizing advanced computer systems technology that would have befuddled the thirteen loan commissioners appointed by Congress in 1790.

In the nation's first decade, the Office of the Register was the Treasury Department's record keeper. Each state's loan commissioner issued and liquidated government certificates or notes to the public, paid interest and disbursed pensions. This system worked reasonably well until 1860, when the public debt was about $65 million.

The Civil War continued longer than anyone anticipated and was enormously expensive -- about $5.2 billion in direct expenditures. The war financing meant additional Treasury employees and creation of a new Division of Loans to manage the debt.

This arrangement changed once again as a result of the higher volume of transactions required in a time of war. World War I required more complex debt management strategies, and all these duties were given in 1920 to a new Commissioner of the Public Debt in Treasury. He reported to the Assistant Secretary for Fiscal Affairs.

In 1939, a New Deal reorganization law finally gave the Public Debt Service its present name, the Bureau of the Public Debt. An Executive Order the following year clearly established the Bureau's leadership role as borrower of the funds necessary for the Federal Government's operation and as the agency that keeps accounts of the debt.

For Additional Information Contact:
Bureau of Public Debt
Office of Public Affairs
(202)376-4302

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE

September 11, 1989

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,220 million of 13-week bills and for $7,214 million of 26-week bills, both to be issued on September 14, 1989, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing December 14, 1989			:	26-week bills maturing March 15, 1990		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.62%	7.88%	98.074	:	7.63%	8.05%	96.143
High	7.65%	7.91%	98.066	:	7.64%	8.06%	96.138
Average	7.64%	7.90%	98.069	:	7.64%	8.06%	96.138

Tenders at the high discount rate for the 13-week bills were allotted 13%.
Tenders at the high discount rate for the 26-week bills were allotted 28%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 29,195	$ 29,195	:	$ 30,740	$ 30,740
New York	23,901,465	6,214,725	:	25,994,455	6,274,920
Philadelphia	17,775	17,775	:	18,630	16,630
Cleveland	32,965	32,595	:	36,825	36,025
Richmond	57,305	57,305	:	62,660	62,660
Atlanta	33,520	33,520	:	33,725	33,725
Chicago	1,616,815	99,265	:	2,736,050	51,050
St. Louis	23,150	23,140	:	28,030	28,030
Minneapolis	28,050	8,050	:	10,355	10,355
Kansas City	35,035	35,035	:	43,315	43,315
Dallas	32,915	22,915	:	31,165	21,165
San Francisco	768,920	65,220	:	959,285	55,285
Treasury	581,370	581,370	:	549,960	549,960
TOTALS	$27,158,480	$7,220,110	:	$30,535,195	$7,213,860
Type					
Competitive	$23,396,900	$3,458,530	:	$25,695,440	$2,374,105
Noncompetitive	1,242,825	1,242,825	:	1,233,455	1,233,455
Subtotal, Public	$24,639,725	$4,701,355	:	$26,928,895	$3,607,560
Federal Reserve	2,360,255	2,360,255	:	2,300,000	2,300,000
Foreign Official Institutions	158,500	158,500	:	1,306,300	1,306,300
TOTALS	$27,158,480	$7,220,110	:	$30,535,195	$7,213,860

1/ Equivalent coupon-issue yield.

NB-445

TREASURY NEWS

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

Text as Prepared
For release at 8:45 a.m.

JM 5?10

REMARKS
BY
JOHN E. ROBSON
DEPUTY SECRETARY OF THE TREASURY
BEFORE
THE NATIONAL MORTGAGE CONFERENCE OF
THE NATIONAL COUNCIL OF SAVINGS INSTITUTIONS
SEPTEMBER 12, 1989

Thank you for inviting me here today to speak about a subject that has occupied a great deal of the nation's attention and the time of the Federal Government over the past several months -- the creation and startup of the largest financial institution workout in United States history.

Less than 20 days after assuming office, President Bush announced the Administration's proposal for a major initiative to address the nation's savings and loan crisis. And scarcely over a month ago in the Rose Garden, the President signed this comprehensive legislation. We are proud of the role the Treasury Department and Secretary Brady had in shaping the proposal and shepherding the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 through Congress to enactment. As the President said at the signing ceremony, the FIRREA legislation represents "a crucial step toward restoring public confidence."

The central features of FIRREA that are designed to rebuild public confidence include the following:

-- First, a sweeping restructuring of thrift industry regulation and deposit insurance;

-- Second, the imposition of tough capital standards and other regulatory controls;

-- Third, stronger tools to enable law enforcement agencies to deal more swiftly and effectively with instances of fraud and abuse; and

-- Fourth, massive funding and the creation of two new agencies -- the Resolution Trust Corporation and the Oversight Board -- to pay for and manage the near-term cleanup of insolvent thrifts.

NB-446

Altogether, FIRREA created or restructured 6 government agencies and authorized $50 billion for RTC in the S&L cleanup, an immense legislative accomplishment.

Now our job is to get the job done. And today I will say a few words about the main workhorses in the immediate task of cleaning up insolvent thrifts, Resolution Trust Corporation and the Oversight Board.

At the outset I would like to clear up any confusion that may exist about the different roles of Resolution Trust Corporation -- referred to by most simply as RTC -- and the Oversight Board.

RTC is the implementor and executor of the thrift cleanup. It is the entity that selects the institutions to be resolved, carries out the resolutions, and sells any residual assets.

The Oversight Board provides the policies under which RTC accomplishes its work, furnishes the funds to RTC, and monitors RTC's execution of its responsibilities.

The RTC and the Oversight Board are partners in an immense enterprise that has potentially far-reaching implications for the thrift industry, real estate markets, communities throughout America, people needing access to housing, and the taxpayer.

The mission of RTC is to manage and resolve all currently insolvent thrifts, as well as thrifts that may become insolvent over the next three years. Some estimates suggest that RTC will ultimately be required to resolve 500 or more thrifts with total assets ranging from $300 to $400 billion.

The RTC must determine the specific thrifts to be resolved and the type of resolution appropriate for each case; it must solicit and evaluate hundreds of bids for institutions and assets; it must consider the potential market effects of its asset disposition activities; it must review the 1988 FSLIC deals; and it must also fulfill the legislation's requirements regarding the disposition of low cost housing. This is by no means an exhaustive catalogue of RTC's responsibilities, but it gives you a feel for the breadth and dimension of the task before it.

Since the RTC would arrive from the legislative maternity ward as a new entity without employees or leadership, Congress directed that its flesh and bones would be the Federal Deposit Insurance Corporation. The FDIC is the exclusive manager of the RTC, subject to policy guidance by the Oversight Board. The directors of the FDIC serve as the board of directors of the RTC, and the Chairman of the FDIC is the chairman of the RTC. Already a sizeable group of FDIC personnel have been assigned to RTC duties, and the number is expected to grow considerably larger before the job is completed.

Recognizing that FIRREA commits substantial taxpayer funds to pay for the losses in our Federal deposit insurance system, Congress established the Oversight Board as an accountable Executive Branch agency. The Secretary of the Treasury serves as chairman, and is joined by the Secretary of Housing and Urban Development, the Chairman of the Federal Reserve Board, and two members to be appointed by the President.

The Oversight Board sets the overall strategies, policies, and goals for RTC, for example, policies and procedures governing case resolutions, asset management and disposition, and the use of private contractors. It also approves RTC's financial plans, authorizes and audits the use of funds by RTC, and has the responsibility for monitoring and evaluating RTC's performance.

As an organization with policy making and financial duties, rather than operational responsibilities which are the province of RTC, the Oversight Board expects to maintain a lean staff of skilled professionals.

The Oversight Board will <u>not</u> be involved in individual cases. It will <u>not</u> sell assets, liquidate or merge thrifts, or retain private sector companies and individuals to assist in the sale or management of properties. These activities are the responsibility of RTC. So if you have interests or questions about these activities, you should make them known to RTC.

The customary practice for new Administrations is to recount their accomplishments after the first 100 days. Since the RTC and Oversight Board have existed for little more than one month, and operated for just 22 business days, we do not have the luxury of such leisurely reflection. Nevertheless, I think it fair to say that we have accomplished a great deal even in this short period:

- Only an hour after President Bush signed the FIRREA legislation, the Oversight Board held its first meeting, completed the necessary organizational actions, promulgated its initial policies for RTC, made its first authorization of funds, and appointed its interim officers and staff. Within hours on the same day RTC held its first board meeting and got the operations underway.

- To date, the Oversight Board has authorized and released to RTC about $9 billion for thrift resolutions, liquidity needs and replacement of high cost funds. Authorized funds are released to RTC upon presentation of specific requests that document the amount and purposes of the funds required.

- The RTC has so far used its funds to close or transfer the deposits of 14 insolvent thrifts and to lower the cost of funds at numerous other institutions, thereby reducing their losses. This translates to savings for the taxpayer. It also should have the broader effect of reducing the cost of funds for healthy thrifts.

- At the first meeting of the Oversight Board, interim ethics and conflict of interest guidelines were adopted, pending final regulations. These provide that temporary Oversight Board employees, from other federal agencies are subject to the ethical standards of their respective home agencies, and that FDIC ethical standards apply to all other Oversight Board employees to the RTC, and to private contractors.

- In addition to issuing 9 policies for RTC -- covering matters ranging from financial procedures to the terms of RTC funding of thrifts -- The Oversight Board established a joint Oversight Board-RTC policy development task force to make recommendations concerning strategies, policies and goals for the RTC, and concerning the strategic plan the Oversight Board must submit to Congress by December 31, 1989. This group, with personnel from both agencies, is developing policies that are responsive to the RTC's immediate needs, as well as developing policies that will give long term guidance. In areas in which the Oversight Board has not yet acted, RTC will carry out its responsibilities in accordance with FDIC policies.

- One interim policy asks the RTC to concentrate initially on resolutions that do not involve complex and controversial asset disposition and financing techniques, such as long-term yield maintenance agreements, asset guarantees and the retention of equity positions. This policy is not intended to preclude resolving large institutions, or initiating the lengthy process to resolve institutions that might require more complex techniques. It simply provides the Oversight Board and the RTC some time to develop appropriate policies for complex transactions, a task that is actively underway.

- The Oversight Board has selected and appointed the required two additional directors of the Resolution Funding Corporation, the fund raising vehicle under FIRREA, and has been actively recruiting the two public members of the Oversight Board, its permanent chief executive officer, and members for the regional advisory councils.

- Most importantly, the Oversight Board and RTC have successfully begun an orderly, cooperative and professional working relationship. This may be the most significant initial step in getting the job done efficiently over the long pull.

All in all we think that's a creditable first month's work.

But we are well aware that this is just the beginning of what will be a long and challenging process. The focus of our efforts at the Oversight Board in the near term will continue to be the development of policies and procedures to guide the RTC's efforts.

Let me mention just a few of the policy issues that must be addressed as we go forward.

First, what factors should the RTC weigh most heavily in determining the order of resolutions? For example, the size or condition of the institution, geographic location, type of resolution, or the nature of the assets held could be considered.

Another set of issues concerns asset management and disposition. How should the RTC use the services of private contractors and what incentives would be appropriate and promote efficiency? How does the RTC evaluate the potential costs and benefits of carrying assets? To what degree have the markets absorbed the real estate overhang? And how does the RTC implement the low and moderate income housing provisions of the legislation?

Should RTC favor whole-bank or clean-bank transactions? Should the RTC use pre-packaged bid formats for potential acquirers or negotiate terms with individual bidders?

We don't have answers to all of these questions yet, but we will. The joint policy development task force has already begun to tackle these and other important policy matters. We welcome comments and suggestions from you in the private sector as we develop these policy guidelines.

In conclusion, I would like to say that I am most encouraged by the start we have made. Our efforts in these first short months will lay the foundations of future success, and you may be assured that we will give the tasks ahead the thought, dedication and energy consonant with their national importance.

Thank you.

THE SECRETARY OF THE TREASURY
WASHINGTON

September 11, 1989

The Honorable
Dan Quayle
President of the Senate
U.S. Capitol
Washington, D.C. 20510

Dear Mr. President:

In its April 20 report on the tied aid credit practices of other countries mandated by the Omnibus Trade and Competitiveness Act of 1988, the Export-Import Bank indicated that the Administration would be reviewing possible responses to these practices and would forward policy recommendations to Congress. We are pleased to transmit the Administration's recommendations herewith.

Briefly, the Administration recommends that the central thrust of the U.S. response to the tied aid credit problem should be vigorous new negotiations aimed at substantially reducing the commercial disadvantages for American exporters engendered by the tied aid credit practices of other countries. We also recommend that available budgetary resources be used aggressively to support these negotiations.

This approach implies a need to modify the way we use the War Chest as well as to ensure that opportunities for financing capital projects receive increased attention within the constraints of our current aid programs. As a separate though related exercise, the Administration will be considering whether and how U.S. foreign assistance programs might provide greater support for infrastructure and capital projects. Given the other options at our disposal for responding to the problem, as well as current budgetary constraints, the Administration has decided not to seek new resources for a separate tied aid credit program at this time.

The Administration hereby recommits itself to working with the Congress to ensure that, to the maximum possible degree, competition in our export markets focuses on price, quality and service rather than on the availability of concessional financing. Although these negotiations will require perseverance, we expect progress will be made over time that will enable U.S. exporters to compete more effectively. The circumstances underlying congressional concerns will be kept under review, and we are prepared to consider additional action if circumstances so require.

Sincerely,

Nicholas F. Brady
Secretary of the Treasury

John D. Macomber
President and Chairman
Export-Import Bank

THE SECRETARY OF THE TREASURY
WASHINGTON

September 11, 1989

The Honorable Thomas S. Foley
Speaker of the House of Representatives
The Speaker's Rooms
U.S. Capitol
Washington, D.C. 20515

Dear Mr. Speaker:

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Sincerely,

Nicholas F. Brady
Secretary of the Treasury

John D. Macomber
President and Chairman
Export-Import Bank

REPORT TO THE U.S. CONGRESS ON TIED AID CREDIT PRACTICES

ADMINISTRATION RECOMMENDATIONS FOR A U.S. RESPONSE

SEPTEMBER 1989

Introduction and Summary

In April, 1989 the Export-Import Bank forwarded the report to the Congress on the tied aid credit practices of other countries mandated by the Omnibus Trade and Competitiveness Act of 1988. In his transmittal letter, Acting Chairman Ryan observed that the report supported the need for continued, and possibly broadened, U.S. negotiating efforts. He promised that, after reviewing the available options, the Administration would offer its recommendations on how best to support such negotiations and on whether it would be desirable to establish an ongoing tied aid credit program.

On the basis of this review, the Administration has concluded that the U.S. response should center on a vigorous new negotiating effort aimed at reducing the commercial disadvantages for American exporters engendered by the tied aid credit practices of other countries.

The Administration further recommends that available budgetary resources be used aggressively to support the negotiations. Eximbank, the Agency for International Development (AID), the Trade and Development Program (TDP), and other interested agencies are reviewing ways of doing so. We are proposing to modify the way in which we use the War Chest. We also are developing procedures for ensuring that opportunities for financing capital projects receive consideration within the constraints of our current aid programs.

As a separate though related exercise, the Administration will be considering whether and how U.S. foreign assistance programs might provide greater support for infrastructure and capital projects.

Given the other options at our disposal for responding to the problem, as well as our budgetary constraints, the Administration has decided not to seek new resources for a separate tied aid credit program at this time.

International Negotiations

The Administration reconfirms its commitment to vigorous pursuit of negotiations with our major trading partners, with the aim of achieving further improvements in multilateral discipline over the use of tied aid credits. Our specific objectives are to minimize the trade distortions caused by tied aid practices to the detriment of U.S. exporters and to ensure that tied aid credits serve the legitimate development needs of recipient countries.

The groundwork for further negotiations on tied aid credits was laid at the spring meeting of Ministers of Foreign Affairs and Finance of the Organization for Economic Cooperation and Development (OECD) and at the Arche Summit in July. At the latter, leaders of other G-7 countries joined President Bush in sending a strong signal of support for further progress in this area. They urged that, at the earliest possible date, competent bodies in the OECD pursue and achieve improvements in the present guidelines governing the use of tied aid credits.

A number of possible avenues for negotiation have been suggested in meetings of OECD countries participating in the Arrangement on Guidelines for Officially Supported Export Credits. This is the forum in which the 1987 tied aid credit agreement was negotiated and in which -- along with the OECD's Development Assistance Committee -- the search for multilateral solutions continues. The Administration is assessing various negotiating objectives and strategies with a view to achieving maximum progress toward international agreement on a new negotiating mandate at this autumn's round of OECD meetings.

The principal directions identified so far in which progress might be sought include (1) effectively untying donor countries' aid programs for capital projects; (2) limiting the use of tied aid in problem sectors and/or markets; (3) limiting the use of relatively low-concessional aid to a certain proportion of a donor's total program; (4) requiring open competitive bidding for transactions below a certain concessionality level as a way of precluding commercially motivated aid; (5) banning the late introduction of tied aid credits into project bidding; and (6) otherwise improving guidelines to enhance the developmental orientation of tied aid.

We recognize that it may not be possible to remove all distortions of trade and aid arising from differences in national approaches to development assistance. Nor do we underestimate the difficulty and effort that a new round of negotiations will entail. But we can and will attempt to minimize the scope of such distortions. We expect to provide a progress report on our efforts to OECD Ministers in the spring of 1990.

The War Chest

Since the March 1987 tied aid credit agreement was reached, the Tied Aid Credit Fund (the "War Chest") has been used to encourage early and full implementation of the agreement by countering offers from other countries that deviate from its provisions. In practical terms this has resulted in few new War Chest transactions, since most tied aid credits conform to the agreement.

The Administration now believes that the War Chest should be used more directly to support our negotiators. In our FY 1990 budget submission, we proposed the extension of the War Chest at the $100 million level to ensure implementation of earlier tied aid credit agreements and to support further negotiations.

When blended with commercial credits guaranteed by the Export-Import Bank, a $100 million War Chest will allow us to offer a total of almost $300 million of "mixed credit" export financing at minimum concessionality levels specified by international agreements. Since not all offers are taken up, it would not be imprudent for the Bank to extend an even higher volume of offers. By using foreign assistance funds from other agencies to supplement the War Chest, the available financing would be larger still.

There are three principal ways of utilizing the War Chest directly in support of international negotiations. One is specifically to target export markets of countries that resist stronger discipline over tied aid credits (i.e., resist further negotiations). This is a course we have followed at times in the past. However, we would be reluctant to recommend such a provocative approach without evidence that countries are not adhering to the tied aid credit agreement or that narrow commercial interests are leading them to block cooperative multilateral solutions to remaining tied aid problems.

A second option is the "defensive" one of matching other countries' tied aid credit offers in cases we judge relevant to our negotiating strategy, whether or not the offering country is resisting negotiations. The defensive approach has been useful because it demonstrates to other countries that the United States is seriously challenging the misuse of tied aid for commercial purposes. Since it is essentially reactive, however, it may bring us into the bidding too late to have a significant impact either on the exporter's chances for winning the order or on the initiating country's tied aid practices.

A third, more activist option is to target offers in sectors and markets of specific commercial interest to U.S. exporters, particularly where tied aid credits are offered extensively. This approach has the potential to have the most impact for a given expenditure of funds, because it allows the United States to control the timing, the location, and the size of tied aid credit offers. It would have to be used judiciously, however, in order not to contribute to an expansion of the tied aid credit problem.

Of these options, the Administration prefers to emphasize the third: targetting the War Chest and other tied aid funds where available in sectors and markets of commercial interest to U.S. exporters where tied aid credits are used extensively. In addition, we propose to use such funds defensively to match or overmatch on a case-by-case basis when it serves our negotiating purposes. Used in this manner, a War Chest of the magnitude proposed would send a convincing message to our trading partners of our firm intent to level the tied aid credit playing field.

Should international negotiations not proceed seriously and expeditiously, the Administration would be willing to review whether the resource levels we have committed are sufficient to address the problem and may be prepared to ask the Congress for additional appropriations in subsequent years. In that case, we also would be prepared to reconsider, if necessary, the ways in which available funds are targetted.

Foreign Assistance Funds

Within the framework of its existing funding and legislative authority, AID will maximize its support for capital projects. As part of this effort, AID, together with TDP, will look for opportunities to cooperate with Eximbank in project financing, particularly in support of the third option above. Exchanges of information early in the program and project evaluation processes of all three agencies will allow joint financing opportunities to be identified.

In cases where AID and TDP funds are available for joint initiatives with Eximbank, such transactions would be expected to (1) contribute to the development of the importing country, (2) meet Eximbank's creditworthiness standards, (3) be of long-term benefit to the U.S. economy, and (4) have a significant impact on competitors.

While some portion of AID's current appropriations can be used to finance the transfer of U.S. capital goods to developing countries, the scope for doing so is limited by the other purposes our aid programs must serve and by the high degree of congressional earmarking. Within overall budget constraints, however, AID will make available what funds it can under established programs.

In addition, TDP's programs will continue to provide substantial tangible support for U.S. capital goods exporters.

Focus of U.S. Foreign Assistance Programs

Over the medium term, the Administration will be considering whether and how U.S. foreign assistance programs might provide greater support for infrastructure and capital projects. Although this would be a shift in emphasis compared to our aid programs of the last two decades, there is ample precedent in AID's history for doing so. Such a shift would have to be accomplished in ways consistent with the broad objective of meeting the development needs of recipient countries. We would continue to insist that programs and projects meet development assistance standards and priorities.

New Resources for a Tied Aid Credit Program

The Administration gave careful consideration to the feasibility and utility of seeking new resources to establish a tied aid credit program. Such a program would be aimed at meeting the developmental needs of recipients, but also would provide more direct support to those of our exporters whose interests suffer most directly from the tied aid credit practices of other countries. It was recognized that a program of this nature could be designed to bolster our negotiating efforts.

On balance, however, the Administration did not find a tied aid credit program of this nature to be of such high national priority as to warrant the expenditure of substantial additional resources at this time. Output and employment in the United States are at healthy levels. Our trade balance is improving as a result of improved international coordination of economic policies and the revitalization of our domestic economy. We also were acutely aware of current budgetary constraints. In these circumstances, the steps we are proposing should be sufficient to accomplish our purposes without the commitment of additional resources required by a new program.

Conclusion

The Administration will keep under continuing review the magnitude of the tied aid credit problem we face and the progress we are able to make in improving multilateral discipline. We retain the option of recommending that additional resources be devoted to the establishment of a tied aid credit program in the future if sufficient progress is not made toward achieving our negotiating objectives. In evaluating our progress, particular attention will be paid to the willingness of other countries to work with us to limit the scope of trade distortions emanating from their foreign aid programs.

The Administration recommits itself to working with Congress and the U.S. export community to ensure that, to the maximum possible degree, export sales competition is conducted on a basis of price, quality, and service rather than concessional financing. We recognize that perseverance will be necessary if this effort is to produce its intended results, particularly in sectors and markets where tied aid credits are extensively used. We believe the course we have outlined will help otherwise competitive U.S. exporters maintain their presence in those sectors and markets.

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
September 12, 1989

CONTACT: Office of Financing 202/376-4350

15310

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 September 21, 1989. This offering will result in a paydown for the Treasury of about $4,625 million, as the maturing bills total $19,030 million (including the 45-day cash management bills issued August 7, 1989, in the amount of $5,002 million). Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239-1500, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, September 18, 1989. 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 December 22, 1988, and to mature December 21, 1989 (CUSIP No. 912794 SP 0), currently outstanding in the amount of $15,792 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,200 million, to be dated September 21, 1989, and to mature March 22, 1990 (CUSIP No. 912794 TW 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 September 21, 1989. 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 $2,102 million as agents for foreign and international monetary authorities, and $3,683 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

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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 one-half hour prior to the closing time for receipt of tenders 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.

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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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.

8/89

TREASURY NEWS

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

For release on delivery
expected at 10:00 am
September 13, 1989

STATEMENT OF
THE HONORABLE CHARLES H. DALLARA
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
SEPTEMBER 13, 1989

Mr. Chairman and Members of the Subcommittee:

I am pleased to discuss with you the Administration's policies on tied aid credits. These policies have been developed by the Economic Policy Council in light of a variety of factors including Eximbank's April report to Congress on the tied aid credit practices of other countries.

My intention is to focus today on the potential role of international negotiations in dealing with the tied aid credit problem and how proposed changes in use of the War Chest -- and possibly in our use of aid resources -- can support these negotiations. I would like to begin, however, by drawing your attention to some data that have only recently become available concerning the scope of the tied aid credit problem.

Magnitude of the Tied Aid Credit Problem

Tied aid is defined as concessional financing linked to procurement of goods and services in the donor country. Its primary purpose generally is to assist developing economies. However, some tied aid also has a commercial motivation in that it seeks to promote artificially the donor country's exports (especially of capital goods) while aiding development. Data collected by the OECD on the tied aid credit programs of member countries do not differentiate between offers which are commercially motivated and those which are not.

OECD figures covering tied aid offers by member countries from mid-1987 to mid-1988 showed an increase in total offers. The increase raised questions as to whether the problem was growing worse despite a March 1987 agreement that raised minimum tied aid concessionality levels from 25 percent to 30 percent in July, 1987 and to 35 percent in July, 1988.

The latest statistics compiled by the OECD for the year from mid-1988 to mid-1989, on the other hand, are somewhat more encouraging. The data, received in late August, show a significant decline in total tied aid credits notified, from just over $17.4 billion in 1987/1988 to slightly over $14.3 billion in 1988/1989 -- a drop of about 18 percent. The drop in credits with concessionality levels of less than 50 percent (one measure of "harder" aid) was larger, from just over $14 billion in 1987-88 to under $10.5 billion in 1988-89. This is a drop of approximately 25 percent. Both these year-on-year comparisons mask an even sharper decline between the last half of 1988 and the first half of 1989.

While encouraging, the latest figures should be treated with caution. Tied aid credit offers remain high by pre-1987 standards. The new data do not necessarily establish a trend, and we do not know with certainty the reason for the decline. Therefore, while welcoming the new figures, we do not as yet consider them a reliable indicator that the tied aid credit problem is on the way to solution.

The Eximbank report to Congress in April made clear that the U.S. tied aid credit problem derives largely from the fact that other countries use their tied aid to support capital projects to a greater degree than we do. Eximbank's report estimated U.S. capital goods exporters lost sales annually of $400-800 million as a result of the tied aid credit practices of other countries. We continue to rely on the Eximbank figures as our estimate of the magnitude of the problem.

International Negotiations

The Administration has concluded that a vigorous new negotiating effort aimed at reducing the commercial disadvantage U.S. exporters face should be the central thrust of the response to the tied aid credit practices of other countries. We will seek to reduce substantially the trade distortions caused by these practices to the detriment of U.S. exporters.

Groundwork for this effort began at the spring Ministerial meeting of the OECD. The Arche Summit in July lent considerable additional momentum. At the Summit, other G-7 government leaders joined President Bush in expressing strong support for further progress in increasing multilateral discipline over the use of tied aid credits, and urged that the OECD begin work as soon as possible. We intend to use the OECD and Summit guidance as the basis for a major new effort to tackle the problem.

Previous negotiations on this issue concentrated on raising the minimum required concessionality levels for tied aid credits in order to make them too costly to be used lightly as trade subsidies. Since that agreement was fully implemented only a year ago, we probably have not yet seen its full effect. Partly for that reason, and partly because OECD countries are reluctant to accept a further significant increase in concessionality levels at this time, there is agreement here and abroad that a new round of negotiations should focus on some other aspect of the issue than concessionality levels.

A number of alternative negotiating objectives have been suggested in the OECD's export credit and development assistance groups. The major options include (1) effectively untying aid programs for capital projects; (2) limiting the use of tied aid in problem sectors and/or markets; (3) limiting the use of relatively low-concessional aid to a certain proportion of a donor's total program; (4) requiring open competitive bidding for transactions below a certain concessionality level to discourage commercial abuse of low-concessional aid; (5) banning the late introduction of tied aid credits into project bidding; and (6) otherwise improving guidelines to enhance the developmental orientation of tied aid.

It is likely that the U.S. strategy will incorporate more than one of these options, especially since significant portions of the negotiating effort will be focused in the development assistance area. We are assessing which options will offer the greatest scope for success, and will be working in OECD meetings this fall to achieve international consensus on ground rules for the new round of negotiations.

Any U.S. negotiating strategy will have to recognize the fact that U.S. procurement policies also seek to ensure that most foreign assistance funds are spent on U.S. goods and services. Other than food aid (which is all tied), AID estimates that in 1986 about 45 percent of all bilateral loans and grants were fully or partially tied to U.S. procurement, including only about 5 percent for capital projects.

I should reemphasize that it will not be possible to eliminate completely other countries' use of aid programs to support capital projects. Nor does the Administration wish to prohibit the use of aid for projects that meet the legitimate development needs of recipient countries. The negotiating road ahead will be long and difficult, and other countries are not generally enthusiastic about the undertaking. The intermediate goal, reflecting our awareness of the complexity of the task ahead, is to provide a progress report to OECD Ministers at their spring 1990 meeting.

The difficulties notwithstanding, further progress is possible. We can and will work to minimize the effects on U.S. capital goods exporters of the differences in countries' aid policies. Less tying of aid would be of obvious benefit. Intensive work on the problems of "spoiled" markets and sectors also should help. Limiting the share of low-concessional aid may be another promising avenue. The final result should be to focus foreign assistance more on development and less on competitive trade advantage.

New Resources for a Tied Aid Credit Program

The Administration gave careful consideration to the feasibility and utility of devoting additional resources to a separate tied aid credit program. We recognized that such a program could benefit American exporters whose interests suffer most directly from the tied aid practices of others. It also could advance U.S. negotiating efforts.

On balance, however, it did not appear necessary to create a separate tied aid program and to commit substantial additional resources at this time. Output and employment in the United States are at healthy levels. The nation still is enjoying the longest peacetime economic expansion in the post World War II era. The U.S. trade balance is improving due to better international coordination of economic policies and the revitalization of the domestic economy; we have experienced double digit export expansion over the last eighteen months. Finally, U.S. capital goods exporters tend to be large, well-capitalized, and technically sophisticated.

Current budgetary constraints also were a major factor. As a practical matter, creation of a new tied aid credit program would require an offsetting diversion of funds to the detriment of other essential programs. Such diversion is not justified at this juncture.

The War Chest

On the other hand, we will not hesitate to commit resources that already are available. The primary financial underpinning for the previous U.S. negotiating effort on tied aid credits was the Tied Aid Credit Fund, or "War Chest." Since the conclusion of the 1987 agreement, the War Chest has been used to encourage early and full compliance with the agreement by matching offers from other countries that deviated from its provisions. In practice, this resulted in little use since most tied aid credits have conformed to the agreement.

The Administration now proposes to use the War Chest actively in support of the new round of negotiations. It also would remain available to ensure implementation of current agreements, should that prove necessary -- though there is no reason to anticipate increased use for this purpose.

The FY 1990 budget proposals include a War Chest of $100 million. When blended with commercial credits guaranteed by Eximbank, this would allow us to offer nearly $300 million of "mixed credit" financing at current required concessionality levels. Since not all of Eximbank's offers are accepted, it would be reasonable for the Bank to extend an even higher volume of offers. To the extent that foreign assistance funds can be used to supplement Eximbank's resources, the volume of funding available for mixed credits would be larger still.

There are three main options for using the War Chest in support of the strategy I am outlining today:

-- Target export markets of countries that refuse to cooperate in negotiations on tied aid, as was done in the past. This would be particularly useful if there is evidence that countries are not adhering to the tied aid credit agreement or that they are blocking cooperative, multilateral solutions to remaining tied aid credit problems.

-- Match tied aid offers of other countries where doing so would advance negotiations, whether or not the other countries are being cooperative. This "defensive" approach can be useful in some cases, but defensive reactions often come too late to give our exporters a real chance of winning the order or to provide much support for a negotiating effort.

-- Take a more activist approach by targetting offers in sectors and markets of interest to U.S. exporters where tied aid credits are used extensively. This approach could have substantial impact for a given expenditure of funds because it allows us to control the timing, location, and size of tied aid credit offers. It would have to be used judiciously, however, in order not to exacerbate the problem.

The Administration prefers to emphasize the third option, targetting sectors and markets of particular interest to U.S. exporters where tied aid is heavily used. However, responding to other countries' tied aid practices may be appropriate in some cases, so matching or overmatching would continue to be options where it serves our negotiating purposes. Such flexible use of a War Chest of the magnitude proposed would send a convincing message of intent to level the tied aid playing field. In addition, we will endeavor to find a variety of ways of augmenting the pressures for prompt, effective action to deal with the trade distortions resulting from tied aid credits.

If negotiations do not proceed seriously and expeditiously, we may be prepared to ask Congress for additional War Chest appropriations in subsequent years. In that case we also would be prepared to reconsider, if necessary, the ways in which War Chest funds are targetted.

Foreign Assistance Programs

Where AID or TDP funds are available, those agencies will undertake joint initiatives with Eximbank. In such cases, the transaction must (1) contribute to the development of the importing country; (2) satisfy Eximbank's creditworthiness standards; (3) be of potentially long-term benefit to the U.S. economy; and (4) have a significant impact on competitors.

To the extent allowed by its current funding and program authority, AID will begin immediately to maximize support for capital projects. As part of this effort AID, together with TDP, will look for ways to support such projects in cooperation with Eximbank. By exchanging information early in the evaluation phase, the three agencies should be able to identify joint funding opportunities.

TDP's legislative mandate of course allows it to provide direct, tangible support for U.S. capital goods exporters, and some portion of AID's current appropriations can be used to finance the transfer of capital goods as well. However, AID's scope for participation in a tied aid credit initiative is limited by the multiple purposes our aid programs must serve and by the high degree of congressional earmarking. Within these constraints, AID will make available what funds it can.

Over the medium term, the Administration will consider whether and how U.S. foreign assistance programs might provide greater support for capital projects. Provided it is done in ways that meet development standards and the needs of recipient countries, such support would be consistent with the fundamental purpose of U.S. aid programs.

Conclusions

The Administration recommits itself to vigorous negotiations to minimize the use of tied aid credits for commercial advantage and to reduce substantially the trade distortions resulting from the current pattern of tied aid credit usage.

In support of these negotiations, we propose active use of the War Chest, combined with a commitment on the part of AID and TDP individually and in combination with Eximbank to support developmentally sound capital projects within existing resource constraints. This will not only demonstrate to other countries our continuing concerns about tied aid credit practices, but also will encourage our exporters to maintain a presence in sectors and markets where the use of tied aid credits by other countries is extensive.

TREASURY NEWS

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NEW INCOME TAX CONVENTION SIGNED WITH THE REPUBLIC OF INDIA

The Treasury Department announced today the signing of an Income Tax Convention and accompanying Protocol ("the treaty") between the United States and the Republic of India. The proposed treaty was signed in New Delhi on September 12, 1989 by Ambassador John R. Hubbard for the United States, and by Revenue Secretary Dr. N. K. Sengupta for the Republic of India. The proposed treaty will be submitted to the Senate for its advice and consent to ratification. Following notification by both countries that all ratification procedures have been completed, the treaty will enter into force. The treaty will have effect in the United States as of January 1 of the year following the year in which the treaty enters into force. In India the treaty will have effect as of April 1 of the year following entry into force.

This will be the first income tax treaty between the two countries. An earlier treaty, signed in 1959, did not enter into force. The proposed treaty differs from the U.S. Model Income Tax Convention in a number of respects in order to reflect India's status as a developing country. In this regard it is similar to other U.S. treaties with developing countries.

The treaty provides maximum rates of tax at source on payments of dividends, interest and royalties. Dividends from a subsidiary to a parent corporation are taxable at a maximum rate of 15 percent; other dividends may be taxed at source at a maximum of 25 percent rate. Interest is, in general, taxable at source at a maximum of 15 percent, although interest received by a financial institution is taxable at a maximum rate of 10 percent, and interest received by either of the two Governments, by certain governmental financial institutions, and by residents of a Contracting State on certain Government approved loans, is exempt from tax at source.

The royalty provisions contain several significant departures from standard U.S. treaty policy. In general, industrial and copyright royalties are taxable at source at a maximum rate of 20 percent for the first five years of the treaty's life, dropping to 15 percent thereafter. Where the payor of the royalty is one of the Governments, a political subdivision or a public sector corporation, tax will be imposed from the effective date of the treaty at a maximum rate of 15 percent. Payments for the use of, or the right to use, industrial, commercial or scientific equipment are treated as royalties, and are subject to a maximum rate of tax at source of 10 percent. Certain service fees, referred to in the treaty as "fees for included services", are treated in the same manner as royalties. Included services are defined as technical or consultancy services which either: (i) are ancillary and subsidiary to the licensing of an intangible or the rental of tangible personal property, both of which give rise to royalty payments, or (ii) if not ancillary or subsidiary, make available to the payor of the service fee, some technical knowledge, experience, skill, etc., or transfer to that person a technical plan or design. A detailed memorandum of understanding was developed to provide guidance as to the intended scope of the concept of "included services". Copies of this memorandum are available along with copies of the Treaty, as described below. Fees for all other services are treated either as business profits or as independent personal services income.

The treaty preserves for the United States the right to impose the branch profits tax. It preserves for both Contracting States their statutory taxing rights with respect to capital gains. The proposed treaty contains rules for the taxation of business profits which, consistent with other U.S. treaties with developing countries, provide a broader range of circumstances under which one partner may tax the business profits of a resident of the other. The treaty contains reciprocal exemption at source for shipping and aircraft operating income. The treatment under the proposed treaty of various classes of personal service income is similar to that under other U.S. treaties with developing countries. The proposed treaty contains provisions designed to prevent third-country residents from treaty shopping. Like all U.S. tax treaties, the proposed treaty prohibits tax discrimination, creates a dispute resolution mechanism and provides for the exchange of otherwise confidential tax information between the tax authorities of the partners.

Copies of the proposed Treaty and Protocol, diplomatic notes exchanged at the time of the signing, and the memorandum of understanding on Fees for Included Services will be available soon from the Treasury's Office of Public Affairs, Room 2315, Treasury Department, Washington, D.C. 20220, telephone (202) 566-2041.

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CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE REPUBLIC OF INDIA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME

The Government of the United States of America and the Government of the Republic of India, desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, have agreed as follows:

ARTICLE 1

General Scope

1. This Convention shall apply to persons who are residents of one or both of the Contracting States, except as otherwise provided in the Convention.

2. The Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded:

a) by the laws of either Contracting State; or

b) by any other agreement between the Contracting States.

3. Notwithstanding any provision of the Convention except paragraph 4, a Contracting State may tax its residents (as determined under Article 4 (Residence)), and by reason of citizenship may tax its citizens, as if the Convention had not come into effect. For this purpose, the term "citizen" shall include a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax, but only for a period of 10 years following such loss.

4. The provisions of paragraph 3 shall not affect

a) the benefits conferred by a Contracting State under paragraph 2 of Article 9 (Associated Enterprises), under paragraphs 2 and 6 of Article 20 (Private Pensions, Annuities, Alimony, and Child Support), and under Articles 25 (Relief From Double Taxation), 26 (Non-Discrimination), and 27 (Mutual Agreement Procedure); and

b) the benefits conferred by a Contracting State under Articles 19 (Remuneration and Pensions in Respect of Government Service), 21 (Payments Received by Students and Apprentices), 22 (Payments Received by Professors, Teachers and Research Scholars) and 29 (Diplomatic Agents and Consular Officers), upon individuals who are neither citizens of, nor have immigrant status in, that State.

ARTICLE 2

Taxes Covered

1. The existing taxes to which this Convention shall apply are:

a) in the United States, the Federal income taxes imposed by the Internal Revenue Code (but excluding the accumulated earnings tax, the personal holding company tax, and social security taxes), and the excise taxes imposed on insurance premiums paid to foreign insurers and with respect to private foundations (hereinafter referred to as "United States tax"); provided, however, the Convention shall apply to the excise taxes imposed on insurance premiums paid to foreign insurers only to the extent that the risks covered by such premiums are not reinsured with a person not entitled to exemption from such taxes under this or any other Convention which applies to these taxes; and

b) in India:

i) the income tax including any surcharge thereon, but excluding income tax on undistributed income of companies, imposed under the Income-tax Act; and

ii) the surtax

(hereinafter referred to as "Indian tax").

Taxes referred to in (a) and (b) above shall not include any amount payable in respect of any default or omission in relation to the above taxes or which represent a penalty imposed relating to those taxes.

2. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes which have been made in their respective taxation laws and of any official published material concerning the application of the Convention.

ARTICLE 3

General Definitions

1. In this Convention, unless the context otherwise requires:

a) the term "India" means the territory of India and includes the territorial sea and airspace above it, as well as any other maritime zone in which India has sovereign rights, other rights and jurisdictions, according to the Indian law and in accordance with international law;

b) the term "United States", when used in a geographical sense means all the territory of the United States of America, including its territorial sea, in which the laws relating to United States tax are in force, and all the area beyond its territorial sea, including the seabed and subsoil thereof, over which the United States has jurisdiction in accordance with international law and in which the laws relating to United States tax are in force;

c) the terms "a Contracting State" and "the other Contracting State" mean India or the United States as the context requires;

d) the term "tax" means Indian tax or United States tax, as the context requires;

e) the term "person" includes an individual, an estate, a trust, a partnership, a company, any other body of persons, or other taxable entity;

f) the term "company" means any body corporate or any entity which is treated as a company or body corporate for tax purposes;

g) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;

h) the term "competent authority" means, in the case of India, the Central Government in the Ministry of Finance (Department of Revenue) or their authorized representative, and in the case of the United States, the Secretary of the Treasury or his delegate;

i) the term "national" means any individual possessing the nationality or citizenship of a Contracting State;

j) the term "international traffic" means any transport by a ship or aircraft operated by an enterprise of a Contracting State, except when the ship or aircraft is operated solely between places within the other Contracting State;

k) the term "taxable year" in relation to Indian Tax means "previous year" as defined in the Income-tax Act, 1961.

2. As regards the application of the Convention by a Contracting State any term not defined therein shall, unless the context otherwise requires or the competent authorities agree to a common meaning pursuant to the provisions of Article 27 (Mutual Agreement Procedure), have the meaning which it has under the laws of that State concerning the taxes to which the Convention applies.

ARTICLE 4

Residence

1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of

that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature, provided, however, that

a) this term does not include any person who is liable to tax in that State in respect only of income from sources in that State; and

b) in the case of income derived or paid by a partnership, estate, or trust, this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries.

2. Where by reason of the provisions of paragraph 1, an individual is a resident of both Contracting States, then his status shall be determined as follows:

a) he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (centre of vital interests);

b) if the State in which he has his centre of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;

c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;

d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where, by reason of paragraph 1, a company is a resident of both Contracting States, such company shall be considered to be outside the scope of this Convention except for purposes of paragraph 2 of Article 10 (Dividends), Article 26 (Non-Discrimination), Article 27 (Mutual Agreement Procedure), Article 28 (Exchange of Information and Administrative Assistance) and Article 30 (Entry Into Force).

4. Where, by reason of the provisions of paragraph 1, a person other than an individual or a company is a resident of both Contracting States, the competent authorities of the Contracting States shall settle the question by mutual agreement and determine the mode of application of the Convention to such person.

ARTICLE 5

Permanent Establishment

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

a) a place of management;

b) a branch;

c) an office;

d) a factory;

e) a workshop;

f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources;

g) a warehouse, in relation to a person providing storage facilities for others;

h) a farm, plantation or other place where agriculture, forestry, plantation or related activities are carried on;

i) a store or premises used as a sales outlet;

j) an installation or structure used for the exploration or exploitation of natural resources, but only if so used for a period of more than 120 days in any twelve month period;

k) a building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project or activities (together with other such sites, projects or activities, if any) continue for a period of more than 120 days in any twelve month period;

l) the furnishing of services, other than included services as defined in Article 12 (Royalties and Fees for Included Services), within a Contracting State by an enterprise through employees or other personnel, but only if:

i) activities of that nature continue within that State for a period or periods aggregating more than 90 days within any twelve-month period; or

ii) the services are performed within that State for a related enterprise (within the meaning of paragraph 1 of Article 9 (Associated Enterprises)).

3. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include any one or more of the following:

a) the use of facilities solely for the purpose of storage, display, or occasional delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or occasional delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for other activities which have a preparatory or auxiliary character, for the enterprise.

4. Notwithstanding the provisions of paragraphs 1 and 2, where a person - other than an agent of an independent status to whom paragraph 5 applies - is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned State if:

a) he has and habitually exercises in the first-mentioned State an authority to conclude contracts on behalf of the enterprise, unless his activities are limited to those mentioned in paragraph 3 which, if exercised through a fixed place of business, would not make that fixed place of business a permanent establishment under the provisions of that paragraph;

b) he has no such authority but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise, and some additional activities conducted in that State on behalf of the enterprise have contributed to the sale of the goods or merchandise; or

c) he habitually secures orders in the first-mentioned State, wholly or almost wholly for the enterprise.

5. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the

ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise and the transactions between the agent and the enterprise are not made under arm's-length conditions, he shall not be considered an agent of independent status within the meaning of this paragraph.

6. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

ARTICLE 6

Income From Immovable Property (Real Property)

1. Income derived by a resident of a Contracting State from immovable property (real property), including income from agriculture or forestry, situated in the other Contracting State may be taxed in that other State.

2. The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated.

3. The provisions of paragraph 1 shall also apply to income derived from the direct use, letting, or use in any other form of immovable property.

4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.

ARTICLE 7

Business Profits

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to a) that permanent establishment; b) sales in the other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or c) other business activities carried on in the other State of the same or similar kind as those effected through that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the

same or similar conditions and dealing wholly at arm's-length with the enterprise of which it is a permanent establishment and other enterprises controlling, controlled by or subject to the same common control as that enterprise. In any case where the correct amount of profits attributable to a permanent establishment is incapable of determination or the determination thereof presents exceptional difficulties, the profits attributable to the permanent establishment may be estimated on a reasonable basis. The estimate adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere, in accordance with the provisions of and subject to the limitations of the taxation laws of that State. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than toward reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other

similar payments in return for the use of patents, know-how or other rights, or by way of commission or other charges for specific services performed or for management, or, except in the case of banking enterprises, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than toward reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents, know-how or other rights, or by way of commission or other charges for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

4. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

5. For the purposes of this Convention, the profits to be attributed to the permanent establishment as provided in paragraph 1(a) of this Article shall include only the profits derived from the assets and activities of the permanent establishment and shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where profits include items of income which are dealt with separately in other Articles of the Convention, then the

provisions of those Articles shall not be affected by the provisions of this Article.

7. For the purposes of the Convention, the term "business profits" means income derived from any trade or business including income from the furnishing of services other than included services as defined in Article 12 (Royalties and Fees for Included Services) and including income from the rental of tangible personal property other than property described in paragraph 3 (b) of Article 12 (Royalties and Fees for Included Services).

ARTICLE 8

Shipping and Air Transport

1. Profits derived by an enterprise of a Contracting State from the operation by that enterprise of ships or aircraft in international traffic shall be taxable only in that State.

2. For the purposes of this Article, profits from the operation of ships or aircraft in international traffic shall mean profits derived by an enterprise described in paragraph 1 from the transportation by sea or air respectively of passengers, mail, livestock or goods carried on by the owners or lessees or charterers of ships or aircraft including--

a) the sale of tickets for such transportation on behalf of other enterprises;

b) other activity directly connected with such transportation; and

c) the rental of ships or aircraft incidental to any activity directly connected with such transportation.

3. Profits of an enterprise of a Contracting State described in paragraph 1 from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used in connection with the operation of ships or aircraft in international traffic shall be taxable only in that State.

4. The provisions of paragraphs 1 and 3 shall also apply to profits from participation in a pool, a joint business, or an international operating agency.

5. For the purposes of this Article, interest on funds connected with the operation of ships or aircraft in international traffic shall be regarded as profits derived from the operation of such ships or aircraft, and the provisions of Article 11 (Interest) shall not apply in relation to such interest.

6. Gains derived by an enterprise of a Contracting State described in paragraph 1 from the alienation of ships, aircraft or containers owned and operated by the enterprise, the income from which is taxable only in that State, shall be taxed only in that State.

ARTICLE 9

Associated Enterprises

1. Where:

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or

b) the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which, but for those conditions would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State, and taxes accordingly, profits on which an enterprise of the other Contracting State has been charged to tax in that other State, and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

ARTICLE 10

Dividends

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident, and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

a) 15 per cent of the gross amount of the dividends if the beneficial owner is a company which owns at least 10 per cent of the voting stock of the company paying the dividends;

b) 25 per cent of the gross amount of the dividends in all other cases.

Subparagraph b) and not subparagraph a) shall apply in the case of dividends paid by a United States person which is a Regulated Investment Company. Subparagraph a) shall not apply to dividends paid by a United States person which is a Real Estate Investment Trust, and subparagraph b) shall only apply if the dividend is beneficially owned by an individual holding a less than 10 percent interest in the Real Estate Investment Trust. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. The term "dividends" as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, income from other corporate rights which are subjected to the same taxation treatment as income from shares by the taxation laws of the State of which the company making the distribution is a resident; and income from arrangements, including debt obligations, carrying the right to participate in profits, to the extent so characterized under the laws of the Contracting State in which the income arises.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State, of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the dividends are attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), as the case may be, shall apply.

5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a

permanent establishment or a fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

ARTICLE 11

Interest

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such interest may also be taxed in the Contracting State in which it arises, and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed:

a) 10 percent of the gross amount of the interest if such interest is paid on a loan granted by a bank carrying on a bona fide banking business or by a similar financial institution (including an insurance company); and

b) 15 percent of the gross amount of the interest in all other cases.

3. Notwithstanding the provisions of paragraph 2 of this Article, interest arising in a Contracting State:

a) and derived and beneficially owned by the Government of the other Contracting State, a political subdivision or local authority thereof, the Reserve Bank of India, or the Federal Reserve Banks of the United States, as the case may be, and such other institutions of either Contracting State as the competent authorities may agree pursuant to Article 27 (Mutual Agreement Procedure);

b) with respect to loans or credits extended or endorsed

i) by the Export Import Bank of the United States, when India is the first-mentioned Contracting State; and

ii) by the EXIM Bank of India, when the United States is the first-mentioned Contracting State; and

c) to the extent approved by the Government of that State, and derived and beneficially owned by any person, other than a person referred to in subparagraphs (a) and (b), who is a resident of the other Contracting State, provided that the transaction giving rise to the debt-claim has been approved in this behalf by the Government of the first-mentioned Contracting State;

shall be exempt from tax in the first-mentioned Contracting State.

4. The term "interest" as used in this Convention means income from debt-claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities, and income from bonds or debentures, including premiums or prizes attaching to such securities, bonds, or debentures. Penalty charges for late payment shall not be

regarded as interest for the purposes of the Convention. However, the term "interest" does not include income dealt with in Article 10 (Dividends).

5. The provisions of paragraphs 2 and 3 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the interest is attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), as the case may be, shall apply.

6. Interest shall be deemed to arise in a Contracting State when the payer is that State itself or a political subdivision, local authority, or resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.

7. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would

have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of the Convention.

ARTICLE 12

Royalties and Fees for Included Services

1. Royalties and fees for included services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such royalties and fees for included services may also be taxed in the Contracting State in which they arise and according to the laws of that State; but if the beneficial owner of the royalties or fees for included services is a resident of the other Contracting State, the tax so charged shall not exceed:

a) in the case of royalties referred to in sub-paragraph (a) of paragraph 3 and fees for included services as defined in this Article (other than services described in sub-paragraph (b) of this paragraph):

i) during the first five taxable years for which this Convention has effect,

A) 15 percent of the gross amount of the royalties or fees for included services as defined in this Article, where the payer of the royalties or fees is the Government of that Contracting State, a political subdivision or a public sector company; and

B) 20 percent of the gross amount of the royalties or fees for included services in all other cases; and

ii) during the subsequent years, 15 percent of the gross amount of royalties or fees for included services; and

b) in the case of royalties referred to in sub-paragraph (b) of paragraph 3 and fees for included services as defined in this Article that are ancillary and subsidiary to the enjoyment of the property for which payment is received under paragraph 3 (b) of this Article, 10 percent of the gross amount of the royalties or fees for included services.

3. The term "royalties" as used in this Article means:

a) payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including cinematograph films or work on film, tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience, including gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof; and

b) payments of any kind received as consideration for the use of, or the right to use, any industrial, commercial, or scientific equipment, other than payments derived by an enterprise described in paragraph 1 of Article 8 (Shipping and Air Transport) from activities described in paragraph 2(c) or 3 of Article 8.

4. For purposes of this Article, "fees for included services" means payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including through the provision of services of technical or other personnel) if such services:

a) are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment described in paragraph 3 is received; or

b) make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design.

5. Notwithstanding paragraph 4, "fees for included services" does not include amounts paid:

a) for services that are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of property other than a sale described in paragraph 3(a);

b) for services that are ancillary and subsidiary to the rental of ships, aircraft, containers or other equipment used in connection with the operation of ships or aircraft in international traffic;

c) for teaching in or by educational institutions;

d) for services for the personal use of the individual or individuals making the payment; or

e) to an employee of the person making the payments or to any individual or firm of individuals (other than a company) for professional services as defined in Article 15 (Independent Personal Services).

6. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties or fees for included services, being a resident of a Contracting State, carries on business in the other Contracting State, in which the royalties or fees for included services arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the royalties or fees for included services are attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), as the case may be, shall apply.

7. (a) Royalties and fees for included services shall be deemed to arise in a Contracting State when the payer is that State itself, a political subdivision, a local authority, or a resident of that State. Where, however, the person paying the royalties or fees for included services, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties or fees for included services

was incurred, and such royalties or fees for included services are borne by such permanent establishment or fixed base, then such royalties or fees for included services shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.

(b) Where under subparagraph (a) royalties or fees for included services do not arise in one of the Contracting States, and the royalties relate to the use of, or the right to use, the right or property, or the fees for included services relate to services performed, in one of the Contracting States, the royalties or fees for included services shall be deemed to arise in that Contracting State.

8. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties or fees for included services paid exceeds the amount which would have been paid in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of the Convention.

ARTICLE 13

Gains

Except as provided in Article 8 (Shipping and Air Transport) of this Convention, each Contracting State may tax capital gains in accordance with the provisions of its domestic law.

ARTICLE 14

Permanent Establishment Tax

1. A company which is a resident of India may be subject in the United States to a tax in addition to the tax allowable under the other provisions of this Convention.

a) Such tax, however, may be imposed only on:

i) the portion of the business profits of the company subject to tax in the United States which represents the dividend equivalent amount; and

ii) the excess, if any, of interest deductible in the United States in computing the profits of the company that are subject to tax in the United States and either attributable to a permanent establishment in the United States or subject to tax in the United States under Article 6 (Income From Immovable Property (Real Property)), Article 12 (Royalties and Fees for Included Services) as fees for included services, or Article 13 (Gains) of this Convention over the interest paid by or from the permanent establishment or trade or business in the United States.

b) For purposes of this article, business profits means profits that are effectively connected (or treated as effectively connected) with the conduct of a trade or business within the United States and are either attributable to a permanent establishment in the United States or subject to tax in the United States under Article 6 (Income From Immovable Property (Real Property)), Article 12 (Royalties and Fees for Included Services) as fees for included services or Article 13 (Gains) of this Convention.

c) The tax referred to in subparagraph (a) shall not be imposed at a rate exceeding:

i) the rate specified in paragraph 2 (a) of Article 10 (Dividends) for the tax described in subparagraph (a) (i); and

ii) the rate specified in paragraph 2 (a) or (b) (whichever is appropriate) of Article 11 (Interest) for the tax described in subparagraph (a) (ii).

2. A company which is a resident of the United States may be subject to tax in India at a rate higher than that applicable to the domestic companies. The difference in the tax rate shall not, however, exceed the existing difference of 15 percentage points.

3. In the case of a banking company which is a resident of the United States, the interest paid by the permanent establishment of such a company in India to the head office may be subject in India to a tax in addition to the tax imposable under the other provisions of this Convention at a rate which shall not exceed the rate specified in paragraph 2 (a) of Article 11 (Interest).

ARTICLE 15

Independent Personal Services

1. Income derived by a person who is an individual or firm of individuals (other than a company) who is a resident of a Contracting State from the performance in the other Contracting State of professional services or other independent activities of a similar character shall be taxable only in the first-mentioned State except in the following circumstances when such income may also be taxed in the other Contracting State:

a) if such person has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other State; or

b) if the person's stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 90 days in the relevant taxable year.

2. The term "professional services" includes independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, surgeons, lawyers, engineers, architects, dentists and accountants.

ARTICLE 16

Dependent Personal Services

1. Subject to the provisions of Articles 17 (Directors' Fees), 18 (Income Earned by Entertainers and Athletes), 19 (Remuneration and Pensions in Respect of Government Service), 20 (Private Pensions, Annuities, Alimony, and Child Support), 21 (Payments Received by Students and Apprentices) and 22 (Payments Received by Professors, Teachers and Research Scholars), salaries, wages, and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in the relevant taxable year;

b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and

c) the remuneration is not borne by a permanent establishment or a fixed base or a trade or business which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic by an enterprise of a Contracting State may be taxed in that State.

ARTICLE 17

Directors' Fees

Directors' fees and similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State.

ARTICLE 18

Income Earned by Entertainers and Athletes

1. Notwithstanding the provisions of Articles 15 (Independent Personal Services) and 16 (Dependent Personal Services), income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as an athlete, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State, except where the amount of the net income derived by such entertainer or athlete from such activities (after deduction of all expense incurred by him in connection with his visit and performance) does not exceed

one thousand five hundred United States dollars ($1,500) or its equivalent in Indian rupees for the taxable year concerned.

2. Where income in respect of activities exercised by an entertainer or an athlete in his capacity as such accrues not to the entertainer or athlete but to another person, that income of that other person may, notwithstanding the provisions of Articles 7 (Business Profits), 15 (Independent Personal Services) and 16 (Dependent Personal Services), be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised unless the entertainer, athlete, or other person establishes that neither the entertainer or athlete nor persons related thereto participate directly or indirectly in the profits of that other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions, or other distributions.

3. Income referred to in the preceding paragraphs of this Article derived by a resident of a Contracting State in respect of activities exercised in the other Contracting State shall not be taxed in that other State if the visit of the entertainers or athletes to that other State is supported wholly or substantially from the public funds of the Government of the first-mentioned Contracting State, or of a political subdivision or local authority thereof.

4. The competent authorities of the Contracting States may, by mutual agreement, increase the dollar amounts referred to in paragraph 1 to reflect economic or monetary developments.

ARTICLE 19

Remuneration and Pensions in Respect of Government Service

1. a) Remuneration, other than a pension, paid by a Contracting State or a political sub-division or a local authority thereof to an individual in respect of services rendered to that State or sub-division or authority shall be taxable only in that State.

b) However, such remuneration shall be taxable only in the other Contracting State if the services are rendered in that other State and the individual is a resident of that State who:

i) is a national of that State; or

ii) did not become a resident of that State solely for the purpose of rendering the services.

2. a) Any pension paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that state or subdivision or authority shall be taxable only in that State.

b) However, such pension shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that State.

3. The provisions of Articles 16 (Dependent Personal Services), 17 (Directors' Fees), 18 (Income Earned by Entertainers and Athletes) and 20 (Private Pensions, Annuities,

Alimony and Child Support) shall apply to remuneration and pensions in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof.

ARTICLE 20

Private Pensions, Annuities, Alimony and Child Support

1. Any pension, other than a pension referred to in Article 19 (Remuneration and Pensions in Respect of Government Service), SB or any annuity derived by a resident of a Contracting State from sources within the other Contracting State may be taxed only in the first-mentioned Contracting State.

2. Notwithstanding paragraph 1, and subject to the provisions of Article 19 (Remuneration and Pensions in Respect of Government Service), social security benefits and other public pensions paid by a Contracting State to a resident of the other Contracting State or a citizen of the United States shall be taxable only in the first-mentioned State.

3. The term "pension" means a periodic payment made in consideration of past services or by way of compensation for injuries received in the course of performance of services.

4. The term "annuity" means stated sums payable periodically at stated times during life or during a specified or ascertainable number of years, under an obligation to make the payments in return for adequate and full consideration in money or money's worth (but not for services rendered).

5. Alimony paid to a resident of a Contracting State shall be taxable only in that State. The term "alimony" as used in this paragraph means periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, which payments are taxable to the recipient under the laws of the State of which he is a resident.

6. Periodic payments for the support of a minor child made pursuant to a written separation agreement or a decree of divorce, separate maintenance or compulsory support, paid by a resident of a Contracting State to a resident of the other Contracting State, shall be taxable only in the first-mentioned State.

ARTICLE 21

Payments Received by Students and Apprentices

1. A student or business apprentice who is or was a resident of one of the Contracting States immediately before visiting the other Contracting State and who is present in that other State principally for the purpose of his education or training shall be exempt from tax in that other State, on payments which arise outside that other State for the purposes of his maintenance, education or training.

2. In respect of grants, scholarships and remuneration from employment not covered by paragraph 1, a student or business

apprentice described in paragraph 1 shall, in addition, be entitled during such education or training to the same exemptions, reliefs or reductions in respect of taxes available to residents of the State which he is visiting.

3. The benefits of this Article shall extend only for such period of time as may be reasonable or customarily required to complete the education or training undertaken.

4. For the purposes of this Article, an individual shall be deemed to be a resident of a Contracting State if he is resident in that Contracting State in the taxable year in which he visits the other Contracting State or in the immediately preceding taxable year.

ARTICLE 22

Payments Received by Professors, Teachers and Research Scholars

1. An individual who visits a Contracting State for a period not exceeding two years for the purpose of teaching or engaging in research at a university, college or other recognized educational institution in that State, and who was immediately before that visit a resident of the other Contracting State, shall be exempted from tax by the first-mentioned Contracting State on any remuneration for such teaching or research for a period not exceeding two years from the date he first visits that State for such purpose.

2. This Article shall apply to income from research only if such research is undertaken by the individual in the public interest and not primarily for the benefit of some other private person or persons.

ARTICLE 23

Other Income

1. Subject to the provisions of paragraph 2, items of income of a resident of a Contracting State, wherever arising, which are not expressly dealt with in the foregoing Articles of this Convention shall be taxable only in that Contracting State.

2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6 (Income from Immovable Property (Real Property)), if the beneficial owner of the income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the income is attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), as the case may be, shall apply.

3. Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing articles of this Convention and arising in the other Contracting State may also be taxed in that other State.

ARTICLE 24

Limitation on Benefits

1. A person (other than an individual) which is a resident of a Contracting State and derives income from the other Contracting State shall be entitled under this Convention to relief from taxation in that other Contracting State only if:

a) more than 50 percent of the beneficial interest in such person (or in the case of a company, more than 50 percent of the number of shares of each class of the company's shares) is owned, directly or indirectly, by one or more individual residents of one of the Contracting States, one of the Contracting States or its political subdivisions or local authorities, or other individuals subject to tax in either Contracting State on their worldwide incomes, or citizens of the United States; and

b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are not residents of one of the Contracting States, one of the Contracting States or its political subdivisions or local authorities, or citizens of the United States.

2. The provisions of paragraph 1 shall not apply if the income derived from the other Contracting State is derived in connection with, or is incidental to, the active conduct by such person of a trade or business in the first-mentioned State (other

than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company).

3. The provisions of paragraph 1 shall not apply if the person deriving the income is a company which is a resident of a Contracting State in whose principal class of shares there is substantial and regular trading on a recognized stock exchange. For purposes of the preceding sentence, the term "recognized stock exchange" means:

a) in the case of the United States, the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Act of 1934;

b) in the case of India, any stock exchange which is recognized by the Central Government under the Securities Contracts Regulation Act, 1956; and

c) any other stock exchange agreed upon by the competent authorities of the Contracting States.

4. A person that is not entitled to the benefits of this Convention pursuant to the provisions of the preceding paragraphs of this Article may, nevertheless, be granted the benefits of the Convention if the competent authority of the State in which the income in question arises so determines.

ARTICLE 25

Relief From Double Taxation

1. In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income

a) the income tax paid to India by or on behalf of such citizen or resident; and

b) in the case of a United States company owning at least 10 percent of the voting stock of a company which is a resident of India and from which the United States company receives dividends, the income tax paid to India by or on behalf of the distributing company with respect to the profits out of which the dividends are paid.

For the purposes of this paragraph, the taxes referred to in paragraphs 1b) and 2 of Article 2 (Taxes Covered) shall be considered income taxes.

2. a) Where a resident of India derives income which, in accordance with the provisions of this Convention, may be taxed in the United States, India shall allow as a deduction from the tax on the income of that resident an amount equal to the income tax paid in the United States, whether directly or by deduction. Such deduction shall not, however, exceed that part of the income tax (as computed before the deduction

is given) which is attributable to the income which may be taxed in the United States.

b) Further, where such resident is a company by which a surtax is payable in India, the deduction in respect of income tax paid in the United States shall be be allowed in the first instance from income tax payable by the company in India and as to the balance, if any, from surtax payable by it in India.

3. For the purposes of allowing relief from double taxation pursuant to this Article, income shall be deemed to arise as follows:

a) income derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention (other than solely by reason of citizenship in accordance with paragraph 3 of Article 1 (General Scope)) shall be deemed to arise in that other State;

b) income derived by a resident of a Contracting State which may not be taxed in the other Contracting State in accordance with the Convention shall be deemed to arise in the first-mentioned State.

Notwithstanding the preceding sentence, the determination of the source of income for purposes of this Article shall be subject to such source rules in the domestic laws of the Contracting States as apply for the purpose of limiting the foreign tax credit. The preceding sentence shall not apply with respect to income dealt

JB with in Article 12 (Royalties and Fees for Included Services). The rules of this paragraph shall not apply in determining credits against United States tax for foreign taxes other than the taxes referred to in paragraphs 1b) and 2 of Article 2 (Taxes Covered).

ARTICLE 26

Non-discrimination

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall apply to persons who are not residents of one or both of the Contracting States.

2. Except where the provisions of paragraph 3 of Article 7 (Business Profits) apply, the taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs, and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

3. Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 7 of Article 11 (Interest), or paragraph 8 of Article 12 (Royalties and Fees for Included Services) apply, interest, royalties, and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State.

4. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

5. Nothing in this article shall be construed as preventing either Contracting State from imposing the taxes described in Article 14 (Permanent Establishment Tax) or the limitations described in paragraph 3 of Article 7 (Business Profits).

ARTICLE 27

Mutual Agreement Procedure

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or national. This case must be presented within three years of the date of receipt of notice of the action which gives rise to taxation not in accordance with the Convention.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits or other procedural limitations in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching

an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, shall develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this Article. In addition, a competent authority may devise appropriate unilateral procedures, conditions, methods and techniques to facilitate the above-mentioned bilateral actions and the implementation of the mutual agreement procedure.

ARTICLE 28

Exchange of Information and Administrative Assistance

1. The competent authorities of the Contracting States shall exchange such information (including documents) as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention, in particular, for the prevention of fraud or evasion of such taxes. The exchange of information is not restricted by Article 1 (General Scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State. However, if the information is originally regarded as secret in the transmitting State, it shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration

of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes which are the subject of the Convention. Such persons or authorities shall use the information only for such purposes, but may disclose the information in public court proceedings or in judicial decisions. The competent authorities shall, through consultation, develop appropriate conditions, methods and techniques concerning the matters in respect of which such exchange of information shall be made, including, where appropriate, exchange of information regarding tax avoidance.

2. The exchange of information or documents shall be either on a routine basis or on request with reference to particular cases, or otherwise. The competent authorities of the Contracting States shall agree from time to time on the list of information or documents which shall be furnished on a routine basis.

3. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

c) to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy (ordre public).

4. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall obtain the information to which the request relates in the same manner and in the same form as if the tax of the first-mentioned State were the tax of that other State and were being imposed by that other State. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this Article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of that other State with respect to its own taxes.

5. For the purposes of this Article, the Convention shall apply, notwithstanding the provisions of Article 2 (Taxes Covered):

a) in the United States, to all taxes imposed under Title 26 of the United States Code; and

b) in India, to the income tax, the wealth tax and the gift tax.

ARTICLE 29

Diplomatic Agents and Consular Officers

Nothing in this Convention shall affect the fiscal privileges of diplomatic agents or consular officers under the general rules of international law or under the provisions of special agreements.

ARTICLE 30

Entry Into Force

1. Each Contracting State shall notify the other Contracting State in writing, through diplomatic channels, upon the completion of their respective legal procedures to bring this Convention into force.

2. The Convention shall enter into force on the date of the latter of such notifications and its provisions shall have effect:

a) in the United States

i) in respect of taxes withheld at source, for amounts paid or credited on or after the first day of January next following the date on which the Convention enters into force;

ii) in respect of other taxes, for taxable periods beginning on or after the first day of January next following the date on which the Convention enters into force; and

b) in India, in respect of income arising in any taxable year beginning on or after the first day of April next following the calendar year in which the Convention enters into force.

ARTICLE 31

Termination

This Convention shall remain in force indefinitely but either of the Contracting States may, on or before the thirtieth day of June in any calendar year beginning after the expiration of a period of five years from the date of the entry into force of the Convention, give the other Contracting State through diplomatic channels, written notice of termination and, in such event, this Convention shall cease to have effect:

a) in the United States

i) in respect of taxes withheld at source, for amounts paid or credited on or after the first day of January next following the calendar year in which notice of termination is given; and

ii) in respect of other taxes, for taxable periods beginning on or after the first day of January next following the calendar year in which the notice of termination is given;

and

b) in India, in respect of income arising in any taxable year beginning on or after the first day of April next following the calendar year in which the notice of termination is given.

IN WITNESS WHEREOF, the undersigned, being duly authorized by their respective Governments, have signed this Convention.

DONE at New Delhi in duplicate, this 12th day of September, 1989, in the English and Hindi languages, both texts being equally authentic. In case of divergence between the two texts, the English text shall be the operative one.

FOR THE GOVERNMENT OF THE UNITED STATES OF AMERICA:	FOR THE GOVERNMENT OF THE REPUBLIC OF INDIA:
John R. Hubbard	N.K. Sengupta
Ambassador	Secretary to the Government of India

PROTOCOL

At the signing today of the Convention between the United States of America and the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, the undersigned have agreed upon the following provisions, which shall form an integral part of the Convention:

I. Ad Article 5

It is understood that where an enterprise of a Contracting State has a permanent establishment in the other Contracting State in accordance with the provisions of paragraphs 2(j), 2(k) or 2(l) of Article 5 (Permanent Establishment), and the time period referred to in that paragraph extends over two taxable years, a permanent establishment shall not be deemed to exist in a year, if any, in which the use, site, project or activity, as the case may be, continues for a period or periods aggregating less than 30 days in that taxable year. A permanent establishment will exist in the other taxable year, and the enterprise will be subject to tax in that other Contracting State in accordance with the provisions of Article 7 (Business Profits), but only on income arising during that other taxable year.

II. Ad Article 7

Where the law of the Contracting State in which a permanent establishment is situated imposes, in accordance with the provisions of paragraph 3 of Article 7 (Business Profits), a restriction on the amount of executive and general administrative expenses which may be allowed as a deduction in determining the profits of such permanent establishment, it is understood that in making such a determination of profits the deduction in respect of such executive and general administrative expenses in no case shall be less than that allowable under the Indian Income-tax Act as on the date of signature of this Convention.

III. Ad Articles 7, 10, 11, 12, 15, and 23

It is understood that for the implementation of paragraphs 1 and 2 of Article 7 (Business Profits), paragraph 4 of Article 10 (Dividends), paragraph 5 of Article 11 (Interest), paragraph 6 of Article 12 (Royalties and Fees for Included Services), paragraph 1 of Article 15 (Independent Personal Services), and paragraph 2 of Article 23 (Other Income), any income attributable to a permanent establishment or fixed base during its existence is taxable in the Contracting State in which such permanent establishment or fixed base is situated even if the payments are deferred until such permanent establishment or fixed base has ceased to exist.

IV. Ad Article 12

It is understood that fees for included services, as defined in paragraph 4 of Article 12 (Royalties and Fees for Included Services) will, in accordance with United States law, be subject to income tax in the United States based on net income and, when earned by a company, will also be subject to the taxes described in paragraph 1 of Article 14 (Permanent Establishment Tax). The total of these taxes which may be imposed on such fees, however, may not exceed the amount computed by multiplying the gross fee by the appropriate tax rate specified in subparagraph a) or b), whichever is applicable, of paragraph 2 of Article 12.

V. Ad Article 14

It is understood that references in paragraph 1 of Article 14 (Permanent Establishment Tax) to profits that are subject to tax in the United States under Article 6 (Income from Immovable Property (Real Property)), under Article 12 (Royalties and Fees for Included Services), as fees for included services as defined in that Article, or under Article 13 (Gains) of this Convention, are intended to refer only to cases in which the profits in question are subject to United States tax based on net income (i.e., by virtue of being effectively connected, or being treated as effectively connected, with the conduct of a trade or business in the United States). Any income which is subject to tax under those Articles based on gross income is not subject to tax under Article 14.

IN WITNESS WHEREOF, the undersigned, being duly authorized by their respective Governments, have signed this Protocol.

DONE at New Delhi in duplicate, this 12th day of September, 1989, in the English and Hindi languages, both texts being equally authentic. In case of divergence between the two texts, the English text shall be the operative one.

FOR THE GOVERNMENT OF THE UNITED STATES OF AMERICA:

John R. Hubbard

Ambassador

FOR THE GOVERNMENT OF THE REPUBLIC OF INDIA:

N.K. Sengupta

Secretary to the Government of India

EMBASSY OF THE
UNITED STATES OF AMERICA

New Delhi, September 12, 1989

Excellency:

I have the honor to refer to the Convention between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income which was signed today (hereinafter referred to as "the Convention") and to confirm, on behalf of the Government of the United States of America, the following understandings reached between the two Governments:

Both sides agree that a tax sparing credit shall not be provided in Article 25 (Relief from Double Taxation) of the Convention at this time. However, the Convention shall be promptly amended to incorporate a tax sparing credit provision if the United States hereafter amends its laws concerning the provision of tax sparing credits, or the United States reaches agreement on the provision of a tax sparing credit with any other country.

Both sides also agree that, for purposes of paragraph 4(c) of Article 5 (Permanent Establishment) of the Convention, a person shall be considered to habitually secure orders in a Contracting State, wholly or almost wholly for an enterprise, only if:

1. such person frequently accepts orders for goods or merchandise on behalf of the enterprise;

2. substantially all of such person's sales-related activities in the Contracting State consist of activities for the enterprise;

3. such person habitually represents to persons offering to buy goods or merchandise that acceptance of an order by such person constitutes the agreement of the enterprise to supply goods or merchandise under the terms and conditions specified in the order; and

4. the enterprise takes actions that give purchasers the basis for a reasonable belief that such person has authority to bind the enterprise.

I have the honor to request Your Excellency to confirm the foregoing understandings of Your Excellency's Government.

Accept, Excellency, the renewed assurances of my highest consideration.

J. R. Hubbard

John R. Hubbard

Ambassador

His Excellency

Dr. N.K. Sengupta,

Secretary (Revenue),

Ministry of Finance,

New Delhi.

भारत सरकार
वित्त मंत्रालय, राजस्व विभाग
नई दिल्ली-110001
GOVERNMENT OF INDIA
MINISTRY OF FINANCE, DEPARTMENT OF REVENUE
NEW DELHI-110001

सचिव
SECRETARY

September 12, 1989

Excellency:

I have the honour to acknowledge receipt of Your Excellency's Note of today's date, which reads as follows:

"I have the honor to refer to the Convention between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income which was signed today (hereinafter referred to as "the Convention") and to confirm, on behalf of the Government of the United States of America, the following understandings reached between the two Governments:

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SECRETARY

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3. such person habitually represents to persons offering to buy goods or merchandise that acceptance of an order by such person constitutes the agreement of the enterprise to supply goods or merchandise under the terms and conditions specified in the order; and

4. the enterprise takes actions that give purchasers the basis for a reasonable belief that such person has authority to bind the enterprise."

I have the honour to confirm the understandings contained in Your Excellency's Note, on behalf of the Government of the Republic of India.

Accept, Excellency, the renewed assurances of my highest consideration.

N. K. Sengupta

His Excellency
Dr. John R. Hubbard,
Ambassador of the
United States of America,
New Delhi.

EMBASSY OF THE
UNITED STATES OF AMERICA

New Delhi, September 12, 1989

Excellency:

I have the honor to refer to the Convention signed today between the United States of America and the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and to inform you on behalf of the United States of America of the following:

During the course of the negotiations leading to conclusion of the Convention signed today, the negotiators developed and agreed upon a memorandum of understanding intended to give guidance both to the taxpayers and the tax authorities of our two countries in interpreting aspects of Article 12 (Royalties and Fees for Included Services) relating to the scope of included services. This memorandum of understanding represents the current views of the United States Government with respect to these aspects of Article 12, and it is my Government's understanding that it also represents the current views of the Indian Government. It is also my Government's view that as our Governments gain experience in administering the Convention, and particularly Article 12, the competent authorities may develop and publish amendments to the memorandum of understanding and further understandings and interpretations of the Convention.

If this position meets with the approval of the Government of the Republic of India, this letter and your reply thereto will indicate that our Governments share a common view of the purpose of the memorandum of understanding relating to Article 12 of the Convention.

Accept, Excellency, the renewed assurances of my highest consideration.

John R. Hubbard

Ambassador

His Excellency

Dr. N.K. Sengupta,

Secretary (Revenue),

Ministry of Finance,

New Delhi.

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भारत सरकार
वित्त मंत्रालय, राजस्व विभाग
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GOVERNMENT OF INDIA
MINISTRY OF FINANCE, DEPARTMENT OF REVENUE
NEW DELHI-110001

September 12, 1989

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"I have the honor to refer to the Convention signed today between the United States of America and the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and to inform you on behalf of the United States of America of the following:

During the course of the negotiations leading to conclusion of the Convention signed today, the negotiators developed and agreed upon a memorandum of understanding intended to give guidance both to the taxpayers and the tax authorities of our two countries in interpreting aspects of Article 12 (Royalties and Fees for Included Services) relating to the scope of included services. This memorandum of understanding represents the current views of the United States Government with respect to these aspects of Article 12, and it is my Government's understanding that it also represents the current views of the Indian Government. It is also my Government's view that as our Governments gain experience in administering the Convention, and particularly Article 12, the competent authorities may

सचिव
SECRETARY

develop and publish amendments to the memorandum of understanding and further understandings and interpretations of the Convention.

If this position meets with the approval of the Government of the Republic of India, this letter and your reply thereto will indicate that our Governments share a common view of the purpose of the memorandum of understanding relating to Article 12 of the Convention."

I have the honour to confirm the understandings contained in Your Excellency's Note, on behalf of the Government of the Republic of India.

Accept, Excellency, the renewed assurances of my highest consideration.

N. K. Sengupta

His Excellency
Dr. John R. Hubbard,
Ambassador of the
United States of America,
New Delhi.

May 15, 1989

U.S. - INDIA TAX TREATY

MEMORANDUM OF UNDERSTANDING CONCERNING FEES FOR INCLUDED SERVICES IN ARTICLE 12

Paragraph 4 (in general)

This memorandum describes in some detail the category of services defined in paragraph 4 of Article 12 (Royalties and Fees for Included Services). It also provides examples of services intended to be covered within the definition of included services and those intended to be excluded, either because they do not satisfy the tests of paragraph 4, or because, notwithstanding the fact that they meet the tests of paragraph 4, they are dealt with under paragraph 5. The examples in either case are not intended as an exhaustive list but rather as illustrating a few typical cases. For ease of understanding, the examples in this memorandum describe U.S. persons providing services to Indian persons, but the rules of Article 12 are reciprocal in application.

Article 12 includes only certain technical and consultancy services. By technical services, we mean in this context services requiring expertise in a technology. By consultancy services, we mean in this context advisory services. The categories of technical and consultancy services are to some extent overlapping because a consultancy service could also be a technical service. However, the category of consultancy services also includes an advisory service, whether or not expertise in a technology is required to perform it.

Under paragraph 4, technical and consultancy services are considered included services only to the following extent: (1) as described in paragraph 4(a), if they are ancillary and subsidiary to the application or enjoyment of a right, property or information for which a royalty payment is made; or (2) as described in paragraph 4(b), if they make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design. Thus, under paragraph 4(b), consultancy services which are not of a technical nature cannot be included services.

Paragraph 4 (a)

Paragraph 4 (a) of Article 12 refers to technical or consultancy services that are ancillary and subsidiary to the application or enjoyment of any right, property, or information for which a payment described in paragraph 3(a) or (b) is received. Thus, paragraph 4(a) includes technical and consultancy services that are ancillary and subsidiary to the application or enjoyment of an intangible for which a royalty is received under a license or sale as described in

paragraph 3(a), as well as those ancillary and subsidiary to the application or enjoyment of industrial, commercial, or scientific equipment for which a royalty is received under a lease as described in paragraph 3(b).

It is understood that, in order for a service fee to be considered "ancillary and subsidiary" to the application or enjoyment of some right, property, or information for which a payment described in paragraph 3(a) or (b) is received, the service must be related to the application or enjoyment of the right, property, or information. In addition, the clearly predominant purpose of the arrangement under which the payment of the service fee and such other payment are made must be the application or enjoyment of the right, property, or information described in paragraph 3. The question of whether the service is related to the application or enjoyment of the right, property, or information described in paragraph 3 and whether the clearly predominant purpose of the arrangement is such application or enjoyment must be determined by reference to the facts and circumstances of each case. Factors which may be relevant to such determination (although not necessarily controlling) include:

1. the extent to which the services in question facilitate the effective application or enjoyment of the right, property, or information described in paragraph 3;

2. the extent to which such services are customarily provided in the ordinary course of business arrangements involving royalties described in paragraph 3;

3. whether the amount paid for the services (or which would be paid by parties operating at arm's length) is an insubstantial portion of the combined payments for the services and the right, property, or information described in paragraph 3;

4. whether the payment made for the services and the royalty described in paragraph 3 are made under a single contract (or a set of related contracts); and

5. whether the person performing the services is the same person as, or a related person to, the person receiving the royalties described in paragraph 3 (for this purpose, persons are considered related if their relationship is described in Article 9 (Associated Enterprises) or if the person providing the service is doing so in connection with an overall arrangement which includes the payor and recipient of the royalties).

To the extent that services are not considered ancillary and subsidiary to the aplication or enjoyment of some

right, property, or information for which a royalty payment under paragraph 3 is made, such services shall be considered "included services" only to the extent that they are described in paragraph 4(b).

Example (1)

Facts:

A U.S. manufacturer grants rights to an Indian company to use manufacturing processes in which the transferor has exclusive rights by virtue of process patents or the protection otherwise extended by law to the owner of a process. As part of the contractual arrangement, the U.S. manufacturer agrees to provide certain consultancy services to the Indian company in order to improve the effectiveness of the latter's use of the processes. Such services include, for example, the provision of information and advice on sources of supply for materials needed in the manufacturing process, and on the development of sales and service literature for the manufactured product. The payments allocable to such services do not form a substantial part of the total consideration payable under the contractual arrangement. Are the payments for these services fees for "included services"?

Analysis:

The payments are fees for included services. The services described in this example are ancillary and subsidiary to the use of a manufacturing process protected by law as described in paragraph 3 (a) of Article 12 because the services are related to the application or enjoyment of the intangible and the granting of the right to use the intangible is the clearly predominant purpose of the arrangement. Because the services are ancillary and subsidiary to the use of the manufacturing process, the fees for these services are considered fees for included services under paragraph 4 (a) of Article 12, regardless of whether the services are described in paragraph 4 (b).

Example(2)

Facts:

An Indian manufacturing company produces a product that must be manufactured under sterile conditions using machinery that must be kept completely free of bacterial or other harmful deposits. A U.S. company has developed a special cleaning process for removing

such deposits from that type of machinery. The U.S. company enters into a contract with the Indian company under which the former will clean the latter's machinery on a regular basis. As part of the arrangement, the U.S. company leases to the Indian company a piece of equipment which allows the Indian company to measure the level of bacterial deposits on its machinery in order for it to know when cleaning is required. Are the payments for the services fees for included services?

Analysis:

In this example, the provision of cleaning services by the U.S. company and the rental of the monitoring equipment are related to each other. However, the clearly predominant purpose of the arrangement is the provision of cleaning services. Thus, although the cleaning services might be considered technical services, they are not "ancillary and subsidiary" to the rental of the monitoring equipment. Accordingly, the cleaning services are not "included services" within the meaning of paragraph 4 (a).

Paragraph 4 (b)

Paragraph 4(b) of Article 12 refers to technical or consultancy services that make available to the person acquiring the service technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design to such person. (For this purpose, the person acquiring the service shall be deemed to include an agent, nominee, or transferee of such person.) This category is narrower than the category described in paragraph 4(a) because it excludes any service that does not make technology available to the person acquiring the service. Generally speaking, technology will be considered "made available" when the person acquiring the service is enabled to apply the technology. The fact that the provision of the service may require technical input by the person providing the service does not *per se* mean that technical knowledge, skills, etc. are made available to the person purchasing the service, within the meaning of paragraph 4 (b). Similarly, the use of a product which embodies technology shall not *per se* be considered to make the technology available.

Typical categories of services that generally involve either the development and transfer of technical plans or technical designs, or making technology available as described in paragraph 4 (b), include:

1. engineering services (including the subcategories of bioengineering and aeronautical, agricultural, ceramics,chemical, civil, electrical, mechanical, metallurgical, and industrial engineering);

2. architectural services; and

3. computer software development.

Under paragraph 4 (b), technical and consultancy services could make technology available in a variety of settings, activities and industries. Such services may, for example, relate to any of the following areas:

1. bio-technical services;

2. food processing;

3. environmental and ecological services;

4. communication through satellite or otherwise;

5. energy conservation;

6. exploration or exploitation of mineral oil or natural gas;

7. geological surveys;

8. scientific services; and

9. technical training.

The following examples indicate the scope of the conditions in paragraph 4 (b):

Example (3)

Facts:

A U.S. manufacturer has experience in the use of a process for manufacturing wallboard for interior walls of houses which is more durable than the standard products of its type. An Indian builder wishes to produce this product for its own use. It rents a plant and contracts with the U.S. company to send experts to India to show engineers in the Indian company how to produce the extra-strong wallboard. The U.S. contractors work with the technicians in the Indian firm for a few months. Are the payments to the U.S. firm considered to be payments for "included services"?

Analysis:

The payments would be fees for included services. The services are of a technical or consultancy nature; in the example, they have elements of both types of services. The services make available to the Indian company technical knowledge, skill, and processes.

Example (4)

Facts:

A U.S. manufacturer operates a wallboard fabrication plant outside India. An Indian builder hires the U.S. company to produce wallboard at that plant for a fee. The Indian company provides the raw materials, and the U.S. manufacturer fabricates the wallboard in its plant, using advanced technology. Are the fees in this example payments for included services?

Analysis:

The fees would not be for included services. Although the U.S. company is clearly performing a technical service, no technical knowledge, skill, etc., are made available to the Indian company, nor is there any development and transfer of a technical plan or design. The U.S. company is merely performing a contract manufacturing service.

Example (5)

Facts:

An Indian firm owns inventory control software for use in its chain of retail outlets throughout India. It expands its sales operation by employing a team of travelling salesmen to travel around the countryside selling the company's wares. The company wants to modify its software to permit the salesmen to access the company's central computers for information on what products are available in inventory and when they can be delivered. The Indian firm hires a U.S. computer programming firm to modify its software for this purpose. Are the fees which the Indian firm pays treated as fees for included services?

Analysis:

The fees are for included services. The U.S. company clearly performs a technical service for the Indian company, and it transfers to the Indian company the technical plan (i.e., the computer program) which it has developed.

Example (6)

Facts:

An Indian vegetable oil manufacturing company wants to produce a cholesterol-free oil from a plant which produces oil normally containing cholesterol. An American company has developed a process for refining the cholesterol out of the oil. The Indian company contracts with the U.S. company to modify the formulas which it uses so as to eliminate the cholesterol, and to train the employees of the Indian company in applying the new formulas. Are the fees paid by the Indian company for included services?

Analysis:

The fees are for included services. The services are technical, and the technical knowledge is made available to the Indian company.

Example (7)

Facts:

The Indian vegetable oil manufacturing firm has mastered the science of producing cholesterol-free oil and wishes to market the product world-wide. It hires an American marketing consulting firm to do a computer simulation of the world market for such oil and to advise it on marketing strategies. Are the fees paid to the U.S. company for included services?

Analysis:

The fees would not be for included services. The American company is providing a consultancy service which involves the use of substantial technical skill and expertise. It is not, however, making available to the Indian company any technical experience, knowledge or skill, etc., nor is it transferring a technical plan or design. What is transferred to the Indian company through the service contract is commercial information. The fact that technical skills were required by the performer of the service in order to perform the commercial information service does not make the service a technical service within the meaning of paragraph 4(b).

Paragraph 5

Paragraph 5 of Article 12 describes several categories of services which are not intended to be treated as included services even if they satisfy the tests of paragraph 4. Set forth below are examples of cases where fees would be included under paragraph 4, but are excluded because of the conditions of paragraph 5.

Example (8)

Facts:

An Indian company purchases a computer from a U.S. computer manufacturer. As part of the purchase agreement, the manufacturer agrees to assist the Indian company in setting up the computer and installing the operating system, and to ensure that the staff of the Indian company is able to operate the computer. Also, as part of the purchase agreement, the seller agrees to provide, for a period of ten years, any updates to the operating system and any training necessary to apply the

update. Both of these service elements to the contract would qualify under paragraph 4(b) as an included service. Would either or both be excluded from the category of included services, under paragraph 5(a), because they are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the computer?

Analysis:

The installation assistance and initial training are ancillary and subsidiary to the sale of the computer, and they are also inextricably and essentially linked to the sale. The computer would be of little value to the Indian purchaser without these services, which are most readily and usefully provided by the seller. The fees for installation assistance and initial training, therefore, are not fees for included services, since these services are not the predominant purpose of the arrangement.

The services of updating the operating system and providing associated necessary training may well be ancillary and subsidiary to the sale of the computer, but they are not inextricably and essentially linked to the sale. Without the upgrades, the computer will continue to operate as it did when purchased, and will continue to accomplish the same functions. Acquiring the updates cannot, therefore, be said to be inextricably and essentially linked to the sale of the computer.

Example (9)

Facts:

An Indian hospital purchases an X-ray machine from a U.S. manufacturer. As part of the purchase agreement, the manufacturer agrees to install the machine, to perform an initial inspection of the machine in India, to train hospital staff in the use of the machine, and to service the machine periodically during the usual warranty period (2 years). Under an optional service contract purchased by the hospital, the manufacturer also agrees to perform certain other services throughout the life of the machine, including periodic inspections and repair services, advising the hospital about developments in X-ray film or techniques which could improve the effectiveness of the machine, and training hospital staff in the application of those new developments. The cost of the initial installation, inspection, training, and warranty service is relatively minor as compared with the cost of the X-ray machine. Is any of the service described here ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the X-ray machine?

Analysis:

The initial installation, inspection, and training services in India and the periodic service during the warranty period are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the X-ray machine because the usefulness of the machine to the hospital depends on this service, the manufacturer has full responsibility during this period, and the cost of the services is a relatively minor component of the contract. Therefore, under paragraph 5(a) these fees are not fees for included services, regardless of whether they otherwise would fall within paragraph 4(b).

Neither the post-warranty period inspection and repair services, nor the advisory and training services relating to new developments are "inextricably and essentially linked" to the initial purchase of the X-ray machine. Accordingly, fees for these services may be treated as fees for included services if they meet the tests of paragraph 4(b).

Example (10)

Facts:

An Indian automobile manufacturer decides to expand into the manufacture of helicopters. It sends a group of engineers from its design staff to a course of study conducted by the Massachusetts Institute of Technology (MIT) for two years to study aeronautical engineering. The Indian firm pays tuition fees to MIT on behalf of the firm's employees. Is the tuition fee a fee for an included service within the meaning of Article 12?

Analysis:

The tuition fee is clearly intended to acquire a technical service for the firm. However, the fee paid is for teaching by an educational institution, and is, therefore, under paragraph 5(c), not an included service. It is irrelevant for this purpsoe whether MIT conducts the course on its campus or at some other location.

Example (11)

Facts:

As in Example (10), the automobile manufacturer wishes to expand into the manufacture of helicopters. It approaches an Indian university about establishing a course of study in aeronautical engineering. The university contracts with a U.S. helicopter manufacturer to send an engineer to be a visiting professor of aeronautical engineering on its faculty for a year. Are the amounts paid by the university for these teaching services fees for included services?

Analysis:

The fees are for teaching in an educational institution. As such, pursuant to paragraph 5(c), they are not fees for included services.

Example (12)

Facts:

An Indian wishes to install a computerized system in his home to control lighting, heating and air conditioning, a stereo sound system and a burglar and fire alarm system. He hires an American electrical engineering firm to design the necessary wiring system, adapt standard software, and provide instructions for installation. Are the fees paid to the American firm by the Indian individual fees for included services?

Analysis:

The services in respect of which the fees are paid are of the type which would generally be treated as fees for included services under paragraph 4(b). However, because the services are for the personal use of the individual making the payment, under paragraph 5(d) the payments would not be fees for included services.

EMBASSY OF THE
UNITED STATES OF AMERICA

New Delhi, September 12, 1989

Excellency:

I have the honor to refer to the Convention between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income which was signed today (hereinafter referred to as "the Convention") and to confirm, on behalf of the Government of the United States of America, the following understandings reached between the two Governments:

Both sides agree that a tax sparing credit shall not be provided in Article 25 (Relief from Double Taxation) of the Convention at this time. However, the Convention shall be promptly amended to incorporate a tax sparing credit provision if the United States hereafter amends its laws concerning the provision of tax sparing credits, or the United States reaches agreement on the provision of a tax sparing credit with any other country.

Both sides also agree that, for purposes of paragraph 4(c) of Article 5 (Permanent Establishment) of the Convention, a person shall be considered to habitually secure orders in a Contracting State, wholly or almost wholly for an enterprise, only if:

1. such person frequently accepts orders for goods or merchandise on behalf of the enterprise;

2. substantially all of such person's sales-related activities in the Contracting State consist of activities for the enterprise;

person habitually represents to persons offering to buy goods or merchandise that acceptance of an order by such person constitutes the agreement of the enterprise to supply goods or merchandise under the terms and conditions specified in the order; and

4. the enterprise takes actions that give purchasers the basis for a reasonable belief that such person has authority to bind the enterprise.

I have the honor to request Your Excellency to confirm the foregoing understandings of Your Excellency's Government.

Accept, Excellency, the renewed assurances of my highest consideration.

John R. Hubbard
Ambassador

His Excellency
Dr. N.K. Sengupta,
Secretary (Revenue),
Ministry of Finance,
New Delhi.

भारत सरकार
वित्त मंत्रालय, राजस्व विभाग
नई दिल्ली-110001
GOVERNMENT OF INDIA
MINISTRY OF FINANCE, DEPARTMENT OF REVENUE
NEW DELHI-110001

सचिव
SECRETARY

September 12, 1989

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N. K. Sengupta

His Excellency
Dr. John R. Hubbard,
Ambassador of the
United States of America,
New Delhi.

EMBASSY OF THE
UNITED STATES OF AMERICA

New Delhi, September 12, 1989

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I have the honor to refer to the Convention signed today between the United States of America and the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and to inform you on behalf of the United States of America of the following:

During the course of the negotiations leading to conclusion of the Convention signed today, the negotiators developed and agreed upon a memorandum of understanding intended to give guidance both to the taxpayers and the tax authorities of our two countries in interpreting aspects of Article 12 (Royalties and Fees for Included Services) relating to the scope of included services. This memorandum of understanding represents the current views of the United States Government with respect to these aspects of Article 12, and it is my Government's understanding that it also represents the current views of the Indian Government. It is also my Government's view that as our Governments gain experience in administering the Convention, and particularly Article 12, the competent authorities may develop and publish amendments to the memorandum of understanding and further understandings and interpretations of the Convention.

If this position meets with the approval of the Government of the Republic of India, this letter and your reply thereto will indicate that our Governments share a common view of the purpose of the memorandum of understanding relating to Article 12 of the Convention.

Accept, Excellency, the renewed assurances of my highest consideration.

John R. Hubbard

Ambassador

His Excellency

Dr. N.K. Sengupta,

Secretary (Revenue),

Ministry of Finance,

New Delhi.

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I have the honour to confirm the understandings contained in Your Excellency's Note, on behalf of the Government of the Republic of India.

Accept, Excellency, the renewed assurances of my highest consideration.

N. K. Sengupta

His Excellency
Dr. John R. Hubbard,
Ambassador of the
United States of America,
New Delhi.

May 15, 1989

U.S. - INDIA TAX TREATY

MEMORANDUM OF UNDERSTANDING CONCERNING
FEES FOR INCLUDED SERVICES
IN ARTICLE 12

Paragraph 4 (in general)

This memorandum describes in some detail the category of services defined in paragraph 4 of Article 12 (Royalties and Fees for Included Services). It also provides examples of services intended to be covered within the definition of included services and those intended to be excluded, either because they do not satisfy the tests of paragraph 4, or because, notwithstanding the fact that they meet the tests of paragraph 4, they are dealt with under paragraph 5. The examples in either case are not intended as an exhaustive list but rather as illustrating a few typical cases. For ease of understanding, the examples in this memorandum describe U.S. persons providing services to Indian persons, but the rules of Article 12 are reciprocal in application.

Article 12 includes only certain technical and consultancy services. By technical services, we mean in this context services requiring expertise in a technology. By consultancy services, we mean in this context advisory services. The categories of technical and consultancy services are to some extent overlapping because a consultancy service could also be a technical service. However, the category of consultancy services also includes an advisory service, whether or not expertise in a technology is required to perform it.

Under paragraph 4, technical and consultancy services are considered included services only to the following extent: (1) as described in paragraph 4(a), if they are ancillary and subsidiary to the application or enjoyment of a right, property or information for which a royalty payment is made; or (2) as described in paragraph 4(b), if they make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design. Thus, under paragraph 4(b), consultancy services which are not of a technical nature cannot be included services.

Paragraph 4 (a)

Paragraph 4 (a) of Article 12 refers to technical or consultancy services that are ancillary and subsidiary to the application or enjoyment of any right, property, or information for which a payment described in paragraph 3(a) or (b) is received. Thus, paragraph 4(a) includes technical and consultancy services that are ancillary and subsidiary to the application or enjoyment of an intangible for which a royalty is received under a license or sale as described in

paragraph 3(a), as well as those ancillary and subsidiary to the application or enjoyment of industrial, commercial, or scientific equipment for which a royalty is received under a lease as described in paragraph 3(b).

It is understood that, in order for a service fee to be considered "ancillary and subsidiary" to the application or enjoyment of some right, property, or information for which a payment described in paragraph 3(a) or (b) is received, the service must be related to the application or enjoyment of the right, property, or information. In addition, the clearly predominant purpose of the arrangement under which the payment of the service fee and such other payment are made must be the application or enjoyment of the right, property, or information described in paragraph 3. The question of whether the service is related to the application or enjoyment of the right, property, or information described in paragraph 3 and whether the clearly predominant purpose of the arrangement is such application or enjoyment must be determined by reference to the facts and circumstances of each case. Factors which may be relevant to such determination (although not necessarily controlling) include:

1. the extent to which the services in question facilitate the effective application or enjoyment of the right, property, or information described in paragraph 3;

2. the extent to which such services are customarily provided in the ordinary course of business arrangements involving royalties described in paragraph 3;

3. whether the amount paid for the services (or which would be paid by parties operating at arm's length) is an insubstantial portion of the combined payments for the services and the right, property, or information described in paragraph 3;

4. whether the payment made for the services and the royalty described in paragraph 3 are made under a single contract (or a set of related contracts); and

5. whether the person performing the services is the same person as, or a related person to, the person receiving the royalties described in paragraph 3 (for this purpose, persons are considered related if their relationship is described in Article 9 (Associated Enterprises) or if the person providing the service is doing so in connection with an overall arrangement which includes the payor and recipient of the royalties).

To the extent that services are not considered ancillary and subsidiary to the aplication or enjoyment of some

right, property, or information for which a royalty payment under paragraph 3 is made, such services shall be considered "included services" only to the extent that they are described in paragraph 4(b).

Example (1)

Facts:

A U.S. manufacturer grants rights to an Indian company to use manufacturing processes in which the transferor has exclusive rights by virtue of process patents or the protection otherwise extended by law to the owner of a process. As part of the contractual arrangement, the U.S. manufacturer agrees to provide certain consultancy services to the Indian company in order to improve the effectiveness of the latter's use of the processes. Such services include, for example, the provision of information and advice on sources of supply for materials needed in the manufacturing process, and on the development of sales and service literature for the manufactured product. The payments allocable to such services do not form a substantial part of the total consideration payable under the contractual arrangement. Are the payments for these services fees for "included services"?

Analysis:

The payments are fees for included services. The services described in this example are ancillary and subsidiary to the use of a manufacturing process protected by law as described in paragraph 3 (a) of Article 12 because the services are related to the application or enjoyment of the intangible and the granting of the right to use the intangible is the clearly predominant purpose of the arrangement. Because the services are ancillary and subsidiary to the use of the manufacturing process, the fees for these services are considered fees for included services under paragraph 4 (a) of Article 12, regardless of whether the services are described in paragraph 4 (b).

Example(2)

Facts:

An Indian manufacturing company produces a product that must be manufactured under sterile conditions using machinery that must be kept completely free of bacterial or other harmful deposits. A U.S. company has developed a special cleaning process for removing

such deposits from that type of machinery. The U.S. company enters into a contract with the Indian company under which the former will clean the latter's machinery on a regular basis. As part of the arrangement, the U.S. company leases to the Indian company a piece of equipment which allows the Indian company to measure the level of bacterial deposits on its machinery in order for it to know when cleaning is required. Are the payments for the services fees for included services?

Analysis:

In this example, the provision of cleaning services by the U.S. company and the rental of the monitoring equipment are related to each other. However, the clearly predominant purpose of the arrangement is the provision of cleaning services. Thus, although the cleaning services might be considered technical services, they are not "ancillary and subsidiary" to the rental of the monitoring equipment. Accordingly, the cleaning services are not "included services" within the meaning of paragraph 4 (a).

Paragraph 4 (b)

Paragraph 4(b) of Article 12 refers to technical or consultancy services that make available to the person acquiring the service technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design to such person. (For this purpose, the person acquiring the service shall be deemed to include an agent, nominee, or transferee of such person.) This category is narrower than the category described in paragraph 4(a) because it excludes any service that does not make technology available to the person acquiring the service. Generally speaking, technology will be considered "made available" when the person acquiring the service is enabled to apply the technology. The fact that the provision of the service may require technical input by the person providing the service does not *per se* mean that technical knowledge, skills, etc. are made available to the person purchasing the service, within the meaning of paragraph 4 (b). Similarly, the use of a product which embodies technology shall not *per se* be considered to make the technology available.

Typical categories of services that generally involve either the development and transfer of technical plans or technical designs, or making technology available as described in paragraph 4 (b), include:

1. engineering services (including the subcategories of bioengineering and aeronautical, agricultural, ceramics,chemical, civil, electrical, mechanical, metallurgical, and industrial engineering);

2. architectural services; and

3. computer software development.

Under paragraph 4 (b), technical and consultancy services could make technology available in a variety of settings, activities and industries. Such services may, for example, relate to any of the following areas:

1. bio-technical services;

2. food processing;

3. environmental and ecological services;

4. communication through satellite or otherwise;

5. energy conservation;

6. exploration or exploitation of mineral oil or natural gas;

7. geological surveys;

8. scientific services; and

9. technical training.

The following examples indicate the scope of the conditions in paragraph 4 (b):

<u>Example (3)</u>

Facts:

A U.S. manufacturer has experience in the use of a process for manufacturing wallboard for interior walls of houses which is more durable than the standard products of its type. An Indian builder wishes to produce this product for its own use. It rents a plant and contracts with the U.S. company to send experts to India to show engineers in the Indian company how to produce the extra-strong wallboard. The U.S. contractors work with the technicians in the Indian firm for a few months. Are the payments to the U.S. firm considered to be payments for "included services"?

Analysis:

The payments would be fees for included services. The services are of a technical or consultancy nature; in the example, they have elements of both types of services. The services make available to the Indian company technical knowledge, skill, and processes.

Example (4)

Facts:

A U.S. manufacturer operates a wallboard fabrication plant outside India. An Indian builder hires the U.S. company to produce wallboard at that plant for a fee. The Indian company provides the raw materials, and the U.S. manufacturer fabricates the wallboard in its plant, using advanced technology. Are the fees in this example payments for included services?

Analysis:

The fees would not be for included services. Although the U.S. company is clearly performing a technical service, no technical knowledge, skill, etc., are made available to the Indian company, nor is there any development and transfer of a technical plan or design. The U.S. company is merely performing a contract manufacturing service.

Example (5)

Facts:

An Indian firm owns inventory control software for use in its chain of retail outlets throughout India. It expands its sales operation by employing a team of travelling salesmen to travel around the countryside selling the company's wares. The company wants to modify its software to permit the salesmen to access the company's central computers for information on what products are available in inventory and when they can be delivered. The Indian firm hires a U.S. computer programming firm to modify its software for this purpose. Are the fees which the Indian firm pays treated as fees for included services?

Analysis:

The fees are for included services. The U.S. company clearly performs a technical service for the Indian company, and it transfers to the Indian company the technical plan (i.e., the computer program) which it has developed.

Example (6)

Facts:

An Indian vegetable oil manufacturing company wants to produce a cholesterol-free oil from a plant which produces oil normally containing cholesterol. An American company has developed a process for refining the cholesterol out of the oil. The Indian company contracts with the U.S. company to modify the formulas which it uses so as to eliminate the cholesterol, and to train the employees of the Indian company in applying the new formulas. Are the fees paid by the Indian company for included services?

Analysis:

The fees are for included services. The services are technical, and the technical knowledge is made available to the Indian company.

Example (7)

Facts:

The Indian vegetable oil manufacturing firm has mastered the science of producing cholesterol-free oil and wishes to market the product world-wide. It hires an American marketing consulting firm to do a computer simulation of the world market for such oil and to advise it on marketing strategies. Are the fees paid to the U.S. company for included services?

Analysis:

The fees would not be for included services. The American company is providing a consultancy service which involves the use of substantial technical skill and expertise. It is not, however, making available to the Indian company any technical experience, knowledge or skill, etc., nor is it transferring a technical plan or design. What is transferred to the Indian company through the service contract is commercial information. The fact that technical skills were required by the performer of the service in order to perform the commercial information service does not make the service a technical service within the meaning of paragraph 4(b).

Paragraph 5

Paragraph 5 of Article 12 describes several categories of services which are not intended to be treated as included services even if they satisfy the tests of paragraph 4. Set forth below are examples of cases where fees would be included under paragraph 4, but are excluded because of the conditions of paragraph 5.

Example (8)

Facts:

An Indian company purchases a computer from a U.S. computer manufacturer. As part of the purchase agreement, the manufacturer agrees to assist the Indian company in setting up the computer and installing the operating system, and to ensure that the staff of the Indian company is able to operate the computer. Also, as part of the purchase agreement, the seller agrees to provide, for a period of ten years, any updates to the operating system and any training necessary to apply the

update. Both of these service elements to the contract would qualify under paragraph 4(b) as an included service. Would either or both be excluded from the category of included services, under paragraph 5(a), because they are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the computer?

Analysis:

The installation assistance and initial training are ancillary and subsidiary to the sale of the computer, and they are also inextricably and essentially linked to the sale. The computer would be of little value to the Indian purchaser without these services, which are most readily and usefully provided by the seller. The fees for installation assistance and initial training, therefore, are not fees for included services, since these services are not the predominant purpose of the arrangement.

The services of updating the operating system and providing associated necessary training may well be ancillary and subsidiary to the sale of the computer, but they are not inextricably and essentially linked to the sale. Without the upgrades, the computer will continue to operate as it did when purchased, and will continue to accomplish the same functions. Acquiring the updates cannot, therefore, be said to be inextricably and essentially linked to the sale of the computer.

Example (9)

Facts:

An Indian hospital purchases an X-ray machine from a U.S. manufacturer. As part of the purchase agreement, the manufacturer agrees to install the machine, to perform an initial inspection of the machine in India, to train hospital staff in the use of the machine, and to service the machine periodically during the usual warranty period (2 years). Under an optional service contract purchased by the hospital, the manufacturer also agrees to perform certain other services throughout the life of the machine, including periodic inspections and repair services, advising the hospital about developments in X-ray film or techniques which could improve the effectiveness of the machine, and training hospital staff in the application of those new developments. The cost of the initial installation, inspection, training, and warranty service is relatively minor as compared with the cost of the X-ray machine. Is any of the service described here ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the X-ray machine?

Analysis:

The initial installation, inspection, and training services in India and the periodic service during the warranty period are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the X-ray machine because the usefulness of the machine to the hospital depends on this service, the manufacturer has full responsibility during this period, and the cost of the services is a relatively minor component of the contract. Therefore, under paragraph 5(a) these fees are not fees for included services, regardless of whether they otherwise would fall within paragraph 4(b).

Neither the post-warranty period inspection and repair services, nor the advisory and training services relating to new developments are "inextricably and essentially linked" to the initial purchase of the X-ray machine. Accordingly, fees for these services may be treated as fees for included services if they meet the tests of paragraph 4(b).

Example (10)

Facts:

An Indian automobile manufacturer decides to expand into the manufacture of helicopters. It sends a group of engineers from its design staff to a course of study conducted by the Massachusetts Institute of Technology (MIT) for two years to study aeronautical engineering. The Indian firm pays tuition fees to MIT on behalf of the firm's employees. Is the tuition fee a fee for an included service within the meaning of Article 12?

Analysis:

The tuition fee is clearly intended to acquire a technical service for the firm. However, the fee paid is for teaching by an educational institution, and is, therefore, under paragraph 5(c), not an included service. It is irrelevant for this purpsoe whether MIT conducts the course on its campus or at some other location.

Example (11)

Facts:

As in Example (10), the automobile manufacturer wishes to expand into the manufacture of helicopters. It approaches an Indian university about establishing a course of study in aeronautical engineering. The university contracts with a U.S. helicopter manufacturer to send an engineer to be a visiting professor of aeronautical engineering on its faculty for a year. Are the amounts paid by the university for these teaching services fees for included services?

Analysis:

The fees are for teaching in an educational institution. As such, pursuant to paragraph 5(c), they are not fees for included services.

Example (12)

Facts:

An Indian wishes to install a computerized system in his home to control lighting, heating and air conditioning, a stereo sound system and a burglar and fire alarm system. He hires an American electrical engineering firm to design the necessary wiring system, adapt standard software, and provide instructions for installation. Are the fees paid to the American firm by the Indian individual fees for included services?

Analysis:

The services in respect of which the fees are paid are of the type which would generally be treated as fees for included services under paragraph 4(b). However, because the services are for the personal use of the individual making the payment, under paragraph 5(d) the payments would not be fees for included services.

TREASURY NEWS
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TEXT AS PREPARED
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September 12, 1989

Remarks by
Secretary of the Treasury
Nicholas F. Brady
at the
American Business Conference Dinner
The Treasury Department
Washington, D.C.
September 12, 1989

I'm delighted that the American Business Conference is able to be here as the Treasury Department celebrates its Bicentennial.

Two hundred years ago yesterday, President Washington nominated Alexander Hamilton to be the first Secretary of the Treasury. He was confirmed by the Senate and took the oath of office, all on the very same day, September 11, 1789 -- a record for speedy confirmation that we can safely assume will never be broken.

I hope you enjoyed your tour of the Treasury building, which has been in use since 1831 -- longer than any other government building in Washington except for the Capitol and the White House.

This magnificent room is one of the most historic in the Treasury Department. For more than a century, the Cash Room was Treasury's bank lobby, where the public redeemed silver and gold certificates and cashed government checks until 1976.

President Ulysses S. Grant held his Inaugural Ball in this room on March 4, 1869. He arranged to have gas jets installed for the occasion to spell out the word "PEACE" in nine-foot-tall letters on the north columns.

From the very beginning of its history, Treasury's primary responsibility has been the nation's financial health. In 1790, Alexander Hamilton stunned the Congress by proposing that the new country repay its Revolutionary War debt and take on the outstanding debt of the states, as well. This commitment laid the foundation for our nation's financial system.

Today, the Treasury is equally committed to guarding the nation's financial health. We are addressing the important financial problems facing our nation at home and abroad -- the budget deficit, the savings and loan crisis and Third World debt -- issues that had to be faced before we could concentrate our efforts on the longer-term, systemic problems in our economy.

We're making progress in each of these areas. We've reached a budget agreement with the Congress that will meet the Gramm-Rudman-Hollings deficit reduction target for 1990 with no new taxes. Legislation is in place that gives us the tools to address the problems in the savings and loan industry. And our Third World debt plan has provided a new framework within which we're working to reduce the debt burden of developing nations.

Of course, this doesn't mean these problems have been solved. But we're off to a solid start and we're headed down the right track.

Now it's time to turn our attention to a more basic economic problem facing us all: The issue is, how are we to sustain our position as the leading economic power in the international arena? And, ultimately, will we be able to preserve and improve our standard of living?

We have many strengths with which to approach this challenge -- strengths that were born of American traditions of independent thinking and innovation, of daring vision and the drive to make that vision a reality.

Our society has been characterized by a work ethic that carries a commitment to quality, by the discipline to produce only our best. Traditionally, the whole American work force-- from the boardrooms to the factory floors -- shared a pride in their work unequaled in the world. That commitment to planning and building for the future as well as for the present is one of our proudest and most valuable legacies.

However, in recent years we have neglected our traditional strengths and have seen the other nations move forward to challenge our position in the world economy. We've been willing to mortgage our future, to sacrifice quality and cut corners in the pursuit of immediate payoff. It worries me when I see many of the best minds in America concentrating on financial engineering rather than laying plans for sound corporate strategies for the future.

It may be that we were so successful in leading the world economy in the post-war era that we let ourselves become complacent. Perhaps we began to assume that what had come to us by the fruits of our labors was instead a birthright due us as Americans.

It's taken our nation some time to come to terms with the new international realities, but we're doing so. Our approach to the challenges of the 1990s and beyond should be to maintain our competitiveness where it's strong, and to rebuild it where it has faltered. This demands a combination of government and private sector initiatives.

We must work together to find new ways to encourage Americans to take the long-term view in their economic thinking as we work to preserve America's economic leadership and our standard of living. This issue is one of the Bush Administration's top priorities.

At Treasury, we're actively studying ways to encourage both managers and investors to lengthen their planning horizons and to increase the common interest between shareholders, managers and workers. We'll be looking at a range of options -- including regulatory and statutory changes that would enhance financial incentives and eliminate financial disincentives.

A very important step we can take in fostering long-term economic planning is to cut the cost of capital to corporations. I know this issue has concerned the American Business Conference from its inception.

The cost of capital is the weighted average of what a company pays for equity and debt financing on an after-tax basis. Currently, U.S. companies face a higher cost of capital than most of our major trading partners. A recent Federal Reserve Bank of New York study found, for example, that the capital cost for an R&D project with a 10-year payoff was more than 20 percent in the U.S., compared to less than nine percent in Japan and less than 15 percent in West Germany. You can't pay twice as much as your competitors for a basic raw material -- capital -- and hope to come out ahead. Our international competitors fully understand this.

This higher cost of capital cripples the competitive position of American companies. To pay for higher capital costs, U.S. businesses must earn a higher return on investments than their foreign competitors. This higher required return may preclude the funding of important projects like a new silicon chip plant or an x-ray lithography research and development facility. It also makes it more difficult to lower prices in order to capture market share. In short, it's harder to compete.

Our high cost of capital makes long-term investments too expensive and forces capital into short-term projects. High capital costs mean projects have to pay off more quickly, and a short-term focus may mean pressure to earn short-term profits. But let me tell you what it doesn't mean. It doesn't mean innovation. It doesn't mean long-term risk-taking. And it doesn't mean competitive prices.

The first step the government must take in bringing down the cost of capital is to reduce the federal budget deficit. The effect of the deficit on interest rates has increased the cost of capital and consequently discouraged long-term investment. The Bush Administration is absolutely committed to reducing the deficit by meeting the deficit targets established by the Gramm-Rudman-Hollings legislation.

We've already taken a first, very important step by achieving an agreement with the bipartisan leadership of Congress on the fiscal 1990 budget -- an agreement which meets the Gramm-Rudman-Hollings target and reduces the deficit to just below 100 billion dollars without raising taxes. Now it's up to the Congress to enact reconciliation legislation consistent with that agreement.

The second step we can take to lower the cost of capital is to approve President Bush's proposal to permanently lower the tax rate on capital gains. It will reduce the cost of capital in the United States and create incentives for investment in the long-term productive capacity of American industry.

A lower capital gains tax rate helps small and growing businesses, which create most of our new jobs. Because new ventures often have difficulty raising start-up capital, lower rates can create incentives for the kind of risk-taking that leads to new technology and a competitive edge.

Relative to our developed trading partners, the United States has among the highest taxes on capital gains. Belgium, Italy and the Netherlands don't tax capital gains at all. West Germany doesn't tax the gain on assets held more than six months. And France and Japan provide a differential rate for long-term capital gains that is considerably below ours. Why should we be the exception?

The President's capital gains proposal will encourage investors to make a long-term commitment, promoting growth-producing investment rather than short-term profit-taking.

A third major step toward lowering the cost of capital would be to increase the rate of personal savings in this country. If we provided for more of our domestic investment needs with our savings, we'd have to import less capital from abroad, thus improving our trade balance. We're asking for trouble if we allow ourselves to become more and more dependent on borrowed capital from abroad.

In the coming months, we will look at a number of options that give people the incentive to save, instead of to consume.

In addition to the three steps I've suggested to lower the cost of capital, we must also work toward the goal of tax integration -- removing the double taxation on dividends. This would provide a great incentive for long-term growth by lowering the overall cost of capital. But it would do more. It would also end the bias of the tax system toward debt financing and return millions of Americans as active investors in our equity markets.

There has been a great deal of concern expressed about the leveraging of America in recent years. Congress correctly traces much of this increased leverage to the unequal tax treatment of debt and equity. The answer put forth by some in Congress is to limit the deductibility of interest on corporate debt. But this would be a mistake. We ought not to make capital more expensive for American companies and hurt their ability to compete.

Rather, if one is interested in removing the bias toward debt in our financial system in a manner which enhances competitiveness, we must focus on removing the double taxation of dividends. Our primary trade partners -- Canada, Japan, West Germany, and the United Kingdom -- all have some form of corporate/shareholder integration.

None of these efforts will produce quick results. Neither will they be easy. But fundamental change is required if our companies are to be truly successful worldwide.

Tonight I've mentioned some basic but critical steps that we as a nation must take to ensure our economic leadership in the world economy and to preserve our standard of living. We must emphasize the long-term view in business decision-making. To do this, we must lower the cost of capital by taking the following actions:

- o Reduce the federal budget deficit,
- o permanently cut the tax rate on long-term capital gains,
- o increase the rate of personal savings in the U.S.,
- o and reduce the double taxation of dividends.

The members of the American Business Conference are among the best and brightest of America's growth companies. You demand a lot from yourselves and your employees, and as a result you generate success.

Tonight I ask you to help me spread the message that we must renew the traditional American commitment to quality, to building for the future. Together, we can assure that American companies continue into the next century as innovative, financially fit competitors in a global market.

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

FOR IMMEDIATE RELEASE
September 13, 1989

STATEMENT BY SECRETARY BRADY

Treasury Secretary Nicholas F. Brady today welcomed the announcement by the Government of Mexico and its Bank Advisory Committee that they have reached agreement on a detailed term sheet for the 1989-92 commercial bank financing package. This agreement represents another important step forward in implementing the strengthened debt strategy and in Mexico's efforts to obtain needed debt reduction and new financing to support its economic reform program.

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE September 14, 1989

Statement of
Nicholas F. Brady
Secretary of the Treasury

The vote in the Ways and Means Committee today to reduce the tax rate on capital gains is a major step forward in providing incentives for long-term investment in the United States. Congressmen Jenkins and Archer are to be commended for their leadership, and we are grateful to the other 17 members who supported them. We also appreciate Chairman Rostenkowski's efforts to work out a compromise and to keep the reconciliation process moving ahead. We believe a reduction in the capital gains rate is important for all Americans. It creates jobs. It lowers the cost of capital in the U.S., which is significantly higher than our principal international competitors. And it promotes economic growth.

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NB-452

TREASURY NEWS

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

For Release Upon Delivery
September 15, 1989

REMARKS
BY
JOHN E. ROBSON
DEPUTY SECRETARY OF THE TREASURY
BEFORE
THE LEADERSHIP CONFERENCE OF
THE AMERICAN BANKERS ASSOCIATION
SEPTEMBER 15, 1989

Thank you for inviting me here today to speak about a subject that has occupied a great deal of the nation's attention and the time of the Federal Government over the past several months -- the creation and startup of the largest financial institution workout in United States history.

Less than 20 days after assuming office, President Bush announced the Administration's proposal for a major initiative to address the nation's savings and loan crisis. And scarcely over a month ago in the Rose Garden, the President signed this comprehensive legislation. We are proud of the role the Treasury Department and Secretary Brady had in shaping the proposal and shepherding the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 through Congress to enactment. As the President said at the signing ceremony, the FIRREA legislation represents "a crucial step toward restoring public confidence."

The central features of FIRREA that are designed to rebuild public confidence include the following:

-- First, a sweeping restructuring of thrift industry regulation and deposit insurance;

-- Second, the imposition of tough capital standards and other regulatory controls;

-- Third, stronger tools to enable law enforcement agencies to deal more swiftly and effectively with instances of fraud and abuse; and

-- Fourth, massive funding and the creation of two new agencies -- the Resolution Trust Corporation and the Oversight Board -- to pay for and manage the near-term cleanup of insolvent thrifts.

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Altogether, FIRREA created or restructured 6 government agencies and authorized $50 billion for RTC in the S&L cleanup, an immense legislative accomplishment.

Now our job is to get the job done. And today I will say a few words about the main workhorses in the immediate task of cleaning up insolvent thrifts, Resolution Trust Corporation and the Oversight Board.

At the outset I would like to clear up any confusion that may exist about the different roles of Resolution Trust Corporation -- referred to by most simply as RTC -- and the Oversight Board.

RTC is the implementor and executor of the thrift cleanup. It is the entity that selects the institutions to be resolved, carries out the resolutions, and sells any residual assets.

The Oversight Board provides the policies under which RTC accomplishes its work, furnishes the funds to RTC, and monitors RTC's execution of its responsibilities.

The RTC and the Oversight Board are partners in an immense enterprise that has potentially far-reaching implications for the thrift industry, real estate markets, communities throughout America, people needing access to housing, and the taxpayer.

The mission of RTC is to manage and resolve all currently insolvent thrifts, as well as thrifts that may become insolvent over the next three years. Some estimates suggest that RTC will ultimately be required to resolve 500 or more thrifts with total assets ranging from $300 to $400 billion.

The RTC must determine the specific thrifts to be resolved and the type of resolution appropriate for each case; it must solicit and evaluate hundreds of bids for institutions and assets; it must consider the potential market effects of its asset disposition activities; it must review the 1988 FSLIC deals; and it must also fulfill the legislation's requirements regarding the disposition of low cost housing. This is by no means an exhaustive catalogue of RTC's responsibilities, but it gives you a feel for the breadth and dimension of the task before it.

Since the RTC would arrive from the legislative maternity ward as a new entity without employees or leadership, Congress directed that its flesh and bones would be the Federal Deposit Insurance Corporation. The FDIC is the exclusive manager of the RTC, subject to policy guidance by the Oversight Board. The directors of the FDIC serve as the board of directors of the RTC, and the Chairman of the FDIC is the chairman of the RTC. Already a sizeable group of FDIC personnel have been assigned to RTC duties, and the number is expected to grow considerably larger before the job is completed.

Recognizing that FIRREA commits substantial taxpayer funds to pay for the losses in our Federal deposit insurance system, Congress established the Oversight Board as an accountable Executive Branch agency. The Secretary of the Treasury serves as chairman, and is joined by the Secretary of Housing and Urban Development, the Chairman of the Federal Reserve Board, and two members to be appointed by the President.

The Oversight Board sets the overall strategies, policies, and goals for RTC, for example, policies and procedures governing case resolutions, asset management and disposition, and the use of private contractors. It also approves RTC's financial plans, authorizes and audits the use of funds by RTC, and has the responsibility for monitoring and evaluating RTC's performance.

As an organization with policy making and financial duties, rather than operational responsibilities which are the province of RTC, the Oversight Board expects to maintain a lean staff of skilled professionals.

The Oversight Board will <u>not</u> be involved in individual cases. It will <u>not</u> sell assets, liquidate or merge thrifts, or retain private sector companies and individuals to assist in the sale or management of properties. These activities are the responsibility of RTC. So if you have interests or questions about these activities, you should make them known to RTC.

The customary practice for new Administrations is to recount their accomplishments after the first 100 days. Since the RTC and Oversight Board have existed for little more than one month, and operated for just 26 business days, we do not have the luxury of such leisurely reflection. Nevertheless, I think it fair to say that we have accomplished a great deal even in this short period:

- Only an hour after President Bush signed the FIRREA legislation, the Oversight Board held its first meeting, completed the necessary organizational actions, promulgated its initial policies for RTC, made its first authorization of funds, and appointed its interim officers and staff. Within hours on the same day RTC held its first board meeting and got the operations underway.

- To date, the Oversight Board has authorized and released to RTC over $11 billion for thrift resolutions, liquidity needs and replacement of high cost funds. Authorized funds are released to RTC upon presentation of specific requests that document the amount and purposes of the funds required.

- The RTC has so far used its funds to close or transfer the deposits of 14 insolvent thrifts and to lower the cost of funds at numerous other institutions, thereby reducing their losses. This translates to savings for the taxpayer. It also should have the broader effect of reducing the cost of funds for healthy thrifts.

- At the first meeting of the Oversight Board, interim ethics and conflict of interest guidelines were adopted, pending final regulations. These provide that temporary Oversight Board employees, from other federal agencies are subject to the ethical standards of their respective home agencies, and that FDIC ethical standards apply to all other Oversight Board employees to the RTC, and to private contractors.

- In addition to issuing 9 policies for RTC -- covering matters ranging from financial procedures to the terms of RTC funding of thrifts -- The Oversight Board established a joint Oversight Board-RTC policy development task force to make recommendations concerning strategies, policies and goals for the RTC, and concerning the strategic plan the Oversight Board must submit to Congress by December 31, 1989. This group, with personnel from both agencies, is developing policies that are responsive to the RTC's immediate needs, as well as developing policies that will give long term guidance. In areas in which the Oversight Board has not yet acted, RTC will carry out its responsibilities in accordance with FDIC policies.

- One interim policy asks the RTC to concentrate initially on resolutions that do not involve complex and controversial asset disposition and financing techniques, such as long-term yield maintenance agreements, asset guarantees and the retention of equity positions. This policy is not intended to preclude resolving large institutions, or initiating the lengthy process to resolve institutions that might require more complex techniques. It simply provides the Oversight Board and the RTC some time to develop appropriate policies for complex transactions, a task that is actively underway.

- The Oversight Board has selected and appointed the required two additional directors of the Resolution Funding Corporation, the fund raising vehicle under FIRREA, and has been actively recruiting the two public members of the Oversight Board, its permanent chief executive officer, and members for the regional advisory councils.

- Most importantly, the Oversight Board and RTC have successfully begun an orderly, cooperative and professional working relationship. This may be the most significant initial step in getting the job done efficiently over the long pull.

All in all we think that's a creditable first month's work.

But we are well aware that this is just the beginning of what will be a long and challenging process. The focus of our efforts at the Oversight Board in the near term will continue to be the development of policies and procedures to guide the RTC's efforts.

Let me mention just a few of the policy issues that must be addressed as we go forward.

First, what factors should the RTC weigh most heavily in determining the order of resolutions? For example, the size or condition of the institution, geographic location, type of resolution, or the nature of the assets held could be considered.

Another set of issues concerns asset management and disposition. How should the RTC use the services of private contractors and what incentives would be appropriate and promote efficiency? How does the RTC evaluate the potential costs and benefits of carrying assets? To what degree have the markets absorbed the real estate overhang? And how does the RTC implement the low and moderate income housing provisions of the legislation?

Should RTC favor whole-bank or clean-bank transactions? Should the RTC use pre-packaged bid formats for potential acquirers or negotiate terms with individual bidders?

We don't have answers to all of these questions yet, but we will. The joint policy development task force has already begun to tackle these and other important policy matters. We welcome comments and suggestions from you in the private sector as we develop these policy guidelines.

In conclusion, I would like to say that I am most encouraged by the start we have made. Our efforts in these first short months will lay the foundations of future success, and you may be assured that we will give the tasks ahead the thought, dedication and energy consonant with their national importance.

Thank you.

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TREASURY NEWS

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

FOR RELEASE AT 12:00 NOON

CONTACT: Office of Financing
202/376-4350

September 15, 1989

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 September 28, 1989, and to mature September 27, 1990 (CUSIP No. 912794 UQ 5). This issue will provide about $75 million of new cash for the Treasury, as the maturing 52-week bill is outstanding in the amount of $9,419 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, September 21, 1989.

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 September 28, 1989. In addition to the maturing 52-week bills, there are $13,694 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 $3,194 million as agents for foreign and international monetary authorities, and $5,617 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 $472 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 5176-3.

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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 one-half hour prior to the closing time for receipt of tenders 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.

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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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.

8/89

DEPARTMENT OF THE TREASURY

Interim Report to the Congress

Concerning

International Discussions on an

International Debt Management Authority

September 1989

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Legislative Requirements

Section 3111 of the Omnibus Trade and Competitiveness Act of 1988 (P.L. 100-418) (the Act) requires the Secretary of the Treasury to study the feasibility and desirability of establishing an International Debt Management Authority (the Authority) to purchase and restructure the sovereign debt of less developed countries. Two interim reports, as well as a final report, are to be prepared on the progress made on the study or in international discussions on establishing such an authority. The first report was submitted on March 15, 1989. This is the second interim report.

According to the provisions of the Act, in studying the feasibility and advisability of establishing the Authority, the Secretary may determine that the initiation of international discussions on the establishment of the Authority would:

-- cause a material increase in the discount on sovereign debt;

-- materially increase the probability of default on such debt; or

-- materially enhance the likelihood of debt service disruption.

If such a determination is not made, the Secretary must initiate discussions with those countries he determines to be appropriate for the purpose of establishing the Authority. The Secretary must include in interim reports to the Congress an explanation in detail of the reasons for the determination.

The first interim report concluded that in light of new initiatives by Treasury Secretary Brady to strengthen the international debt strategy, and ongoing discussions of these proposals within the international community, it would not be appropriate at that time to begin formal negotiations concerning the Authority. The report noted that the new initiatives could produce substantial reduction of debt and debt service burdens without the public sector assuming the underlying risk of outstanding commercial bank debt. Furthermore, it was the determination of the Secretary of the Treasury that such formal negotiations could materially depress secondary market prices and materially enhance the likelihood of debt service disruption. Indeed, past discussions of such facility proposals have contributed to domestic pressures to restrict debt/equity swap programs, which, in turn, have had a negative impact on secondary market prices.

The Strengthened Debt Strategy

Secretary of the Treasury Brady suggested in March 1989 a new approach to revitalize the international debt strategy. This new approach: (1) builds upon the fundamental principles of the previous debt strategy; (2) focuses international efforts on achieving broadly based, voluntary debt reduction to ease debt and debt service burdens and improve prospects for strong growth; (3) recognizes the continuing need for new lending from the commercial banks in conjunction with voluntary debt reduction, while placing stronger emphasis on new investment flows and the repatriation of flight capital; (4) maintains a central role for the IMF and the World Bank within the debt strategy in encouraging debtor policy reforms and catalyzing financial support; and (5) redirects and increases available IMF and World Bank resources -- from their current resources -- to support debt and debt service reduction transactions agreed upon by the commercial banks and debtor nations as an additional spur to growth in the debtor nations.

We believe this approach can provide substantial benefits for debtor nations through lower levels of debt, more manageable debt service obligations, smaller and more realistic financing needs, stronger economic growth, and higher standards of living. It is a versatile approach, creating opportunities for voluntary debt and debt service reduction by commercial banks as well as encouraging new lending and alternative sources of private capital. Unlike proposals for a debt facility, this strategy (1) minimizes the cost or contingent shift in risk to creditor governments, (2) avoids mandatory prices for debt exchanges (with prices pre-set by the facility), and (3) maintains a market-oriented approach to debt restructurings.

During the April 1989 meetings of the International Monetary Fund and the World Bank, these ideas received strong support from the Group of Seven and Group of Ten industrial nations. Both the IMF Interim Committee and the Development Committee of the IMF and World Bank also strongly endorsed the strengthened debt strategy.

For example, the Interim Committee, which represents the views of both debtor and creditor governments, welcomed the U.S. proposals to strengthen the debt strategy and "requested the [IMF] Executive Board to consider as a matter of urgency the issues and actions involved." In particular, the Committee agreed that "the Fund should provide resources in appropriate amounts to members to facilitate debt reduction for countries undertaking ... economic reforms, by setting aside a portion of members' purchases under Fund-supported arrangements." Furthermore, "the question of provision of resources for limited interest support transactions involving significant debt or debt service reduction should be examined."

In addition, the Development Committee "agreed that the [World] Bank and [International Monetary] Fund should set aside a portion of members' policy-based financing to support debt-reduction operations" and, like the Interim Committee, called for an examination of the "possibility of limited interest support for transactions involving significant debt or debt-service reduction."

The IMF and World Bank managements established a joint task force to prepare papers on implementation of these new suggestions. The Executive Boards of the International Monetary Fund and the World Bank subsequently adopted operational guidelines for providing financial support for debt and debt service reduction at the end of May. For countries requesting such support, the IMF and World Bank would set aside approximately one-fourth of their regular policy-based lending programs to support debt reduction. The IMF would provide additional resources of up to 40 percent of a country's quota for interest support. The World Bank also will make available additional resources to support interest payments in connection with debt or debt service reduction transactions, generally up to 15 percent of the total 3-year lending program.

This financing will be available to countries with large external commercial bank debt which have adopted sound medium-term adjustment programs, which can demonstrate a clear need for debt and debt service reduction to accomplish medium-term growth and development objectives, and which reach agreement with their commercial bank creditors on operations involving significant debt and debt service reduction. Sound adjustment programs will include measures aimed at encouraging foreign investment and flight capital repatriation and should, in addition, emphasize debt/equity swap programs.

Consistent with Section 3113 of the Act, the U.S. Executive Directors at the IMF and World Bank with the support of other directors requested studies which reviewed and analyzed the debt burden of developing countries. The IMF and World Bank have both prepared major papers for their Executive Boards on the debt situation and on alternative ways for dealing with it, including new lending instruments, rescheduling and refinancing of existing debt, securitization and debt conversion techniques, and discounted debt repurchases. IMF and World Bank staff have also analyzed the potential costs and benefits of international debt facilities, and both have held seminars or symposia on alternative ways for dealing with the debt strategy, including the use of debt facilities. Both the IMF Interim Committee and the Development Committee of the IMF and World Bank concluded at the spring meetings that the proposals put forth by Secretary Brady to strengthen the international debt strategy provide the best approach for addressing the external financing problems of developing countries.

These general endorsements have been translated into specific support for reform in a number of individual countries. The IMF Board has approved the use of Fund resources to support debt and debt service reduction in connection with the adoption of strong economic programs in Mexico, the Philippines, Costa Rica and Venezuela. In addition, the World Bank has approved policy-based loan commitments with provisions for debt reduction support for Mexico and Venezuela. The Paris Club has agreed to reschedule loans, including interest obligations, of Mexico, the Philippines, and Costa Rica.

At the Paris Economic Summit held July 14-16, 1989, the Group of Seven industrial countries firmly endorsed the strengthened debt strategy. In its communique, the Group urged the debtor countries to move promptly to develop strong economic reform programs as a basis for achieving debt and debt service reduction. It welcomed the steps taken by the IMF and World Bank to support debt and debt service reduction. Finally, it urged the commercial banks to take realistic and constructive approaches in their negotiations with the debtor countries and to move rapidly to conclude financial arrangements including debt reduction, debt service reduction and new money.

Mexico reached an agreement in principle in late July with its commercial bank advisory committee on financing arrangements that have the potential for significant debt and debt service reduction (see below). A tentative agreement was also reached in mid-August between the Philippines and its commercial bank advisory committee which offers a combination of renewed voluntary lending, restructured payments and significant debt reduction. Commercial bank discussions with Costa Rica and Venezuela are currently underway.

The Mexican Financing Package

The Mexican financing package, a medium-term financing agreement for the period 1989 through 1992, is the first practical application of the key elements of the strengthened debt strategy. The package supports the Mexican economic reforms negotiated with the IMF and World Bank, including a medium-term macroeconomic program, trade and financial liberalization, investment reforms, and privatization of the public sector.

The financial support offered by the commercial banks includes options for debt reduction, debt service reduction, and new financing, as follows:

(1) Fully collateralized, registered debt reduction bonds which may be exchanged for existing medium-term debt at a discount of 35 percent from current face value with a single principal repayment in 30 years and an interest rate of LIBOR plus 13/16 of one percent.

(2) Debt service reduction bonds which will be exchanged at face value for existing medium-term debt, but with a reduced, fixed interest rate of 6.25 percent. As in the case of the debt reduction bonds, these instruments will have a maturity of 30 years, will be fully collateralized by 30-year zero-coupon bonds, and will be repaid at maturity with a single payment. Commercial banks will also have the option after 1997 to recover some of the income foregone if Mexican real oil prices and real oil revenues increase.

(3) New financing over a four-year period which is equal to 25 percent of the bank exposure not exchanged for one of these two instruments. This new financing may be in the form of new Mexican bonds, onlending to public sector borrowers, or medium-term trade credits.

Interest support of 1 1/2-2 years for both the debt and debt service reduction bonds will be available. Seven billion dollars in IMF, World Bank, and other Mexican resources are expected to be used to enhance the new debt and debt service reduction instruments. Japan will provide two billion dollars in resources in parallel with IMF and World Bank loans to support the Mexican program.

Banks may choose one or more of these options, in any combination, based on their own interests and strategies. Loans extended between 1983 and 1988 which are not converted into new instruments will be rescheduled for 15 years, with a seven year grace period, and an interest rate of LIBOR plus 13/16 of one percent. The banks participating in this agreement will be able to participate in a new debt/equity swap program permitting the exchange of up to $3.5 billion in debt for equity holdings between January 1990 and June 1993.

The precise effects of this agreement will depend upon the choices made by Mexico's creditor banks. However, it is expected that the benefits accruing to Mexico will include significantly reduced principal or interest payments on approximately $40 billion in Mexican medium-term and long-term bank debt and a reduction in annual Mexican interest payments on the medium-term and long-term bank debt by nearly one-third. By the end of 1992, the stock of Mexican debt is expected to be some $10 to $12 billion lower than it would have been were Mexico to rely on getting new money alone. Moreover, some $40 billion in principal payments will be "defeased" through the purchase of zero-coupon bonds, lifting the burden of these payments from future Mexican generations.

This package represents a major step forward in international efforts to encourage debt and debt service reduction. It demonstrates that voluntary debt and debt service reduction can be accomplished to the benefit of both debtor and creditor without the need for centralized facilities that control, manage, and possibly mandate prices for the debt reduction process.

Secondary Market Prices

The first interim report contained a broad discussion of secondary market prices and how they are influenced by market-wide demand and supply conditions, country-specific developments, and general expectations regarding future developments. As pointed out in that report, short-term factors are clearly more dominant in determining secondary market prices than long-term prospects for individual nations to return to voluntary access to markets. In general, prices quoted in the secondary market reflect the most recent transaction rather than a homogeneous, highly liquid market.

There were two major drops in secondary market prices during 1987 and 1988. During 1987, average secondary market prices for the 15 major debtors[1] fell from 64 cents to 47 cents per dollar of face value, largely reflecting the impact of a Brazilian moratorium on payments to commercial banks and substantial reserving by U.S. money center banks early in the year.

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[1] Includes Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

The second major decline in secondary market prices occurred from mid- to late 1988, when the weighted average price fell to about 40 cents per dollar. Market participants suggested that this decline was generated by adverse market psychology fueled, in part, by the impression that investment opportunities in the debtor countries were narrowing and, in part, by the regional banks' selling off claims to clear their books of LDC debt by the end of the year. Canadian provisioning requirements may also have increased the supply of Canadian paper for sale. Moreover, a number of country-specific developments reflected either worsening domestic economic situations or increased rhetorical stridency within some of the key debtors. In particular, speculation about a possible suspension of Venezuelan payments, as well as heightened publicity on proposals for the establishment of an international debt facility in the latter part of 1988, also contributed to the downward pressures on prices.

This downward movement continued into 1989 as weighted average prices for the 15 major debtors fell from approximately 40 cents at the beginning of the year to 29 cents by the first week in March, the lowest level over the January 1989 to August 1989 period. Brazil's suspension of its debt/equity program may have contributed to a drop of more than 13 cents in its secondary market price over this two-month period. In addition, Venezuela decided in January to halt principal payments to commercial banks to conserve reserves. Its secondary market prices fell by 11.5

cents over the same period. Because of the size of their debt, both the Brazilian and Venezuelan actions further reduced secondary market values for their debt and depressed the market for Latin American debt in general. According to some reports, shorting of the market by speculative holders of debt paper may also have affected secondary market quotations during this period.

Average secondary market prices began to rebound dramatically from their early March low following Secretary Brady's speech on March 10 which offered specific proposals to strengthen the international debt strategy. In response to these proposals, which included the use of official resources to support debt and debt service reduction, demand for debt paper rose while commercial banks tended to hold off on further sales in the market. As a result, prices rose by an average of more than seven cents through the end of April.

Especially buoyed were the prices of three likely candidates for debt relief under the strengthened strategy -- Mexico, the Philippines, and Venezuela. By the end of April, the price of Mexican debt had shot up 30 percent from the beginning of March; Philippine debt, by 31 percent; and Venezuelan debt, by 41 percent -- or by roughly 10 to 11 cents per dollar for each of these countries. These dramatic increases were matched only by the 40 percent increase in prices for Brazilian debt paper. Although Brazil had not been considered a likely "first" candidate, its standing as the largest developing country debtor certainly fueled the assumption in the market that Brazil would soon be seeking similar debt reduction. In sharp contrast, Argentina, with all of its economic uncertainty, was not at that time viewed as a serious candidate in the near term. The secondary market price of its debt dropped by 8 percent, second in magnitude only to the 25 percent decline in the price of Peruvian debt paper.

From the end of April until early June, market prices fell by three cents on average, due to protracted discussions of new financing arrangements for Mexico. Secondary market prices for Mexican debt paper fell 9 percent in this six-week period. Mexico had suspended its debt/equity swap program in 1988, with a consequent evaporation of a major source of demand for Mexican paper, and traders did not expect that this program would resume until the conclusion of the agreement with the negotiating banks.

Prices subsequently rose steadily between June and mid-July, generated, in part, by the expectation that the Mexican agreement would be completed by the time of the July Paris Summit of key industrial nations. In late May and early June, several developments within the debt strategy influenced market perceptions. The IMF and World Bank announced guidelines for supporting debt and debt service reduction transactions between debtor countries and commercial banks. At this time, they also indicated to Mexico and its commercial banks the specific amounts that could be made available to support Mexican debt and debt service reduction. Accordingly, the banks and Mexico began serious, intensive negotiations.

Furthermore, Mexico, as well as the Philippines, Venezuela, and Costa Rica, received IMF Board approval for the use of Fund resources to support debt and debt service reduction in conjunction with strong economic programs. The Paris Club also agreed to reschedule outstanding loans as well as interest obligations of Mexico, the Philippines, and Costa Rica. On July 23, nine days after the Paris Summit, Mexico reached agreement in principle with its bank advisory committee on a financing package. Market prices at that point had fully regained the high of late April, confirming the early market response to the strengthened debt strategy.

Conclusion

The strengthened debt strategy has boosted secondary market prices. The proposals put forth for voluntary, market-oriented debt and debt service reduction have been viewed as potentially effective steps in resolving deep-rooted debt problems. When negotiations on debt and debt service reduction appeared to stall, as the Mexican negotiations did in May, secondary market prices declined. This further affirms the finding presented in the first interim report that protracted delays in debt work-out negotiations undermine secondary market prices.

With the Mexican agreement concluded in principle, a preliminary agreement reached in the Philippines, and active engagement by Costa Rica and Venezuela in negotiations with their respective bank advisory groups, extensive discussions on the establishment of an international debt facility would at this juncture prove counterproductive. Negotiations would be disrupted, preliminary agreements reassessed, and the overall process of debt reduction delayed. Prevailing uncertainty would propel secondary market prices lower. The prospect of an international debt facility would also fuel expectations of across-the-board debt relief. This could encourage actions to restrict debt/equity programs or to countenance debt service arrearages in anticipation of subsequent large scale debt relief.

Consistent with the previous report, it is once again the determination of the Secretary of the Treasury that formal negotiations on the establishment of an International Debt Management Authority would be disruptive to the market and would unnecessarily delay negotiations already underway between commercial bank creditors and debtor nations, with potential debt service disruptions and price declines in the secondary market for debtor country debt paper. In addition, with the operational details of the strengthened debt strategy in place and with significant progress already being made in its implementation, the establishment of an Authority is considered unnecessary.

As shown by the negotiation of the Mexican and Philippine financing packages, debt and debt service reduction in conjunction with debtor reform can be formulated without the intervention of an international debt management authority. We expect several other countries which are undertaking serious economic reforms and which stand to gain measurably from debt and debt service reduction to take advantage of the opportunities within this approach to reduce debt burdens and enhance their prospects for growth.

Table 1

Secondary Market Prices for the 15

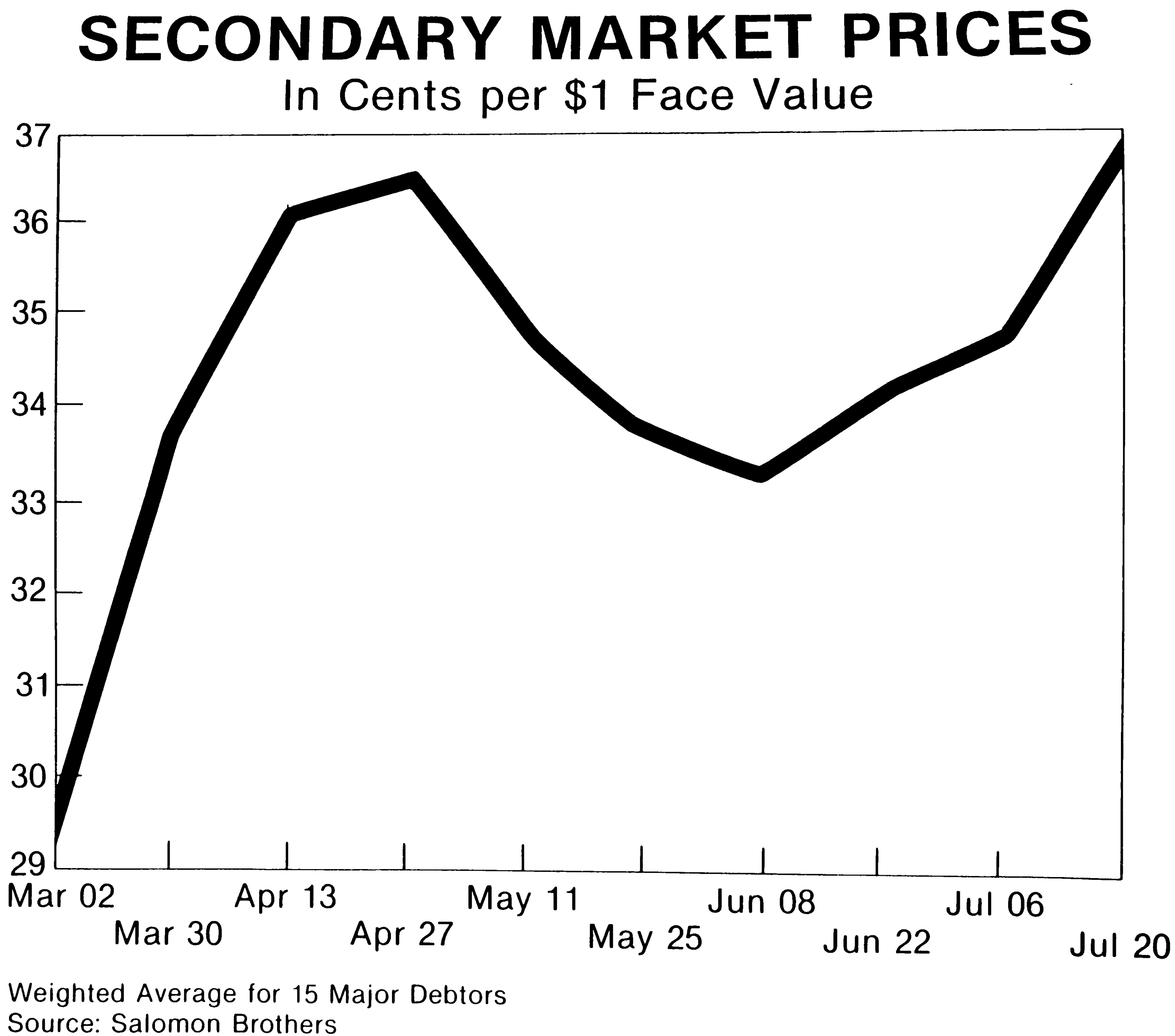
Major Debtors' Bank Debt

(Selected Dates and in Cents per Dollar)

Country	Mar 02	Mar 30	Apr 13	Apr 27	May 11	May 25	Jun 08	Jun 22	Jul 06	Jul 20
Argentina	17.3	16.5	16.3	16.0	15.0	12.5	11.8	14.3	17.3	18.3
Bolivia	9.0	11.0	11.0	11.0	11.0	11.0	11.0	11.0	11.0	11.0
Brazil	26.8	33.5	37.0	37.5	34.0	32.0	31.0	31.0	29.5	32.5
Chile	55.3	58.5	58.5	58.5	58.5	59.0	60.0	62.0	64.5	64.5
Colombia	50.0	50.0	55.3	57.0	57.0	57.0	57.0	57.0	57.0	60.0
Ecuador	12.0	10.0	10.5	12.3	12.3	12.3	12.3	12.0	13.5	14.5
Ivory Coast	15.0	14.0	14.0	14.0	14.0	14.0	14.0	14.0	6.0	6.0
Mexico	33.0	40.0	42.5	42.8	40.8	40.0	39.0	40.0	41.5	44.0
Morocco	44.0	42.0	42.0	41.8	41.8	41.8	42.8	43.0	43.5	44.0
Nigeria	21.0	21.0	20.0	21.0	21.0	21.0	21.0	23.0	23.5	23.5
Peru	4.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.5
Philippines	36.0	41.0	46.0	47.0	46.5	46.3	47.3	48.5	49.5	53.5
Uruguay	57.0	56.0	56.0	56.0	56.0	56.0	56.0	55.0	55.0	55.0
Venezuela	27.3	34.0	37.5	38.5	37.0	36.3	36.8	37.0	37.8	40.0
Yugoslavia	43.3	43.5	44.0	44.5	46.0	47.0	49.0	50.0	51.0	53.5
Weighted Average	**29.4**	**33.8**	**36.1**	**36.5**	**34.8**	**33.7**	**33.3**	**34.1**	**34.7**	**36.8**

Weighted by outstanding commercial bank claims as of year-end 1988.

Source: Salomon Brothers


SECONDARY MARKET PRICES
In Cents per $1 Face Value
37
36
35
34
33
32
31
30
29
Mar 02
Mar 30
Apr 13
Apr 27
May 11
May 25
Jun 08
Jun 22
Jul 06
Jul 20
Weighted Average for 15 Major Debtors
Source: Salomon Brothers

TREASURY NEWS

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

<u>FOR IMMEDIATE RELEASE</u>
Sept. 19, 1989

CONTACT: Bob Levine
(202) 566-2041

BOLIVIAN BRIDGE LOAN

The Department of ther Treasury today announced an agreement with the Republic of Bolivia on a new facility to succeed the existing $100 million short-term bridge financing facility. This short-term facility will provide further support for Bolivia's financial position as the government of President Paz Zamora continues the program of comprehensive structural reform designed to provide the basis for sustained economic growth. The facility complements the arrangements being made for longer-term financial assistance from the International Monetary Fund, multilateral development banks and bilateral donors.

The United States Government supports the determination of the Bolivian government to consolidate its success in reforming the economy and achieving a dramatic reduction of inflation.

oOo

NB-455

TREASURY NEWS

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

ROOM 5310

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
September 18, 1989

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $7,200 million of 13-week bills and for $7,201 million of 26-week bills, both to be issued on September 21, 1989, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing December 21, 1989			:	26-week bills maturing March 22, 1990		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.61%	7.87%	98.076	:	7.60%a/	8.01%	96.158
High	7.65%	7.91%	98.066	:	7.68%	8.10%	96.117
Average	7.64%	7.90%	98.069	:	7.64%	8.06%	96.138

a/ Excepting 2 tenders totaling $2,925,000.

Tenders at the high discount rate for the 13-week bills were allotted 82%.
Tenders at the high discount rate for the 26-week bills were allotted 62%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 22,630	$ 22,630	:	$ 25,215	$ 25,215
New York	22,210,440	6,484,565	:	18,797,150	5,926,150
Philadelphia	14,190	14,190	:	19,325	19,325
Cleveland	24,060	24,060	:	23,810	23,810
Richmond	41,310	38,950	:	34,290	34,290
Atlanta	23,370	23,370	:	18,840	18,840
Chicago	1,544,375	39,375	:	1,270,780	320,780
St. Louis	36,340	20,440	:	25,170	25,170
Minneapolis	6,215	6,215	:	4,980	4,980
Kansas City	28,510	28,510	:	36,440	36,440
Dallas	30,485	20,485	:	28,095	28,095
San Francisco	766,735	146,035	:	600,945	450,945
Treasury	331,555	331,555	:	286,620	286,620
TOTALS	$25,080,215	$7,200,380	:	$21,171,660	$7,200,660
Type					
Competitive	$22,285,520	$4,405,685	:	$17,040,355	$3,069,355
Noncompetitive	860,615	860,615	:	754,705	754,705
Subtotal, Public	$23,146,135	$5,266,300	:	$17,795,060	$3,824,060
Federal Reserve	1,883,380	1,883,380	:	1,800,000	1,800,000
Foreign Official Institutions	50,700	50,700	:	1,576,600	1,576,600
TOTALS	$25,080,215	$7,200,380	:	$21,171,660	$7,200,660

1/ Equivalent coupon-issue yield.

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TREASURY NEWS

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

5310

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.
September 19, 1989

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 September 28, 1989. This offering will provide about $1,100 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $13,694 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, September 25, 1989. 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 June 29, 1989, and to mature December 28, 1989 (CUSIP No. 912794 TJ 3), currently outstanding in the amount of $6,557 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $7,400 million, to be dated September 28, 1989, and to mature March 29, 1990 (CUSIP No. 912794 TX 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 September 28, 1989. In addition to the maturing 13-week and 26-week bills, there are $9,419 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 $2,622 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $3,094 million as agents for foreign and international monetary authorities, and $5,617 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 5176-1 (for 13-week series) or Form PD 5176-2 (for 26-week series).

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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 one-half hour prior to the closing time for receipt of tenders 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.

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.

If a bill is purchased at issue, and is held to maturity, the amount of discount is reportable as ordinary income on the Federal income tax return of the owner for the year in which the bill matures. 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, any gain in excess of the basis is treated as ordinary income.

Department of the Treasury Circulars, Public Debt Series - Nos. 26-76, 27-76, and 2-86, as applicable, 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.

8/89

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
September 19, 1989

CONTACT: LARRY BATDORF
Phone: (202) 566-2041

TREASURY ANNOUNCES ADDITIONS TO THE LIST OF CUBAN FRONTS CONDUCTING TRANSACTIONS IN PANAMA ON BEHALF OF CUBA

The Department of Treasury today added 14 names to the existing list of 117 Cuban fronts which the Noriega regime allows to conduct transactions in Panama on behalf of Cuba.

Any person subject to the jurisdiction of the United States is prohibited from engaging, directly or indirectly, in any transactions with the Specially Designated Nationals of Cuba or in any transaction involving any property in which there exists any interest of Cuba.

The listing of names as Specially Designated Nationals of Cuba in Panama has the effect of transferring the full force of the U.S. trade embargo against Cuba to these designated persons and firms operating in Panama. Additional names of those acting for or on behalf of Cuba in Panama and elsewhere in the world, wherever Cuba conducts business relations, will continue to be added to the list and published in the Federal Register as they are identified.

Violations by corporations are punishable criminally under the Trading with the Enemy Act by fines of up to $500,000 per count. Individuals can be fined up to $250,000 per count and willful individual violators can be imprisoned up to 12 years.

A copy of the notice filed with the Federal Register is attached.

NB-458

IN ADVANCE OF PRINTED COPY

4810-25-M

DEPARTMENT OF THE TREASURY

RECEIVED IN THE OFFICE OF THE FEDERAL REGISTER
9/19/89 10:04 am

Office of Foreign Assets Control

31 CFR Part 515

Supplemental List of Specially Designated Nationals (Cuba) in Panama

AGENCY: Office of Foreign Assets Control, Department of the Treasury.

ACTION: Notice of Additions to the List of Specially Designated Nationals of Cuba.

SUMMARY: This notice provides the names of firms operating in Panama that have been added to the list of Specially Designated Nationals under the Treasury Department's Cuban Assets Control Regulations (31 CFR Part 515). Also provided is a complete current listing of Specially Designated Nationals of Cuba in Panama.

EFFECTIVE DATE: [Date of publication]

FOR FURTHER INFORMATION CONTACT: Richard J. Hollas, Chief, Enforcement Division, Office of Foreign Assets Control, Tel: (202) 376-0400. Copies of the list of Specially Designated Nationals are available upon request at the following location: Office of Foreign Assets Control, Department of the Treasury, 1331 G Street, N.W., Room 300, Washington, D.C. 20220.

SUPPLEMENTARY INFORMATION:

Under the Cuban Assets Control Regulations, persons subject to the jurisdiction of the United States are prohibited from engaging, directly or indirectly, in transactions with any nationals or specially designated nationals of Cuba, or involving any property in which there exists an interest of any national or specially designated national of Cuba, except as authorized by the Treasury Department's Office of Foreign Assets Control by means of a general or specific license.

Section 515.302 of Part 515 defines the term "national," in part, as (a) a subject or citizen domiciled in a particular country, or (b) any partnership, association, corporation, or other organization owned or controlled by nationals of that country, or that is organized under the laws of, or that has had its principal place of business in that foreign country since the effective date (for Cuba, 12:01 a.m., e.s.t., July 8, 1963), or (c) any person that has directly or indirectly acted for the benefit or on behalf of any designated foreign country. Section 515.305 defines the term "designated national" as Cuba or any national thereof, including any person who is a specially designated national. Section 515.306 defines "specially designated national" as any person who has been designated as such by the Secretary of the Treasury; any person who, on or since the effective date, has either acted for or on behalf of the government of, or authorities exercising control over any designated foreign country; or any partnership, association, corporation or other organization that, on or since the applicable effective date, has been owned or controlled directly or indirectly by such government or authorities, or by any specially designated national.

Section 515.201 prohibits any transaction, except as authorized by the Secretary of the Treasury, involving property in which there exists an interest of any national or specially designated national of Cuba. The list of Specially Designated Cuban Nationals is a partial one, since the Department of the Treasury may not be aware of all the persons located outside Cuba that might be acting as agents or front organizations for Cuba, thus qualifying as specially designated nationals of Cuba. Also, names may have been omitted because it seemed unlikely that those persons would engage in transactions with persons subject to the jurisdiction of the United States. Therefore, persons engaging in transactions with foreign nationals may not rely on the fact that any particular foreign national is not on the list as evidence that it is not a specially designated national.

The Treasury Department regards it as incumbent upon all U.S. persons engaging in transactions with foreign nationals to take reasonable steps to ascertain for themselves whether such foreign nationals are specially designated nationals of Cuba, or other designated countries (at present, Cambodia, North Korea, and Vietnam). The list of Specially Designated Nationals was last published on December 10, 1986, in the Federal Register (51 FR 44459), and was amended on November 3, 1988 (53 FR 44397), January 24, 1989 (54 FR 3446), April 10, 1989 (54 FR 14215) and August 4, 1989 (54 FR 32064) .

Please take notice that section 16 of the Trading with the Enemy Act (the "Act"), as amended, provides in part that whoever willfully violates any provision of the Act or any license, rule or regulation issued thereunder:

"Shall, upon conviction, be fined not more than $50,000, or, if a natural person, imprisoned for not more than ten years, or both; and the officer, director, or agent of any corporation who knowingly participates in such violation shall be punished by a like fine, imprisonment, or both; and any property, funds, securities, papers, or other articles or documents, or any vessel, together with her tackle, apparel, furniture, and equipment, concerned in such violation shall be forfeited to the United States."

In addition, persons convicted of an offense under the Act may be fined a greater amount than set forth in the Act, as provided in 18 U.S.C. 3571 and 3581.

Authority: 50 U.S.C. App. 5(b) and 18 U.S.C. 3571 and 3581.

<u>Specially Designated Nationals of Cuba in Panama (New Additions at this Publication)</u>

Duque, Carlos

Panama

Facobata

Panama

Fruni Trading, S.A.

Panama City, Panama

Gallo Import

Panama

Guaca Export

Panama

Interconsult

Panama

International Petroleum, S.A.

Colon Free Zone, Panama

IPESCO (See International Petroleum, S.A.)

Panama

Kave, S.A.

Panama

Lakshmi

Panama

Marine Registration Company

Panama

Piramide Internacional

Panama

Transit, S.A.

Panama

Trust Import-Export, S.A.

Panama

Complete Current List of Specially Designated Nationals of Cuba in Panama

Abastecadora Naval Y Industrial, S.A. (a.k.a. Anainsa)

Panama

Abdelnur, Nury De Jesus

Panama

Agencia de Viajes Guama (a.k.a. Viajes Guama Tours, Guamatur, S.A. and Guama Tour)

Bal Harbour Shopping Center, Via Italia,

Panama City, Panama

Alfonso, Carlos, (a.k.a. Carlos Alfonso Gonzalez)

Panama

Alvarez, Manuel (Aguirre)

Panama

Anainsa (a.k.a. Abastecadora Naval y Industrial, S.A)

Panama

Angelini, Alejandro Abood

Panama

Avalon, S.A.

Colon Free Zone, Panama

Batista, Miguel

Panama

Bewell Corporation, Inc.

Panama

Boutique La Maison

42 Via Brasil

Panama City, Panama

Bradfield Maritime Corp., Inc.

Panama

Caballero, Roger Montanes (a.k.a. Roger Montanes and Roger Edward Dooley)

Panama

Canapel, S.A.

Panama

Caribbean Happy Lines (a.k.a. Caribbean Happy Lines Co.)

Panama

Caribsugar, S.A.

Panama

Carisub, S.A.

Panama

Casa del Respuesto

Panama

Castell, Osvaldo Antonio (Valdez)

Panama

Cecoex, S.A.

Panama City, Panama

Chamet Import, S.A.

Panama

Cimex, S.A.

Panama

Coll, Gabriel (Prado)

Panama

Colon, Eduardo (Betancourt)

Panama

Colony Trading, S.A.

Panama

Comercial Cimex, S.A.

Panama

Comercial Muralla, S.A. (a.k.a. Muralla, S.A.)

Panama City, Panama

Compania Pesquera Internacional, S.A.

Panama

Contex, S.A.

Panama

Corporacion Cimex, S.A.

Panama

Cubana Airlines (a.k.a. Empresa Cubana de Aviacion)

Calle 29 y Avda Justo Arosemena

Panama City, Panama

Cuenca, Ramon Cesar

Panama

Delgado, Antonio (Arsenio)

Panama

Deprosa, S.A. (a.k.a. Desarrollo De Proyectos, S.A.)

Panama City, Panama

Desarrollo De Proyectos, S.A. (a.k.a. Deprosa, S.A.)

Panama City, Panama

Dooley, Michael P.

Panama

Dooley, Roger Edward (a.k.a. Roger Montanes Caballero and Roger Montanes)

Panama

Duque, Carlos

Panama

Echeverri, German

Panama

Edyju, S.A.

Panama

Empresa Cubana de Aviacion (see Cubana Airlines)

Panama

Fabro Investment, Inc.

Panama

Facobata

Panama

Fruni Trading, S.A.

Panama City, Panama

Gallo Import

Panama

Garcia Santamaria de la Torre, Alfredo Rafael (see also "Santamarina")

Panama

Global Marine Overseas, Inc.

Panama

Golden Comet Navigation Co., Ltd.

Panama

Gonzalez, Carlos Alfonso (a.k.a. Carlos Alfonso)

Panama

Grete Shipping Co., S.A.

Panama

Guaco Export

Panama

Guama Tour (a.k.a. Agencia de Viajes Guàma, Viajes Guama Tours and Guamatur, S.A.)

Bal Harbour Shopping Center, Via Italia

Panama City, Panama

Guamar Shipping Co., S.A.

Panama

Guamatur, S.A. (a.k.a. Agencia de Viajes Guama, Viajes Guama Tours and Guama Tour)

Bal Harbour Shopping Center, Via Italia

Panama City, Panama

Havanatur, S.A.

Panama City, Panama

Havinpex, S.A. (a.k.a. Transover, S.A.)

Panama City, Panama

Haya, Francisco

Panama

Hermann Shipping Corp., Inc.

Panama

Heywood Navigation Corp.

Panama

Imprisa, S.A.

Panama

Interconsult

Panama

International Petroleum, S.A.

Colon Free Zone, Panama

International Transport Corporation

Colon Free Zone, Panama

Inversiones Lupamar, S.A. (a.k.a. The Lupamar Investment Company)

Panama

IPESCO (a.k.a. International Petroleum S.A.)

Colon Free Zone, Panama

Jiminez, Gillermo (Soler)

Panama

Kaspar Shipping, S.A.

Panama

Kave, S.A.

Panama

Lakshmi

Panama

Leybda Corporation, S.A.

Panama

Louth Holdings, S.A.

Panama

Manzper Corp.

Panama

Marine Registration Company

Panama

Marisco (or Mariscos) de Farallon, S.A.

Panama

Marketing Associates Corporation

Calle 52 E, Campo Alegre

Panama City, Panama

Maryol Enterprises, Inc.

Panama

Medina, Anita (a.k.a. Ana Maria Medina)

Panama

Mercurius Import/Export Company, Panama, S.A.

Calle C, Edificio 18

Box 4048, Colon Free zone, Panama

Monet Trading Company

Panama

Montanes, Roger (a.k.a. Roger Montanes Caballero and Roger Edward Dooley)

Panama

Montanez, Michael

Panama

Moonex International, S.A.

Panama

Muralla, S.A. (a.k.a. Comercial Muralla, S.A.)

Panama City, Panama

Navigable Water Corp., Ltd.

Panama

Ortega, Dario (Pina)

Edificio Saldivar

Panama City, Panama

Panamerican Import and Export Commercial Corp.

Panama

Panoamericana

Panama

Pena, Jose (Torres)

Panama

Pena, Victor

Panama

Perez, Alfonso

Panama

Perez, Manuel Martin

Panama

Perez, Osvaldo (Cruz)

Panama

Pescados Y Mariscos de Panama (a.k.a. Pesmar or Pezmar) S.A.

Panama City, Panama

Pesmar (or Pezmar), S.A. (a.k.a. Pescados y Mariscos de Panama)

Panama City, Panama

Piramide Internacional

Panama

Pons, Alberto

Executive Representative

Banco Nacional de Cuba

Federico Boyd Ave. & 51 St.

Panama City, Panama

Prado, Julio (a.k.a. Julio Lobato)

Panama

Presa, S.A.

Panama

Radio Service, S.A.

Panama

Reciclaje Industrial, S.A.

Panama

Rent-A-Car, S.A.

Panama

Reyes, Guillermo (Vergara)

Panama City, Panama

Rocha, Antonio

Panama City, Panama

Rodriquez, Jesus (Borges or Borjes)

Panama

Romeo, Charles (a.k.a. Charles Henri Robert Romeo)

Panama

Roque, Roberto (Perez)

Panama

Ruiz, Ramon Miguel (Poo)

Panama

Santamarina, de la Torre Rafael Garcia (see also "Garcia")

Panama

Servimpex, S.A.

Panama

Servinaves, S.A.

Panama

Shipley Shipping Corp.

Panama

Siboney Internacional, S.A.

Edificio Balmoral, 82 Via Argentina

Panama City, Panama

Suplidora Latino Americana, S.A. (a.k.a. Suplilat, S.A.)

Panama City, Panama

Suplilat, S.A., (a.k.a. Suplidora Latino Americana, S.A.)

Panama City, Panama

Taller De Reparaciones Navales, S.A. (a.k.a. Tarena)

Panama City, Panama

Tarena, S.A. (a.k.a. Taller De Reparaciones Navales S.A.)

Panama

Technic Digemex Corp.

Calle 34 No. 4-50, Office 301

Panama City, Panama

Technic Holding Inc.

Calle 34 No. 4-50, Office 301

Panama City, Panama

Temis Shipping Co.

Panama

Tosco, Arnaldo (Garcia)

Panama

Tramp Pioneer Shipping Co.

Panama

Transit, S.A.

Panama

Transover, S.A. (a.k.a. Havinpex, S.A.)

Panama City, Panama

Treviso Trading Corporation

Edificio Banco de Boston

Panama City, Panama

Trober, S.A. (a.k.a. Trover, S.A.)

Edificio Saldivar

Panama City, Panama

Trust Import-Export, S.A.

Panama

Valletta Shipping Corp.

Panama

Vasquez, Oscar D. (a.k.a. Vazques, Oscar D.)

Panama

Viacon International, Inc.

Apartment 7B Torre Mar Building

Punta Paitilla Area, Panama City, Panama

France Field, Colon Free Zone, Panama

Viajes Guama Tours (a.k.a. Guamatur, S.A., Guama Tour and Agencia de Viajes Guama)

Bal Harbour Shopping Center, Via Italia

Panama City, Panama

Wittgreen, Carlos (a.k.a. Carlos Wittgreen Antinori, Carlos Wittgreen A., and Carlos Antonio Wittgreen)

Panama

Date: September 5, **1989**

R. Richard Newcomb
Director,
Office of Foreign Assets
Control

Approved: 11 SEP 1989, 1989

John P. Simpson
Acting Assistant Secretary
(Enforcement)

Filed: September 19, 1989

Publication date: September 20, 1989

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

FOR RELEASE AT 4:00 P.M.
September 20, 1989

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION 2-YEAR AND 4-YEAR NOTES
TOTALING $17,500 MILLION

The Treasury will auction $9,750 million of 2-year notes and $7,750 million of 4-year notes to refund $16,529 million of securities maturing September 30, 1989, and to raise about $975 million new cash. The $16,529 million of maturing securities are those held by the public, including $1,730 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $17,500 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.

In addition to the public holdings, Federal Reserve Banks, for their own accounts, hold $1,466 million of the maturing securities that may be refunded by issuing additional amounts of the new securities 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.

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Attachment

NB-459

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC
OF 2-YEAR AND 4-YEAR NOTES TO BE ISSUED OCTOBER 2, 1989

September 20, 1989

Amount Offered to the Public ...	$9,750 million	$7,750 million
<u>Description of Security</u>:		
Term and type of security	2-year notes	4-year notes
Series and CUSIP designation ...	Series AE-1991 (CUSIP No. 912827 XZ 0)	Series Q-1993 (CUSIP No. 912827 YA 4)
Maturity date	September 30, 1991	September 30, 1993
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	March 31 and September 30	March 31 and September 30
Minimum denomination available .	$5,000	$1,000
<u>Terms of Sale</u>:		
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
<u>Payment Terms</u>:		
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
<u>Key Dates</u>:		
Receipt of tenders	Tuesday, September 26, 1989, prior to 1:00 p.m., EDST	Wednesday, September 27, 1989, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):		
a) funds immediately available to the Treasury ...	Monday, October 2, 1989	Monday, October 2, 1989
b) readily-collectible check ...	Thursday, September 28, 1989	Thursday, September 28, 1989

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
September 21, 1989

CONTACT: LARRY BATDORF
(202) 566-2041

TAX TREATY NEGOTIATIONS WITH ITALY

Treasury Department today announced that discussions will be held with Italy during the week of October 9th about possible amendments to the bilateral income tax treaty, signed in April, 1984. The discussions will take into account changes in the tax laws of the two countries since that time, including the changes in U.S. law introduced by the 1986 Tax Reform Act.

Interested persons are invited to submit comments about the operation of the treaty and suggestions as to desirable modifications by writing to Philip Morrison, Acting International Tax Counsel, room 3064, U.S. Treasury Department, Washington, D.C. 20220.

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TREASURY NEWS

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

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FOR IMMEDIATE RELEASE
September 20, 1989

Dr. Linda M. Combs
Assistant Secretary (Management)

Dr. Linda M. Combs was confirmed as Assistant Secretary for Management on July 27, 1989. She succeeds Jill E. Kent.

In this position, Dr. Combs is responsible for directing the Department's personnel and financial management, information systems, and administrative operations. As Assistant Secretary for Management, Dr. Combs is also the principal policy advisor to the Secretary and Deputy Secretary on the annual planning and budget process.

Prior to joining Treasury, Dr. Combs served as Acting Associate Deputy Administrator for Management at the Department of Veterans Affairs. Before joining Veterans Affairs, she held numerous positions in both the private and public sector. Her public positions included Advisor to the Governor of North Carolina, Executive Secretary of the U.S. Department of Education, and Deputy Under Secretary for Management at the Department of Education. Dr. Combs' private sector experience was with Wachovia Corporation in Winston-Salem, North Carolina where she served as Operations Officer and Manager of National Direct Student Loans. In addition, Dr. Combs has held elective office, serving as a member of the Winston-Salem/Forsyth County Board of Education. She is currently a member of the Board of Visitors of the Babcock School of Management at Wake Forest University.

Dr. Combs earned a masters degree from Appalachian State University, a Doctorate from Virginia Polytechnic State University, and is a graduate of the Program for Senior Managers in Government at Harvard University. She also has an honorary Doctorate from Gardner-Webb College.

Dr. Combs is married to David M. Combs and resides in Montgomery County, Maryland.

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE
September 21, 1989

Monthly Release of U.S. Reserve Assets

The Treasury Department today released U.S. reserve assets data for the month of August 1989.

As indicated in this table, U.S. reserve assets amounted to $62,364 million at the end of August, down from $63,462 million in July.

U.S. Reserve Assets
(in millions of dollars)

End of Month	Total Reserve Assets	Gold Stock 1/	Special Drawing Rights 2/3/	Foreign Currencies 4/	Reserve Position in IMF 2/
1989					
July	63,462	11,066	9,340	34,001	9,055
August	62,364	11,066	9,240	33,413	8,644

1/ Valued at $42.2222 per fine troy ounce.

2/ Beginning July 1974, the IMF adopted a technique for valuing the SDR based on a weighted average of exchange rates for the currencies of selected member countries. The U.S. SDR holdings and reserve position in the IMF also are valued on this basis beginning July 1974.

3/ Includes allocations of SDRs by the IMF plus transactions in SDRs.

4/ Valued at current market exchange rates.

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TREASURY NEWS

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

OM 5310

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
September 21, 1989

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $9,506 million of 52-week bills to be issued September 28, 1989, and to mature September 27, 1990, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	7.60% a/	8.18%	92.316
High -	7.62%	8.20%	92.295
Average -	7.61%	8.19%	92.305

a/ Excepting 2 tenders totaling $2,250,000.
Tenders at the high discount rate were allotted 68%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 11,770	$ 11,770
New York	23,049,125	8,901,125
Philadelphia	9,005	9,005
Cleveland	12,255	12,255
Richmond	22,050	22,050
Atlanta	14,600	14,600
Chicago	1,313,355	127,755
St. Louis	17,975	15,655
Minneapolis	16,535	13,335
Kansas City	20,775	20,775
Dallas	18,755	12,155
San Francisco	849,830	141,830
Treasury	204,085	204,085
TOTALS	$25,560,115	$9,506,395
Type		
Competitive	$22,750,250	$6,696,530
Noncompetitive	469,865	469,865
Subtotal, Public	$23,220,115	$7,166,395
Federal Reserve	2,200,000	2,200,000
Foreign Official Institutions	140,000	140,000
TOTALS	$25,560,115	$9,506,395

NB-463

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TREASURY NEWS

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

FOR IMMEDIATE RELEASE
September 12, 1989

CONTACT: LARRY BATDORF
(202) 566-2041

NEW INCOME TAX CONVENTION SIGNED WITH THE REPUBLIC OF INDIA

The Treasury Department announced today the signing of an Income Tax Convention and accompanying Protocol ("the treaty") between the United States and the Republic of India. The proposed treaty was signed in New Delhi on September 12, 1989 by Ambassador John R. Hubbard for the United States, and by Revenue Secretary Dr. N. K. Sengupta for the Republic of India. The proposed treaty will be submitted to the Senate for its advice and consent to ratification. Following notification by both countries that all ratification procedures have been completed, the treaty will enter into force. The treaty will have effect in the United States as of January 1 of the year following the year in which the treaty enters into force. In India the treaty will have effect as of April 1 of the year following entry into force.

This will be the first income tax treaty between the two countries. An earlier treaty, signed in 1959, did not enter into force. The proposed treaty differs from the U.S. Model Income Tax Convention in a number of respects in order to reflect India's status as a developing country. In this regard it is similar to other U.S. treaties with developing countries.

The treaty provides maximum rates of tax at source on payments of dividends, interest and royalties. Dividends from a subsidiary to a parent corporation are taxable at a maximum rate of 15 percent; other dividends may be taxed at source at a maximum of 25 percent rate. Interest is, in general, taxable at source at a maximum of 15 percent, although interest received by a financial institution is taxable at a maximum rate of 10 percent, and interest received by either of the two Governments, by certain governmental financial institutions, and by residents of a Contracting State on certain Government approved loans, is exempt from tax at source.

The royalty provisions contain several significant departures from standard U.S. treaty policy. In general, industrial and copyright royalties are taxable at source at a maximum rate of 20 percent for the first five years of the treaty's life, dropping to 15 percent thereafter. Where the payor of the royalty is one of the Governments, a political subdivision or a public sector corporation, tax will be imposed from the effective date of the treaty at a maximum rate of 15 percent. Payments for the use of, or the right to use, industrial, commercial or scientific equipment are treated as royalties, and are subject to a maximum rate of tax at source of 10 percent. Certain service fees, referred to in the treaty as "fees for included services", are treated in the same manner as royalties. Included services are defined as technical or consultancy services which either: (i) are ancillary and subsidiary to the licensing of an intangible or the rental of tangible personal property, both of which give rise to royalty payments, or (ii) if not ancillary or subsidiary, make available to the payor of the service fee, some technical knowledge, experience, skill, etc., or transfer to that person a technical plan or design. A detailed memorandum of understanding was developed to provide guidance as to the intended scope of the concept of "included services". Copies of this memorandum are available along with copies of the Treaty, as described below. Fees for all other services are treated either as business profits or as independent personal services income.

The treaty preserves for the United States the right to impose the branch profits tax. It preserves for both Contracting States their statutory taxing rights with respect to capital gains. The proposed treaty contains rules for the taxation of business profits which, consistent with other U.S. treaties with developing countries, provide a broader range of circumstances under which one partner may tax the business profits of a resident of the other. The treaty contains reciprocal exemption at source for shipping and aircraft operating income. The treatment under the proposed treaty of various classes of personal service income is similar to that under other U.S. treaties with developing countries. The proposed treaty contains provisions designed to prevent third-country residents from treaty shopping. Like all U.S. tax treaties, the proposed treaty prohibits tax discrimination, creates a dispute resolution mechanism and provides for the exchange of otherwise confidential tax information between the tax authorities of the partners.

Copies of the proposed Treaty and Protocol, diplomatic notes exchanged at the time of the signing, and the memorandum of understanding on Fees for Included Services will be available soon from the Treasury's Office of Public Affairs, Room 2315, Treasury Department, Washington, D.C. 20220, telephone (202) 566-2041.

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CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE REPUBLIC OF INDIA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME

The Government of the United States of America and the Government of the Republic of India, desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, have agreed as follows:

ARTICLE 1

General Scope

1. This Convention shall apply to persons who are residents of one or both of the Contracting States, except as otherwise provided in the Convention.

2. The Convention shall not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded:

a) by the laws of either Contracting State; or

b) by any other agreement between the Contracting States.

3. Notwithstanding any provision of the Convention except paragraph 4, a Contracting State may tax its residents (as determined under Article 4 (Residence)), and by reason of citizenship may tax its citizens, as if the Convention had not come into effect. For this purpose, the term "citizen" shall include a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax, but only for a period of 10 years following such loss.

4. The provisions of paragraph 3 shall not affect

a) the benefits conferred by a Contracting State under paragraph 2 of Article 9 (Associated Enterprises), under paragraphs 2 and 6 of Article 20 (Private Pensions, Annuities, Alimony, and Child Support), and under Articles 25 (Relief From Double Taxation), 26 (Non-Discrimination), and 27 (Mutual Agreement Procedure); and

b) the benefits conferred by a Contracting State under Articles 19 (Remuneration and Pensions in Respect of Government Service), 21 (Payments Received by Students and Apprentices), 22 (Payments Received by Professors, Teachers and Research Scholars) and 29 (Diplomatic Agents and Consular Officers), upon individuals who are neither citizens of, nor have immigrant status in, that State.

ARTICLE 2

Taxes Covered

1. The existing taxes to which this Convention shall apply are:

a) in the United States, the Federal income taxes imposed by the Internal Revenue Code (but excluding the accumulated earnings tax, the personal holding company tax, and social security taxes), and the excise taxes imposed on insurance premiums paid to foreign insurers and with respect to private foundations (hereinafter referred to as "United States tax"); provided, however, the Convention shall apply to the excise taxes imposed on insurance premiums paid to foreign insurers only to the extent that the risks covered by such premiums are not reinsured with a person not entitled to exemption from such taxes under this or any other Convention which applies to these taxes; and

b) in India:

i) the income tax including any surcharge thereon, but excluding income tax on undistributed income of companies, imposed under the Income-tax Act; and

ii) the surtax

(hereinafter referred to as "Indian tax").

Taxes referred to in (a) and (b) above shall not include any amount payable in respect of any default or omission in relation to the above taxes or which represent a penalty imposed relating to those taxes.

2. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes which have been made in their respective taxation laws and of any official published material concerning the application of the Convention.

ARTICLE 3

General Definitions

1. In this Convention, unless the context otherwise requires:

a) the term "India" means the territory of India and includes the territorial sea and airspace above it, as well as any other maritime zone in which India has sovereign rights, other rights and jurisdictions, according to the Indian law and in accordance with international law;

b) the term "United States", when used in a geographical sense means all the territory of the United States of America, including its territorial sea, in which the laws relating to United States tax are in force, and all the area beyond its territorial sea, including the seabed and subsoil thereof, over which the United States has jurisdiction in accordance with international law and in which the laws relating to United States tax are in force;

c) the terms "a Contracting State" and "the other Contracting State" mean India or the United States as the context requires;

d) the term "tax" means Indian tax or United States tax, as the context requires;

e) the term "person" includes an individual, an estate, a trust, a partnership, a company, any other body of persons, or other taxable entity;

f) the term "company" means any body corporate or any entity which is treated as a company or body corporate for tax purposes;

g) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;

h) the term "competent authority" means, in the case of India, the Central Government in the Ministry of Finance (Department of Revenue) or their authorized representative, and in the case of the United States, the Secretary of the Treasury or his delegate;

i) the term "national" means any individual possessing the nationality or citizenship of a Contracting State;

j) the term "international traffic" means any transport by a ship or aircraft operated by an enterprise of a Contracting State, except when the ship or aircraft is operated solely between places within the other Contracting State;

k) the term "taxable year" in relation to Indian Tax means "previous year" as defined in the Income-tax Act, 1961.

2. As regards the application of the Convention by a Contracting State any term not defined therein shall, unless the context otherwise requires or the competent authorities agree to a common meaning pursuant to the provisions of Article 27 (Mutual Agreement Procedure), have the meaning which it has under the laws of that State concerning the taxes to which the Convention applies.

ARTICLE 4

Residence

1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of

that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature, provided, however, that

a) this term does not include any person who is liable to tax in that State in respect only of income from sources in that State; and

b) in the case of income derived or paid by a partnership, estate, or trust, this term applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries.

2. Where by reason of the provisions of paragraph 1, an individual is a resident of both Contracting States, then his status shall be determined as follows:

a) he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (centre of vital interests);

b) if the State in which he has his centre of vital interests cannot be determined, or if he does not have a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;

c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;

d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where, by reason of paragraph 1, a company is a resident of both Contracting States, such company shall be considered to be outside the scope of this Convention except for purposes of paragraph 2 of Article 10 (Dividends), Article 26 (Non-Discrimination), Article 27 (Mutual Agreement Procedure), Article 28 (Exchange of Information and Administrative Assistance) and Article 30 (Entry Into Force).

4. Where, by reason of the provisions of paragraph 1, a person other than an individual or a company is a resident of both Contracting States, the competent authorities of the Contracting States shall settle the question by mutual agreement and determine the mode of application of the Convention to such person.

ARTICLE 5

Permanent Establishment

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

a) a place of management;

b) a branch;

c) an office;

d) a factory;

e) a workshop;

f) a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources;

g) a warehouse, in relation to a person providing storage facilities for others;

h) a farm, plantation or other place where agriculture, forestry, plantation or related activities are carried on;

i) a store or premises used as a sales outlet;

j) an installation or structure used for the exploration or exploitation of natural resources, but only if so used for a period of more than 120 days in any twelve month period;

k) a building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project or activities (together with other such sites, projects or activities, if any) continue for a period of more than 120 days in any twelve month period;

l) the furnishing of services, other than included services as defined in Article 12 (Royalties and Fees for Included Services), within a Contracting State by an enterprise through employees or other personnel, but only if:

i) activities of that nature continue within that State for a period or periods aggregating more than 90 days within any twelve-month period; or

ii) the services are performed within that State for a related enterprise (within the meaning of paragraph 1 of Article 9 (Associated Enterprises)).

3. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include any one or more of the following:

a) the use of facilities solely for the purpose of storage, display, or occasional delivery of goods or merchandise belonging to the enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display, or occasional delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for other activities which have a preparatory or auxiliary character, for the enterprise.

4. Notwithstanding the provisions of paragraphs 1 and 2, where a person - other than an agent of an independent status to whom paragraph 5 applies - is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned State if:

a) he has and habitually exercises in the first-mentioned State an authority to conclude contracts on behalf of the enterprise, unless his activities are limited to those mentioned in paragraph 3 which, if exercised through a fixed place of business, would not make that fixed place of business a permanent establishment under the provisions of that paragraph;

b) he has no such authority but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise, and some additional activities conducted in that State on behalf of the enterprise have contributed to the sale of the goods or merchandise; or

c) he habitually secures orders in the first-mentioned State, wholly or almost wholly for the enterprise.

5. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the

ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise and the transactions between the agent and the enterprise are not made under arm's-length conditions, he shall not be considered an agent of independent status within the meaning of this paragraph.

6. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

ARTICLE 6

Income From Immovable Property (Real Property)

1. Income derived by a resident of a Contracting State from immovable property (real property), including income from agriculture or forestry, situated in the other Contracting State may be taxed in that other State.

2. The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated.

3. The provisions of paragraph 1 shall also apply to income derived from the direct use, letting, or use in any other form of immovable property.

4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.

ARTICLE 7

Business Profits

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to a) that permanent establishment; b) sales in the other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or c) other business activities carried on in the other State of the same or similar kind as those effected through that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the

same or similar conditions and dealing wholly at arm's-length with the enterprise of which it is a permanent establishment and other enterprises controlling, controlled by or subject to the same common control as that enterprise. In any case where the correct amount of profits attributable to a permanent establishment is incapable of determination or the determination thereof presents exceptional difficulties, the profits attributable to the permanent establishment may be estimated on a reasonable basis. The estimate adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere, in accordance with the provisions of and subject to the limitations of the taxation laws of that State. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than toward reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other

similar payments in return for the use of patents, know-how or other rights, or by way of commission or other charges for specific services performed or for management, or, except in the case of banking enterprises, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than toward reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents, know-how or other rights, or by way of commission or other charges for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

4. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

5. For the purposes of this Convention, the profits to be attributed to the permanent establishment as provided in paragraph 1(a) of this Article shall include only the profits derived from the assets and activities of the permanent establishment and shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where profits include items of income which are dealt with separately in other Articles of the Convention, then the

provisions of those Articles shall not be affected by the provisions of this Article.

7. For the purposes of the Convention, the term "business profits" means income derived from any trade or business including income from the furnishing of services other than included services as defined in Article 12 (Royalties and Fees for Included Services) and including income from the rental of tangible personal property other than property described in paragraph 3 (b) of Article 12 (Royalties and Fees for Included Services).

ARTICLE 8

Shipping and Air Transport

1. Profits derived by an enterprise of a Contracting State from the operation by that enterprise of ships or aircraft in international traffic shall be taxable only in that State.

2. For the purposes of this Article, profits from the operation of ships or aircraft in international traffic shall mean profits derived by an enterprise described in paragraph 1 from the transportation by sea or air respectively of passengers, mail, livestock or goods carried on by the owners or lessees or charterers of ships or aircraft including--

a) the sale of tickets for such transportation on behalf of other enterprises;

b) other activity directly connected with such transportation; and

c) the rental of ships or aircraft incidental to any activity directly connected with such transportation.

3. Profits of an enterprise of a Contracting State described in paragraph 1 from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used in connection with the operation of ships or aircraft in international traffic shall be taxable only in that State.

4. The provisions of paragraphs 1 and 3 shall also apply to profits from participation in a pool, a joint business, or an international operating agency.

5. For the purposes of this Article, interest on funds connected with the operation of ships or aircraft in international traffic shall be regarded as profits derived from the operation of such ships or aircraft, and the provisions of Article 11 (Interest) shall not apply in relation to such interest.

6. Gains derived by an enterprise of a Contracting State described in paragraph 1 from the alienation of ships, aircraft or containers owned and operated by the enterprise, the income from which is taxable only in that State, shall be taxed only in that State.

ARTICLE 9

Associated Enterprises

1. Where:

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State; or

b) the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which, but for those conditions would have accrued to one of the enterprises, but by reason of those conditions have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State, and taxes accordingly, profits on which an enterprise of the other Contracting State has been charged to tax in that other State, and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

ARTICLE 10

Dividends

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident, and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

a) 15 per cent of the gross amount of the dividends if the beneficial owner is a company which owns at least 10 per cent of the voting stock of the company paying the dividends;

b) 25 per cent of the gross amount of the dividends in all other cases.

Subparagraph b) and not subparagraph a) shall apply in the case of dividends paid by a United States person which is a Regulated Investment Company. Subparagraph a) shall not apply to dividends paid by a United States person which is a Real Estate Investment Trust, and subparagraph b) shall only apply if the dividend is beneficially owned by an individual holding a less than 10 percent interest in the Real Estate Investment Trust. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. The term "dividends" as used in this Article means income from shares or other rights, not being debt-claims, participating in profits, income from other corporate rights which are subjected to the same taxation treatment as income from shares by the taxation laws of the State of which the company making the distribution is a resident; and income from arrangements, including debt obligations, carrying the right to participate in profits, to the extent so characterized under the laws of the Contracting State in which the income arises.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State, of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the dividends are attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), as the case may be, shall apply.

5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a

permanent establishment or a fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

ARTICLE 11

Interest

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such interest may also be taxed in the Contracting State in which it arises, and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed:

a) 10 percent of the gross amount of the interest if such interest is paid on a loan granted by a bank carrying on a bona fide banking business or by a similar financial institution (including an insurance company); and

b) 15 percent of the gross amount of the interest in all other cases.

3. Notwithstanding the provisions of paragraph 2 of this Article, interest arising in a Contracting State:

a) and derived and beneficially owned by the Government of the other Contracting State, a political subdivision or local authority thereof, the Reserve Bank of India, or the Federal Reserve Banks of the United States, as the case may be, and such other institutions of either Contracting State as the competent authorities may agree pursuant to Article 27 (Mutual Agreement Procedure);

b) with respect to loans or credits extended or endorsed

i) by the Export Import Bank of the United States, when India is the first-mentioned Contracting State; and

ii) by the EXIM Bank of India, when the United States is the first-mentioned Contracting State; and

c) to the extent approved by the Government of that State, and derived and beneficially owned by any person, other than a person referred to in subparagraphs (a) and (b), who is a resident of the other Contracting State, provided that the transaction giving rise to the debt-claim has been approved in this behalf by the Government of the first-mentioned Contracting State;

shall be exempt from tax in the first-mentioned Contracting State.

4. The term "interest" as used in this Convention means income from debt-claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities, and income from bonds or debentures, including premiums or prizes attaching to such securities, bonds, or debentures. Penalty charges for late payment shall not be

regarded as interest for the purposes of the Convention. However, the term "interest" does not include income dealt with in Article 10 (Dividends).

5. The provisions of paragraphs 2 and 3 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the interest is attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), as the case may be, shall apply.

6. Interest shall be deemed to arise in a Contracting State when the payer is that State itself or a political subdivision, local authority, or resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.

7. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would

have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of the Convention.

ARTICLE 12

Royalties and Fees for Included Services

1. Royalties and fees for included services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such royalties and fees for included services may also be taxed in the Contracting State in which they arise and according to the laws of that State; but if the beneficial owner of the royalties or fees for included services is a resident of the other Contracting State, the tax so charged shall not exceed:

a) in the case of royalties referred to in sub-paragraph (a) of paragraph 3 and fees for included services as defined in this Article (other than services described in sub-paragraph (b) of this paragraph):

i) during the first five taxable years for which this Convention has effect,

A) 15 percent of the gross amount of the royalties or fees for included services as defined in this Article, where the payer of the royalties or fees is the Government of that Contracting State, a political subdivision or a public sector company; and

B) 20 percent of the gross amount of the royalties or fees for included services in all other cases; and

ii) during the subsequent years, 15 percent of the gross amount of royalties or fees for included services; and

b) in the case of royalties referred to in sub-paragraph (b) of paragraph 3 and fees for included services as defined in this Article that are ancillary and subsidiary to the enjoyment of the property for which payment is received under paragraph 3 (b) of this Article, 10 percent of the gross amount of the royalties or fees for included services.

3. The term "royalties" as used in this Article means:

a) payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including cinematograph films or work on film, tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience, including gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof; and

b) payments of any kind received as consideration for the use of, or the right to use, any industrial, commercial, or scientific equipment, other than payments derived by an enterprise described in paragraph 1 of Article 8 (Shipping and Air Transport) from activities described in paragraph 2(c) or 3 of Article 8.

4. For purposes of this Article, "fees for included services" means payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including through the provision of services of technical or other personnel) if such services:

a) are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment described in paragraph 3 is received; or

b) make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design.

5. Notwithstanding paragraph 4, "fees for included services" does not include amounts paid:

a) for services that are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of property other than a sale described in paragraph 3(a);

b) for services that are ancillary and subsidiary to the rental of ships, aircraft, containers or other equipment used in connection with the operation of ships or aircraft in international traffic;

c) for teaching in or by educational institutions;

d) for services for the personal use of the individual or individuals making the payment; or

e) to an employee of the person making the payments or to any individual or firm of individuals (other than a company) for professional services as defined in Article 15 (Independent Personal Services).

6. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties or fees for included services, being a resident of a Contracting State, carries on business in the other Contracting State, in which the royalties or fees for included services arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the royalties or fees for included services are attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), as the case may be, shall apply.

7. (a) Royalties and fees for included services shall be deemed to arise in a Contracting State when the payer is that State itself, a political subdivision, a local authority, or a resident of that State. Where, however, the person paying the royalties or fees for included services, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties or fees for included services

was incurred, and such royalties or fees for included services are borne by such permanent establishment or fixed base, then such royalties or fees for included services shall be deemed to arise in the Contracting State in which the permanent establishment or fixed base is situated.

(b) Where under subparagraph (a) royalties or fees for included services do not arise in one of the Contracting States, and the royalties relate to the use of, or the right to use, the right or property, or the fees for included services relate to services performed, in one of the Contracting States, the royalties or fees for included services shall be deemed to arise in that Contracting State.

8. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties or fees for included services paid exceeds the amount which would have been paid in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of the Convention.

ARTICLE 13

Gains

Except as provided in Article 8 (Shipping and Air Transport) of this Convention, each Contracting State may tax capital gains in accordance with the provisions of its domestic law.

ARTICLE 14

Permanent Establishment Tax

1. A company which is a resident of India may be subject in the United States to a tax in addition to the tax allowable under the other provisions of this Convention.

a) Such tax, however, may be imposed only on:

i) the portion of the business profits of the company subject to tax in the United States which represents the dividend equivalent amount; and

ii) the excess, if any, of interest deductible in the United States in computing the profits of the company that are subject to tax in the United States and either attributable to a permanent establishment in the United States or subject to tax in the United States under Article 6 (Income From Immovable Property (Real Property)), Article 12 (Royalties and Fees for Included Services) as fees for included services, or Article 13 (Gains) of this Convention over the interest paid by or from the permanent establishment or trade or business in the United States.

b) For purposes of this article, business profits means profits that are effectively connected (or treated as effectively connected) with the conduct of a trade or business within the United States and are either attributable to a permanent establishment in the United States or subject to tax in the United States under Article 6 (Income From Immovable Property (Real Property)), Article 12 (Royalties and Fees for Included Services) as fees for included services or Article 13 (Gains) of this Convention.

c) The tax referred to in subparagraph (a) shall not be imposed at a rate exceeding:

i) the rate specified in paragraph 2 (a) of Article 10 (Dividends) for the tax described in subparagraph (a) (i); and

ii) the rate specified in paragraph 2 (a) or (b) (whichever is appropriate) of Article 11 (Interest) for the tax described in subparagraph (a) (ii).

2. A company which is a resident of the United States may be subject to tax in India at a rate higher than that applicable to the domestic companies. The difference in the tax rate shall not, however, exceed the existing difference of 15 percentage points.

3. In the case of a banking company which is a resident of the United States, the interest paid by the permanent establishment of such a company in India to the head office may be subject in India to a tax in addition to the tax imposable under the other provisions of this Convention at a rate which shall not exceed the rate specified in paragraph 2 (a) of Article 11 (Interest).

ARTICLE 15

Independent Personal Services

1. Income derived by a person who is an individual or firm of individuals (other than a company) who is a resident of a Contracting State from the performance in the other Contracting State of professional services or other independent activities of a similar character shall be taxable only in the first-mentioned State except in the following circumstances when such income may also be taxed in the other Contracting State:

a) if such person has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other State; or

b) if the person's stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 90 days in the relevant taxable year.

2. The term "professional services" includes independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, surgeons, lawyers, engineers, architects, dentists and accountants.

ARTICLE 16

Dependent Personal Services

1. Subject to the provisions of Articles 17 (Directors' Fees), 18 (Income Earned by Entertainers and Athletes), 19 (Remuneration and Pensions in Respect of Government Service), 20 (Private Pensions, Annuities, Alimony, and Child Support), 21 (Payments Received by Students and Apprentices) and 22 (Payments Received by Professors, Teachers and Research Scholars), salaries, wages, and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in the relevant taxable year;

b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and

c) the remuneration is not borne by a permanent establishment or a fixed base or a trade or business which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic by an enterprise of a Contracting State may be taxed in that State.

ARTICLE 17

Directors' Fees

Directors' fees and similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State.

ARTICLE 18

Income Earned by Entertainers and Athletes

1. Notwithstanding the provisions of Articles 15 (Independent Personal Services) and 16 (Dependent Personal Services), income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as an athlete, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State, except where the amount of the net income derived by such entertainer or athlete from such activities (after deduction of all expense incurred by him in connection with his visit and performance) does not exceed

one thousand five hundred United States dollars ($1,500) or its equivalent in Indian rupees for the taxable year concerned.

2. Where income in respect of activities exercised by an entertainer or an athlete in his capacity as such accrues not to the entertainer or athlete but to another person, that income of that other person may, notwithstanding the provisions of Articles 7 (Business Profits), 15 (Independent Personal Services) and 16 (Dependent Personal Services), be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised unless the entertainer, athlete, or other person establishes that neither the entertainer or athlete nor persons related thereto participate directly or indirectly in the profits of that other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions, or other distributions.

3. Income referred to in the preceding paragraphs of this Article derived by a resident of a Contracting State in respect of activities exercised in the other Contracting State shall not be taxed in that other State if the visit of the entertainers or athletes to that other State is supported wholly or substantially from the public funds of the Government of the first-mentioned Contracting State, or of a political subdivision or local authority thereof.

4. The competent authorities of the Contracting States may, by mutual agreement, increase the dollar amounts referred to in paragraph 1 to reflect economic or monetary developments.

ARTICLE 19

Remuneration and Pensions in Respect of Government Service

1. a) Remuneration, other than a pension, paid by a Contracting State or a political sub-division or a local authority thereof to an individual in respect of services rendered to that State or sub-division or authority shall be taxable only in that State.

b) However, such remuneration shall be taxable only in the other Contracting State if the services are rendered in that other State and the individual is a resident of that State who:

i) is a national of that State; or

ii) did not become a resident of that State solely for the purpose of rendering the services.

2. a) Any pension paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that state or subdivision or authority shall be taxable only in that State.

b) However, such pension shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that State.

3. The provisions of Articles 16 (Dependent Personal Services), 17 (Directors' Fees), 18 (Income Earned by Entertainers and Athletes) and 20 (Private Pensions, Annuities,

Alimony and Child Support) shall apply to remuneration and pensions in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof.

ARTICLE 20

Private Pensions, Annuities, Alimony and Child Support

1. Any pension, other than a pension referred to in Article 19 (Remuneration and Pensions in Respect of Government Service), &B or any annuity derived by a resident of a Contracting State from sources within the other Contracting State may be taxed only in the first-mentioned Contracting State.

2. Notwithstanding paragraph 1, and subject to the provisions of Article 19 (Remuneration and Pensions in Respect of Government Service), social security benefits and other public pensions paid by a Contracting State to a resident of the other Contracting State or a citizen of the United States shall be taxable only in the first-mentioned State.

3. The term "pension" means a periodic payment made in consideration of past services or by way of compensation for injuries received in the course of performance of services.

4. The term "annuity" means stated sums payable periodically at stated times during life or during a specified or ascertainable number of years, under an obligation to make the payments in return for adequate and full consideration in money or money's worth (but not for services rendered).

5. Alimony paid to a resident of a Contracting State shall be taxable only in that State. The term "alimony" as used in this paragraph means periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, which payments are taxable to the recipient under the laws of the State of which he is a resident.

6. Periodic payments for the support of a minor child made pursuant to a written separation agreement or a decree of divorce, separate maintenance or compulsory support, paid by a resident of a Contracting State to a resident of the other Contracting State, shall be taxable only in the first-mentioned State.

ARTICLE 21

Payments Received by Students and Apprentices

1. A student or business apprentice who is or was a resident of one of the Contracting States immediately before visiting the other Contracting State and who is present in that other State principally for the purpose of his education or training shall be exempt from tax in that other State, on payments which arise outside that other State for the purposes of his maintenance, education or training.

2. In respect of grants, scholarships and remuneration from employment not covered by paragraph 1, a student or business

apprentice described in paragraph 1 shall, in addition, be entitled during such education or training to the same exemptions, reliefs or reductions in respect of taxes available to residents of the State which he is visiting.

3. The benefits of this Article shall extend only for such period of time as may be reasonable or customarily required to complete the education or training undertaken.

4. For the purposes of this Article, an individual shall be deemed to be a resident of a Contracting State if he is resident in that Contracting State in the taxable year in which he visits the other Contracting State or in the immediately preceding taxable year.

ARTICLE 22

Payments Received by Professors, Teachers and Research Scholars

1. An individual who visits a Contracting State for a period not exceeding two years for the purpose of teaching or engaging in research at a university, college or other recognized educational institution in that State, and who was immediately before that visit a resident of the other Contracting State, shall be exempted from tax by the first-mentioned Contracting State on any remuneration for such teaching or research for a period not exceeding two years from the date he first visits that State for such purpose.

2. This Article shall apply to income from research only if such research is undertaken by the individual in the public interest and not primarily for the benefit of some other private person or persons.

ARTICLE 23

Other Income

1. Subject to the provisions of paragraph 2, items of income of a resident of a Contracting State, wherever arising, which are not expressly dealt with in the foregoing Articles of this Convention shall be taxable only in that Contracting State.

2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6 (Income from Immovable Property (Real Property)), if the beneficial owner of the income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the income is attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), as the case may be, shall apply.

3. Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing articles of this Convention and arising in the other Contracting State may also be taxed in that other State.

ARTICLE 24

Limitation on Benefits

1. A person (other than an individual) which is a resident of a Contracting State and derives income from the other Contracting State shall be entitled under this Convention to relief from taxation in that other Contracting State only if:

a) more than 50 percent of the beneficial interest in such person (or in the case of a company, more than 50 percent of the number of shares of each class of the company's shares) is owned, directly or indirectly, by one or more individual residents of one of the Contracting States, one of the Contracting States or its political subdivisions or local authorities, or other individuals subject to tax in either Contracting State on their worldwide incomes, or citizens of the United States; and

b) the income of such person is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons who are not residents of one of the Contracting States, one of the Contracting States or its political subdivisions or local authorities, or citizens of the United States.

2. The provisions of paragraph 1 shall not apply if the income derived from the other Contracting State is derived in connection with, or is incidental to, the active conduct by such person of a trade or business in the first-mentioned State (other

than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company).

3. The provisions of paragraph 1 shall not apply if the person deriving the income is a company which is a resident of a Contracting State in whose principal class of shares there is substantial and regular trading on a recognized stock exchange. For purposes of the preceding sentence, the term "recognized stock exchange" means:

a) in the case of the United States, the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Act of 1934;

b) in the case of India, any stock exchange which is recognized by the Central Government under the Securities Contracts Regulation Act, 1956; and

c) any other stock exchange agreed upon by the competent authorities of the Contracting States.

4. A person that is not entitled to the benefits of this Convention pursuant to the provisions of the preceding paragraphs of this Article may, nevertheless, be granted the benefits of the Convention if the competent authority of the State in which the income in question arises so determines.

ARTICLE 25

Relief From Double Taxation

1. In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income

a) the income tax paid to India by or on behalf of such citizen or resident; and

b) in the case of a United States company owning at least 10 percent of the voting stock of a company which is a resident of India and from which the United States company receives dividends, the income tax paid to India by or on behalf of the distributing company with respect to the profits out of which the dividends are paid.

For the purposes of this paragraph, the taxes referred to in paragraphs 1b) and 2 of Article 2 (Taxes Covered) shall be considered income taxes.

2. a) Where a resident of India derives income which, in accordance with the provisions of this Convention, may be taxed in the United States, India shall allow as a deduction from the tax on the income of that resident an amount equal to the income tax paid in the United States, whether directly or by deduction. Such deduction shall not, however, exceed that part of the income tax (as computed before the deduction

is given) which is attributable to the income which may be taxed in the United States.

b) Further, where such resident is a company by which a surtax is payable in India, the deduction in respect of income tax paid in the United States shall be be allowed in the first instance from income tax payable by the company in India and as to the balance, if any, from surtax payable by it in India.

3. For the purposes of allowing relief from double taxation pursuant to this Article, income shall be deemed to arise as follows:

a) income derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention (other than solely by reason of citizenship in accordance with paragraph 3 of Article 1 (General Scope)) shall be deemed to arise in that other State;

b) income derived by a resident of a Contracting State which may not be taxed in the other Contracting State in accordance with the Convention shall be deemed to arise in the first-mentioned State.

Notwithstanding the preceding sentence, the determination of the source of income for purposes of this Article shall be subject to such source rules in the domestic laws of the Contracting States as apply for the purpose of limiting the foreign tax credit. The preceding sentence shall not apply with respect to income dealt ßB with in Article 12 (Royalties and Fees for Included Services). The rules of this paragraph shall not apply in determining credits against United States tax for foreign taxes other than the taxes referred to in paragraphs 1b) and 2 of Article 2 (Taxes Covered).

ARTICLE 26

Non-discrimination

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall apply to persons who are not residents of one or both of the Contracting States.

2. Except where the provisions of paragraph 3 of Article 7 (Business Profits) apply, the taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs, and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

3. Except where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 7 of Article 11 (Interest), or paragraph 8 of Article 12 (Royalties and Fees for Included Services) apply, interest, royalties, and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State.

4. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

5. Nothing in this article shall be construed as preventing either Contracting State from imposing the taxes described in Article 14 (Permanent Establishment Tax) or the limitations described in paragraph 3 of Article 7 (Business Profits).

ARTICLE 27

Mutual Agreement Procedure

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or national. This case must be presented within three years of the date of receipt of notice of the action which gives rise to taxation not in accordance with the Convention.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits or other procedural limitations in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching

an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, shall develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this Article. In addition, a competent authority may devise appropriate unilateral procedures, conditions, methods and techniques to facilitate the above-mentioned bilateral actions and the implementation of the mutual agreement procedure.

ARTICLE 28

Exchange of Information and Administrative Assistance

1. The competent authorities of the Contracting States shall exchange such information (including documents) as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention, in particular, for the prevention of fraud or evasion of such taxes. The exchange of information is not restricted by Article 1 (General Scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State. However, if the information is originally regarded as secret in the transmitting State, it shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration

of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes which are the subject of the Convention. Such persons or authorities shall use the information only for such purposes, but may disclose the information in public court proceedings or in judicial decisions. The competent authorities shall, through consultation, develop appropriate conditions, methods and techniques concerning the matters in respect of which such exchange of information shall be made, including, where appropriate, exchange of information regarding tax avoidance.

2. The exchange of information or documents shall be either on a routine basis or on request with reference to particular cases, or otherwise. The competent authorities of the Contracting States shall agree from time to time on the list of information or documents which shall be furnished on a routine basis.

3. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

c) to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy (ordre public).

4. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall obtain the information to which the request relates in the same manner and in the same form as if the tax of the first-mentioned State were the tax of that other State and were being imposed by that other State. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this Article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of that other State with respect to its own taxes.

5. For the purposes of this Article, the Convention shall apply, notwithstanding the provisions of Article 2 (Taxes Covered):

a) in the United States, to all taxes imposed under Title 26 of the United States Code; and

b) in India, to the income tax, the wealth tax and the gift tax.

ARTICLE 29

Diplomatic Agents and Consular Officers

Nothing in this Convention shall affect the fiscal privileges of diplomatic agents or consular officers under the general rules of international law or under the provisions of special agreements.

ARTICLE 30

Entry Into Force

1. Each Contracting State shall notify the other Contracting State in writing, through diplomatic channels, upon the completion of their respective legal procedures to bring this Convention into force.

2. The Convention shall enter into force on the date of the latter of such notifications and its provisions shall have effect:

a) in the United States

i) in respect of taxes withheld at source, for amounts paid or credited on or after the first day of January next following the date on which the Convention enters into force;

ii) in respect of other taxes, for taxable periods beginning on or after the first day of January next following the date on which the Convention enters into force; and

b) in India, in respect of income arising in any taxable year beginning on or after the first day of April next following the calendar year in which the Convention enters into force.

ARTICLE 31

Termination

This Convention shall remain in force indefinitely but either of the Contracting States may, on or before the thirtieth day of June in any calendar year beginning after the expiration of a period of five years from the date of the entry into force of the Convention, give the other Contracting State through diplomatic channels, written notice of termination and, in such event, this Convention shall cease to have effect:

a) in the United States

i) in respect of taxes withheld at source, for amounts paid or credited on or after the first day of January next following the calendar year in which notice of termination is given; and

ii) in respect of other taxes, for taxable periods beginning on or after the first day of January next following the calendar year in which the notice of termination is given;

and

b) in India, in respect of income arising in any taxable year beginning on or after the first day of April next following the calendar year in which the notice of termination is given.

IN WITNESS WHEREOF, the undersigned, being duly authorized by their respective Governments, have signed this Convention.

DONE at New Delhi in duplicate, this 12th day of September, 1989, in the English and Hindi languages, both texts being equally authentic. In case of divergence between the two texts, the English text shall be the operative one.

FOR THE GOVERNMENT OF THE UNITED STATES OF AMERICA:

John R. Hubbard

Ambassador

FOR THE GOVERNMENT OF THE REPUBLIC OF INDIA:

N.K. Sengupta

Secretary to the Government of India

PROTOCOL

At the signing today of the Convention between the United States of America and the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, the undersigned have agreed upon the following provisions, which shall form an integral part of the Convention:

I. Ad Article 5

It is understood that where an enterprise of a Contracting State has a permanent establishment in the other Contracting State in accordance with the provisions of paragraphs 2(j), 2(k) or 2(l) of Article 5 (Permanent Establishment), and the time period referred to in that paragraph extends over two taxable years, a permanent establishment shall not be deemed to exist in a year, if any, in which the use, site, project or activity, as the case may be, continues for a period or periods aggregating less than 30 days in that taxable year. A permanent establishment will exist in the other taxable year, and the enterprise will be subject to tax in that other Contracting State in accordance with the provisions of Article 7 (Business Profits), but only on income arising during that other taxable year.

II. Ad Article 7

Where the law of the Contracting State in which a permanent establishment is situated imposes, in accordance with the provisions of paragraph 3 of Article 7 (Business Profits), a restriction on the amount of executive and general administrative expenses which may be allowed as a deduction in determining the profits of such permanent establishment, it is understood that in making such a determination of profits the deduction in respect of such executive and general administrative expenses in no case shall be less than that allowable under the Indian Income-tax Act as on the date of signature of this Convention.

III. Ad Articles 7, 10, 11, 12, 15, and 23

It is understood that for the implementation of paragraphs 1 and 2 of Article 7 (Business Profits), paragraph 4 of Article 10 (Dividends), paragraph 5 of Article 11 (Interest), paragraph 6 of Article 12 (Royalties and Fees for Included Services), paragraph 1 of Article 15 (Independent Personal Services), and paragraph 2 of Article 23 (Other Income), any income attributable to a permanent establishment or fixed base during its existence is taxable in the Contracting State in which such permanent establishment or fixed base is situated even if the payments are deferred until such permanent establishment or fixed base has ceased to exist.

IV. Ad Article 12

It is understood that fees for included services, as defined in paragraph 4 of Article 12 (Royalties and Fees for Included Services) will, in accordance with United States law, be subject to income tax in the United States based on net income and, when earned by a company, will also be subject to the taxes described in paragraph 1 of Article 14 (Permanent Establishment Tax). The total of these taxes which may be imposed on such fees, however, may not exceed the amount computed by multiplying the gross fee by the appropriate tax rate specified in subparagraph a) or b), whichever is applicable, of paragraph 2 of Article 12.

V. Ad Article 14

It is understood that references in paragraph 1 of Article 14 (Permanent Establishment Tax) to profits that are subject to tax in the United States under Article 6 (Income from Immovable Property (Real Property)), under Article 12 (Royalties and Fees for Included Services), as fees for included services as defined in that Article, or under Article 13 (Gains) of this Convention, are intended to refer only to cases in which the profits in question are subject to United States tax based on net income (*i.e.*, by virtue of being effectively connected, or being treated as effectively connected, with the conduct of a trade or business in the United States). Any income which is subject to tax under those Articles based on gross income is not subject to tax under Article 14.

IN WITNESS WHEREOF, the undersigned, being duly authorized by their respective Governments, have signed this Protocol.

DONE at New Delhi in duplicate, this 12th day of September, 1989, in the English and Hindi languages, both texts being equally authentic. In case of divergence between the two texts, the English text shall be the operative one.

FOR THE GOVERNMENT OF THE UNITED STATES OF AMERICA:

John R. Hubbard
Ambassador

FOR THE GOVERNMENT OF THE REPUBLIC OF INDIA:

N.K. Sengupta
Secretary to the Government of India

EMBASSY OF THE
UNITED STATES OF AMERICA

New Delhi, September 12, 1989

Excellency:

I have the honor to refer to the Convention between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income which was signed today (hereinafter referred to as "the Convention") and to confirm, on behalf of the Government of the United States of America, the following understandings reached between the two Governments:

Both sides agree that a tax sparing credit shall not be provided in Article 25 (Relief from Double Taxation) of the Convention at this time. However, the Convention shall be promptly amended to incorporate a tax sparing credit provision if the United States hereafter amends its laws concerning the provision of tax sparing credits, or the United States reaches agreement on the provision of a tax sparing credit with any other country.

Both sides also agree that, for purposes of paragraph 4(c) of Article 5 (Permanent Establishment) of the Convention, a person shall be considered to habitually secure orders in a Contracting State, wholly or almost wholly for an enterprise, only if:

1. such person frequently accepts orders for goods or merchandise on behalf of the enterprise;

2. substantially all of such person's sales-related activities in the Contracting State consist of activities for the enterprise;

3. such person habitually represents to persons offering to buy goods or merchandise that acceptance of an order by such person constitutes the agreement of the enterprise to supply goods or merchandise under the terms and conditions specified in the order; and

4. the enterprise takes actions that give purchasers the basis for a reasonable belief that such person has authority to bind the enterprise.

I have the honor to request Your Excellency to confirm the foregoing understandings of Your Excellency's Government.

Accept, Excellency, the renewed assurances of my highest consideration.

J. R. Hubbard

John R. Hubbard

Ambassador

His Excellency

Dr. N.K. Sengupta,

Secretary (Revenue),

Ministry of Finance,

New Delhi.

भारत सरकार
वित्त मंत्रालय, राजस्व विभाग
नई दिल्ली-110001
GOVERNMENT OF INDIA
MINISTRY OF FINANCE, DEPARTMENT OF REVENUE
NEW DELHI-110001

सचिव
SECRETARY

September 12, 1989

Excellency:

I have the honour to acknowledge receipt of Your Excellency's Note of today's date, which reads as follows:

"I have the honor to refer to the Convention between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income which was signed today (hereinafter referred to as "the Convention") and to confirm, on behalf of the Government of the United States of America, the following understandings reached between the two Governments:

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4. the enterprise takes actions that give purchasers the basis for a reasonable belief that such person has authority to bind the enterprise."

I have the honour to confirm the understandings contained in Your Excellency's Note, on behalf of the Government of the Republic of India.

Accept, Excellency, the renewed assurances of my highest consideration.

N. K. Sengupta

His Excellency
Dr. John R. Hubbard,
Ambassador of the
United States of America,
New Delhi.

EMBASSY OF THE
UNITED STATES OF AMERICA

New Delhi, September 12, 1989

Excellency:

I have the honor to refer to the Convention signed today between the United States of America and the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and to inform you on behalf of the United States of America of the following:

During the course of the negotiations leading to conclusion of the Convention signed today, the negotiators developed and agreed upon a memorandum of understanding intended to give guidance both to the taxpayers and the tax authorities of our two countries in interpreting aspects of Article 12 (Royalties and Fees for Included Services) relating to the scope of included services. This memorandum of understanding represents the current views of the United States Government with respect to these aspects of Article 12, and it is my Government's understanding that it also represents the current views of the Indian Government. It is also my Government's view that as our Governments gain experience in administering the Convention, and particularly Article 12, the competent authorities may develop and publish amendments to the memorandum of understanding and further understandings and interpretations of the Convention.

If this position meets with the approval of the Government of the Republic of India, this letter and your reply thereto will indicate that our Governments share a common view of the purpose of the memorandum of understanding relating to Article 12 of the Convention.

Accept, Excellency, the renewed assurances of my highest consideration.

John R. Hubbard

Ambassador

His Excellency

Dr. N.K. Sengupta,

Secretary (Revenue),

Ministry of Finance,

New Delhi.

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NEW DELHI-110001

सचिव
SECRETARY

September 12, 1989

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During the course of the negotiations leading to conclusion of the Convention signed today, the negotiators developed and agreed upon a memorandum of understanding intended to give guidance both to the taxpayers and the tax authorities of our two countries in interpreting aspects of Article 12 (Royalties and Fees for Included Services) relating to the scope of included services. This memorandum of understanding represents the current views of the United States Government with respect to these aspects of Article 12, and it is my Government's understanding that it also represents the current views of the Indian Government. It is also my Government's view that as our Governments gain experience in administering the Convention, and particularly Article 12, the competent authorities may

सचिव
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If this position meets with the approval of the Government of the Republic of India, this letter and your reply thereto will indicate that our Governments share a common view of the purpose of the memorandum of understanding relating to Article 12 of the Convention."

I have the honour to confirm the understandings contained in Your Excellency's Note, on behalf of the Government of the Republic of India.

Accept, Excellency, the renewed assurances of my highest consideration.

N. K. Sengupta

His Excellency
Dr. John R. Hubbard,
Ambassador of the
United States of America,
New Delhi.

May 15, 1989

U.S. - INDIA TAX TREATY

MEMORANDUM OF UNDERSTANDING CONCERNING
FEES FOR INCLUDED SERVICES
IN ARTICLE 12

Paragraph 4 (in general)

This memorandum describes in some detail the category of services defined in paragraph 4 of Article 12 (Royalties and Fees for Included Services). It also provides examples of services intended to be covered within the definition of included services and those intended to be excluded, either because they do not satisfy the tests of paragraph 4, or because, notwithstanding the fact that they meet the tests of paragraph 4, they are dealt with under paragraph 5. The examples in either case are not intended as an exhaustive list but rather as illustrating a few typical cases. For ease of understanding, the examples in this memorandum describe U.S. persons providing services to Indian persons, but the rules of Article 12 are reciprocal in application.

Article 12 includes only certain technical and consultancy services. By technical services, we mean in this context services requiring expertise in a technology. By consultancy services, we mean in this context advisory services. The categories of technical and consultancy services are to some extent overlapping because a consultancy service could also be a technical service. However, the category of consultancy services also includes an advisory service, whether or not expertise in a technology is required to perform it.

Under paragraph 4, technical and consultancy services are considered included services only to the following extent: (1) as described in paragraph 4(a), if they are ancillary and subsidiary to the application or enjoyment of a right, property or information for which a royalty payment is made; or (2) as described in paragraph 4(b), if they make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design. Thus, under paragraph 4(b), consultancy services which are not of a technical nature cannot be included services.

Paragraph 4 (a)

Paragraph 4 (a) of Article 12 refers to technical or consultancy services that are ancillary and subsidiary to the application or enjoyment of any right, property, or information for which a payment described in paragraph 3(a) or (b) is received. Thus, paragraph 4(a) includes technical and consultancy services that are ancillary and subsidiary to the application or enjoyment of an intangible for which a royalty is received under a license or sale as described in

paragraph 3(a), as well as those ancillary and subsidiary to the application or enjoyment of industrial, commercial, or scientific equipment for which a royalty is received under a lease as described in paragraph 3(b).

It is understood that, in order for a service fee to be considered "ancillary and subsidiary" to the application or enjoyment of some right, property, or information for which a payment described in paragraph 3(a) or (b) is received, the service must be related to the application or enjoyment of the right, property, or information. In addition, the clearly predominant purpose of the arrangement under which the payment of the service fee and such other payment are made must be the application or enjoyment of the right, property, or information described in paragraph 3. The question of whether the service is related to the application or enjoyment of the right, property, or information described in paragraph 3 and whether the clearly predominant purpose of the arrangement is such application or enjoyment must be determined by reference to the facts and circumstances of each case. Factors which may be relevant to such determination (although not necessarily controlling) include:

1. the extent to which the services in question facilitate the effective application or enjoyment of the right, property, or information described in paragraph 3;

2. the extent to which such services are customarily provided in the ordinary course of business arrangements involving royalties described in paragraph 3;

3. whether the amount paid for the services (or which would be paid by parties operating at arm's length) is an insubstantial portion of the combined payments for the services and the right, property, or information described in paragraph 3;

4. whether the payment made for the services and the royalty described in paragraph 3 are made under a single contract (or a set of related contracts); and

5. whether the person performing the services is the same person as, or a related person to, the person receiving the royalties described in paragraph 3 (for this purpose, persons are considered related if their relationship is described in Article 9 (Associated Enterprises) or if the person providing the service is doing so in connection with an overall arrangement which includes the payor and recipient of the royalties).

To the extent that services are not considered ancillary and subsidiary to the aplication or enjoyment of some

right, property, or information for which a royalty payment under paragraph 3 is made, such services shall be considered "included services" only to the extent that they are described in paragraph 4(b).

Example (1)

Facts:

A U.S. manufacturer grants rights to an Indian company to use manufacturing processes in which the transferor has exclusive rights by virtue of process patents or the protection otherwise extended by law to the owner of a process. As part of the contractual arrangement, the U.S. manufacturer agrees to provide certain consultancy services to the Indian company in order to improve the effectiveness of the latter's use of the processes. Such services include, for example, the provision of information and advice on sources of supply for materials needed in the manufacturing process, and on the development of sales and service literature for the manufactured product. The payments allocable to such services do not form a substantial part of the total consideration payable under the contractual arrangement. Are the payments for these services fees for "included services"?

Analysis:

The payments are fees for included services. The services described in this example are ancillary and subsidiary to the use of a manufacturing process protected by law as described in paragraph 3 (a) of Article 12 because the services are related to the application or enjoyment of the intangible and the granting of the right to use the intangible is the clearly predominant purpose of the arrangement. Because the services are ancillary and subsidiary to the use of the manufacturing process, the fees for these services are considered fees for included services under paragraph 4 (a) of Article 12, regardless of whether the services are described in paragraph 4 (b).

Example(2)

Facts:

An Indian manufacturing company produces a product that must be manufactured under sterile conditions using machinery that must be kept completely free of bacterial or other harmful deposits. A U.S. company has developed a special cleaning process for removing

such deposits from that type of machinery. The U.S. company enters into a contract with the Indian company under which the former will clean the latter's machinery on a regular basis. As part of the arrangement, the U.S. company leases to the Indian company a piece of equipment which allows the Indian company to measure the level of bacterial deposits on its machinery in order for it to know when cleaning is required. Are the payments for the services fees for included services?

Analysis:

In this example, the provision of cleaning services by the U.S. company and the rental of the monitoring equipment are related to each other. However, the clearly predominant purpose of the arrangement is the provision of cleaning services. Thus, although the cleaning services might be considered technical services, they are not "ancillary and subsidiary" to the rental of the monitoring equipment. Accordingly, the cleaning services are not "included services" within the meaning of paragraph 4 (a).

Paragraph 4 (b)

Paragraph 4(b) of Article 12 refers to technical or consultancy services that make available to the person acquiring the service technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design to such person. (For this purpose, the person acquiring the service shall be deemed to include an agent, nominee, or transferee of such person.) This category is narrower than the category described in paragraph 4(a) because it excludes any service that does not make technology available to the person acquiring the service. Generally speaking, technology will be considered "made available" when the person acquiring the service is enabled to apply the technology. The fact that the provision of the service may require technical input by the person providing the service does not *per se* mean that technical knowledge, skills, etc. are made available to the person purchasing the service, within the meaning of paragraph 4 (b). Similarly, the use of a product which embodies technology shall not *per se* be considered to make the technology available.

Typical categories of services that generally involve either the development and transfer of technical plans or technical designs, or making technology available as described in paragraph 4 (b), include:

1. engineering services (including the subcategories of bioengineering and aeronautical, agricultural, ceramics,chemical, civil, electrical, mechanical, metallurgical, and industrial engineering);

2. architectural services; and

3. computer software development.

Under paragraph 4 (b), technical and consultancy services could make technology available in a variety of settings, activities and industries. Such services may, for example, relate to any of the following areas:

1. bio-technical services;

2. food processing;

3. environmental and ecological services;

4. communication through satellite or otherwise;

5. energy conservation;

6. exploration or exploitation of mineral oil or natural gas;

7. geological surveys;

8. scientific services; and

9. technical training.

The following examples indicate the scope of the conditions in paragraph 4 (b):

<u>Example (3)</u>

Facts:

A U.S. manufacturer has experience in the use of a process for manufacturing wallboard for interior walls of houses which is more durable than the standard products of its type. An Indian builder wishes to produce this product for its own use. It rents a plant and contracts with the U.S. company to send experts to India to show engineers in the Indian company how to produce the extra-strong wallboard. The U.S. contractors work with the technicians in the Indian firm for a few months. Are the payments to the U.S. firm considered to be payments for "included services"?

Analysis:

The payments would be fees for included services. The services are of a technical or consultancy nature; in the example, they have elements of both types of services. The services make available to the Indian company technical knowledge, skill, and processes.

Example (4)

Facts:

A U.S. manufacturer operates a wallboard fabrication plant outside India. An Indian builder hires the U.S. company to produce wallboard at that plant for a fee. The Indian company provides the raw materials, and the U.S. manufacturer fabricates the wallboard in its plant, using advanced technology. Are the fees in this example payments for included services?

Analysis:

The fees would not be for included services. Although the U.S. company is clearly performing a technical service, no technical knowledge, skill, etc., are made available to the Indian company, nor is there any development and transfer of a technical plan or design. The U.S. company is merely performing a contract manufacturing service.

Example (5)

Facts:

An Indian firm owns inventory control software for use in its chain of retail outlets throughout India. It expands its sales operation by employing a team of travelling salesmen to travel around the countryside selling the company's wares. The company wants to modify its software to permit the salesmen to access the company's central computers for information on what products are available in inventory and when they can be delivered. The Indian firm hires a U.S. computer programming firm to modify its software for this purpose. Are the fees which the Indian firm pays treated as fees for included services?

Analysis:

The fees are for included services. The U.S. company clearly performs a technical service for the Indian company, and it transfers to the Indian company the technical plan (i.e., the computer program) which it has developed.

Example (6)

Facts:

An Indian vegetable oil manufacturing company wants to produce a cholesterol-free oil from a plant which produces oil normally containing cholesterol. An American company has developed a process for refining the cholesterol out of the oil. The Indian company contracts with the U.S. company to modify the formulas which it uses so as to eliminate the cholesterol, and to train the employees of the Indian company in applying the new formulas. Are the fees paid by the Indian company for included services?

Analysis:

The fees are for included services. The services are technical, and the technical knowledge is made available to the Indian company.

Example (7)

Facts:

The Indian vegetable oil manufacturing firm has mastered the science of producing cholesterol-free oil and wishes to market the product world-wide. It hires an American marketing consulting firm to do a computer simulation of the world market for such oil and to advise it on marketing strategies. Are the fees paid to the U.S. company for included services?

Analysis:

The fees would not be for included services. The American company is providing a consultancy service which involves the use of substantial technical skill and expertise. It is not, however, making available to the Indian company any technical experience, knowledge or skill, etc., nor is it transferring a technical plan or design. What is transferred to the Indian company through the service contract is commercial information. The fact that technical skills were required by the performer of the service in order to perform the commercial information service does not make the service a technical service within the meaning of paragraph 4(b).

Paragraph 5

Paragraph 5 of Article 12 describes several categories of services which are not intended to be treated as included services even if they satisfy the tests of paragraph 4. Set forth below are examples of cases where fees would be included under paragraph 4, but are excluded because of the conditions of paragraph 5.

Example (8)

Facts:

An Indian company purchases a computer from a U.S. computer manufacturer. As part of the purchase agreement, the manufacturer agrees to assist the Indian company in setting up the computer and installing the operating system, and to ensure that the staff of the Indian company is able to operate the computer. Also, as part of the purchase agreement, the seller agrees to provide, for a period of ten years, any updates to the operating system and any training necessary to apply the

update. Both of these service elements to the contract would qualify under paragraph 4(b) as an included service. Would either or both be excluded from the category of included services, under paragraph 5(a), because they are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the computer?

Analysis:

The installation assistance and initial training are ancillary and subsidiary to the sale of the computer, and they are also inextricably and essentially linked to the sale. The computer would be of little value to the Indian purchaser without these services, which are most readily and usefully provided by the seller. The fees for installation assistance and initial training, therefore, are not fees for included services, since these services are not the predominant purpose of the arrangement.

The services of updating the operating system and providing associated necessary training may well be ancillary and subsidiary to the sale of the computer, but they are not inextricably and essentially linked to the sale. Without the upgrades, the computer will continue to operate as it did when purchased, and will continue to accomplish the same functions. Acquiring the updates cannot, therefore, be said to be inextricably and essentially linked to the sale of the computer.

<u>Example (9)</u>

Facts:

An Indian hospital purchases an X-ray machine from a U.S. manufacturer. As part of the purchase agreement, the manufacturer agrees to install the machine, to perform an initial inspection of the machine in India, to train hospital staff in the use of the machine, and to service the machine periodically during the usual warranty period (2 years). Under an optional service contract purchased by the hospital, the manufacturer also agrees to perform certain other services throughout the life of the machine, including periodic inspections and repair services, advising the hospital about developments in X-ray film or techniques which could improve the effectiveness of the machine, and training hospital staff in the application of those new developments. The cost of the initial installation, inspection, training, and warranty service is relatively minor as compared with the cost of the X-ray machine. Is any of the service described here ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the X-ray machine?

Analysis:

The initial installation, inspection, and training services in India and the periodic service during the warranty period are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the X-ray machine because the usefulness of the machine to the hospital depends on this service, the manufacturer has full responsibility during this period, and the cost of the services is a relatively minor component of the contract. Therefore, under paragraph 5(a) these fees are not fees for included services, regardless of whether they otherwise would fall within paragraph 4(b).

Neither the post-warranty period inspection and repair services, nor the advisory and training services relating to new developments are "inextricably and essentially linked" to the initial purchase of the X-ray machine. Accordingly, fees for these services may be treated as fees for included services if they meet the tests of paragraph 4(b).

Example (10)

Facts:

An Indian automobile manufacturer decides to expand into the manufacture of helicopters. It sends a group of engineers from its design staff to a course of study conducted by the Massachusetts Institute of Technology (MIT) for two years to study aeronautical engineering. The Indian firm pays tuition fees to MIT on behalf of the firm's employees. Is the tuition fee a fee for an included service within the meaning of Article 12?

Analysis:

The tuition fee is clearly intended to acquire a technical service for the firm. However, the fee paid is for teaching by an educational institution, and is, therefore, under paragraph 5(c), not an included service. It is irrelevant for this purpsoe whether MIT conducts the course on its campus or at some other location.

Example (11)

Facts:

As in Example (10), the automobile manufacturer wishes to expand into the manufacture of helicopters. It approaches an Indian university about establishing a course of study in aeronautical engineering. The university contracts with a U.S. helicopter manufacturer to send an engineer to be a visiting professor of aeronautical engineering on its faculty for a year. Are the amounts paid by the university for these teaching services fees for included services?

Analysis:

The fees are for teaching in an educational institution. As such, pursuant to paragraph 5(c), they are not fees for included services.

Example (12)

Facts:

An Indian wishes to install a computerized system in his home to control lighting, heating and air conditioning, a stereo sound system and a burglar and fire alarm system. He hires an American electrical engineering firm to design the necessary wiring system, adapt standard software, and provide instructions for installation. Are the fees paid to the American firm by the Indian individual fees for included services?

Analysis:

The services in respect of which the fees are paid are of the type which would generally be treated as fees for included services under paragraph 4(b). However, because the services are for the personal use of the individual making the payment, under paragraph 5(d) the payments would not be fees for included services.

EMBASSY OF THE
UNITED STATES OF AMERICA

New Delhi, September 12, 1989

Excellency:

I have the honor to refer to the Convention between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income which was signed today (hereinafter referred to as "the Convention") and to confirm, on behalf of the Government of the United States of America, the following understandings reached between the two Governments:

Both sides agree that a tax sparing credit shall not be provided in Article 25 (Relief from Double Taxation) of the Convention at this time. However, the Convention shall be promptly amended to incorporate a tax sparing credit provision if the United States hereafter amends its laws concerning the provision of tax sparing credits, or the United States reaches agreement on the provision of a tax sparing credit with any other country.

Both sides also agree that, for purposes of paragraph 4(c) of Article 5 (Permanent Establishment) of the Convention, a person shall be considered to habitually secure orders in a Contracting State, wholly or almost wholly for an enterprise, only if:

1. such person frequently accepts orders for goods or merchandise on behalf of the enterprise;

2. substantially all of such person's sales-related activities in the Contracting State consist of activities for the enterprise;

3. such person habitually represents to persons offering to buy goods or merchandise that acceptance of an order by such person constitutes the agreement of the enterprise to supply goods or merchandise under the terms and conditions specified in the order; and

4. the enterprise takes actions that give purchasers the basis for a reasonable belief that such person has authority to bind the enterprise.

I have the honor to request Your Excellency to confirm the foregoing understandings of Your Excellency's Government.

Accept, Excellency, the renewed assurances of my highest consideration.

J. R. Hubbard

John R. Hubbard

Ambassador

His Excellency

Dr. N.K. Sengupta,

Secretary (Revenue),

Ministry of Finance,

New Delhi.

भारत सरकार
वित्त मंत्रालय, राजस्व विभाग
नई दिल्ली-110001
GOVERNMENT OF INDIA
MINISTRY OF FINANCE, DEPARTMENT OF REVENUE
NEW DELHI-110001

सचिव
SECRETARY

September 12, 1989

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SECRETARY

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4. the enterprise takes actions that give purchasers the basis for a reasonable belief that such person has authority to bind the enterprise."

I have the honour to confirm the understandings contained in Your Excellency's Note, on behalf of the Government of the Republic of India.

Accept, Excellency, the renewed assurances of my highest consideration.

NKSengupta

His Excellency
Dr. John R. Hubbard,
Ambassador of the
United States of America,
New Delhi.

N. K. Sengupta

EMBASSY OF THE
UNITED STATES OF AMERICA

New Delhi, September 12, 1989

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I have the honor to refer to the Convention signed today between the United States of America and the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and to inform you on behalf of the United States of America of the following:

During the course of the negotiations leading to conclusion of the Convention signed today, the negotiators developed and agreed upon a memorandum of understanding intended to give guidance both to the taxpayers and the tax authorities of our two countries in interpreting aspects of Article 12 (Royalties and Fees for Included Services) relating to the scope of included services. This memorandum of understanding represents the current views of the United States Government with respect to these aspects of Article 12, and it is my Government's understanding that it also represents the current views of the Indian Government. It is also my Government's view that as our Governments gain experience in administering the Convention, and particularly Article 12, the competent authorities may develop and publish amendments to the memorandum of understanding and further understandings and interpretations of the Convention.

If this position meets with the approval of the Government of the Republic of India, this letter and your reply thereto will indicate that our Governments share a common view of the purpose of the memorandum of understanding relating to Article 12 of the Convention.

Accept, Excellency, the renewed assurances of my highest consideration.

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SECRETARY

September 12, 1989

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During the course of the negotiations leading to conclusion of the Convention signed today, the negotiators developed and agreed upon a memorandum of understanding intended to give guidance both to the taxpayers and the tax authorities of our two countries in interpreting aspects of Article 12 (Royalties and Fees for Included Services) relating to the scope of included services. This memorandum of understanding represents the current views of the United States Government with respect to these aspects of Article 12, and it is my Government's understanding that it also represents the current views of the Indian Government. It is also my Government's view that as our Governments gain experience in administering the Convention, and particularly Article 12, the competent authorities may

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If this position meets with the approval of the Government of the Republic of India, this letter and your reply thereto will indicate that our Governments share a common view of the purpose of the memorandum of understanding relating to Article 12 of the Convention."

I have the honour to confirm the understandings contained in Your Excellency's Note, on behalf of the Government of the Republic of India.

Accept, Excellency, the renewed assurances of my highest consideration.

N. K. Sengupta

His Excellency
Dr. John R. Hubbard,
Ambassador of the
United States of America,
New Delhi.

May 15, 1989

U.S. - INDIA TAX TREATY

MEMORANDUM OF UNDERSTANDING CONCERNING
FEES FOR INCLUDED SERVICES
IN ARTICLE 12

Paragraph 4 (in general)

This memorandum describes in some detail the category of services defined in paragraph 4 of Article 12 (Royalties and Fees for Included Services). It also provides examples of services intended to be covered within the definition of included services and those intended to be excluded, either because they do not satisfy the tests of paragraph 4, or because, notwithstanding the fact that they meet the tests of paragraph 4, they are dealt with under paragraph 5. The examples in either case are not intended as an exhaustive list but rather as illustrating a few typical cases. For ease of understanding, the examples in this memorandum describe U.S. persons providing services to Indian persons, but the rules of Article 12 are reciprocal in application.

Article 12 includes only certain technical and consultancy services. By technical services, we mean in this context services requiring expertise in a technology. By consultancy services, we mean in this context advisory services. The categories of technical and consultancy services are to some extent overlapping because a consultancy service could also be a technical service. However, the category of consultancy services also includes an advisory service, whether or not expertise in a technology is required to perform it.

Under paragraph 4, technical and consultancy services are considered included services only to the following extent: (1) as described in paragraph 4(a), if they are ancillary and subsidiary to the application or enjoyment of a right, property or information for which a royalty payment is made; or (2) as described in paragraph 4(b), if they make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design. Thus, under paragraph 4(b), consultancy services which are not of a technical nature cannot be included services.

Paragraph 4 (a)

Paragraph 4 (a) of Article 12 refers to technical or consultancy services that are ancillary and subsidiary to the application or enjoyment of any right, property, or information for which a payment described in paragraph 3(a) or (b) is received. Thus, paragraph 4(a) includes technical and consultancy services that are ancillary and subsidiary to the application or enjoyment of an intangible for which a royalty is received under a license or sale as described in

paragraph 3(a), as well as those ancillary and subsidiary to the application or enjoyment of industrial, commercial, or scientific equipment for which a royalty is received under a lease as described in paragraph 3(b).

It is understood that, in order for a service fee to be considered "ancillary and subsidiary" to the application or enjoyment of some right, property, or information for which a payment described in paragraph 3(a) or (b) is received, the service must be related to the application or enjoyment of the right, property, or information. In addition, the clearly predominant purpose of the arrangement under which the payment of the service fee and such other payment are made must be the application or enjoyment of the right, property, or information described in paragraph 3. The question of whether the service is related to the application or enjoyment of the right, property, or information described in paragraph 3 and whether the clearly predominant purpose of the arrangement is such application or enjoyment must be determined by reference to the facts and circumstances of each case. Factors which may be relevant to such determination (although not necessarily controlling) include:

1. the extent to which the services in question facilitate the effective application or enjoyment of the right, property, or information described in paragraph 3;

2. the extent to which such services are customarily provided in the ordinary course of business arrangements involving royalties described in paragraph 3;

3. whether the amount paid for the services (or which would be paid by parties operating at arm's length) is an insubstantial portion of the combined payments for the services and the right, property, or information described in paragraph 3;

4. whether the payment made for the services and the royalty described in paragraph 3 are made under a single contract (or a set of related contracts); and

5. whether the person performing the services is the same person as, or a related person to, the person receiving the royalties described in paragraph 3 (for this purpose, persons are considered related if their relationship is described in Article 9 (Associated Enterprises) or if the person providing the service is doing so in connection with an overall arrangement which includes the payor and recipient of the royalties).

To the extent that services are not considered ancillary and subsidiary to the aplication or enjoyment of some

right, property, or information for which a royalty payment under paragraph 3 is made, such services shall be considered "included services" only to the extent that they are described in paragraph 4(b).

Example (1)

Facts:

A U.S. manufacturer grants rights to an Indian company to use manufacturing processes in which the transferor has exclusive rights by virtue of process patents or the protection otherwise extended by law to the owner of a process. As part of the contractual arrangement, the U.S. manufacturer agrees to provide certain consultancy services to the Indian company in order to improve the effectiveness of the latter's use of the processes. Such services include, for example, the provision of information and advice on sources of supply for materials needed in the manufacturing process, and on the development of sales and service literature for the manufactured product. The payments allocable to such services do not form a substantial part of the total consideration payable under the contractual arrangement. Are the payments for these services fees for "included services"?

Analysis:

The payments are fees for included services. The services described in this example are ancillary and subsidiary to the use of a manufacturing process protected by law as described in paragraph 3 (a) of Article 12 because the services are related to the application or enjoyment of the intangible and the granting of the right to use the intangible is the clearly predominant purpose of the arrangement. Because the services are ancillary and subsidiary to the use of the manufacturing process, the fees for these services are considered fees for included services under paragraph 4 (a) of Article 12, regardless of whether the services are described in paragraph 4 (b).

Example(2)

Facts:

An Indian manufacturing company produces a product that must be manufactured under sterile conditions using machinery that must be kept completely free of bacterial or other harmful deposits. A U.S. company has developed a special cleaning process for removing

such deposits from that type of machinery. The U.S. company enters into a contract with the Indian company under which the former will clean the latter's machinery on a regular basis. As part of the arrangement, the U.S. company leases to the Indian company a piece of equipment which allows the Indian company to measure the level of bacterial deposits on its machinery in order for it to know when cleaning is required. Are the payments for the services fees for included services?

Analysis:

In this example, the provision of cleaning services by the U.S. company and the rental of the monitoring equipment are related to each other. However, the clearly predominant purpose of the arrangement is the provision of cleaning services. Thus, although the cleaning services might be considered technical services, they are not "ancillary and subsidiary" to the rental of the monitoring equipment. Accordingly, the cleaning services are not "included services" within the meaning of paragraph 4 (a).

Paragraph 4 (b)

Paragraph 4(b) of Article 12 refers to technical or consultancy services that make available to the person acquiring the service technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design to such person. (For this purpose, the person acquiring the service shall be deemed to include an agent, nominee, or transferee of such person.) This category is narrower than the category described in paragraph 4(a) because it excludes any service that does not make technology available to the person acquiring the service. Generally speaking, technology will be considered "made available" when the person acquiring the service is enabled to apply the technology. The fact that the provision of the service may require technical input by the person providing the service does not *per se* mean that technical knowledge, skills, etc. are made available to the person purchasing the service, within the meaning of paragraph 4 (b). Similarly, the use of a product which embodies technology shall not *per se* be considered to make the technology available.

Typical categories of services that generally involve either the development and transfer of technical plans or technical designs, or making technology available as described in paragraph 4 (b), include:

1. engineering services (including the subcategories of bioengineering and aeronautical, agricultural, ceramics,chemical, civil, electrical, mechanical, metallurgical, and industrial engineering);

2. architectural services; and

3. computer software development.

Under paragraph 4 (b), technical and consultancy services could make technology available in a variety of settings, activities and industries. Such services may, for example, relate to any of the following areas:

1. bio-technical services;

2. food processing;

3. environmental and ecological services;

4. communication through satellite or otherwise;

5. energy conservation;

6. exploration or exploitation of mineral oil or natural gas;

7. geological surveys;

8. scientific services; and

9. technical training.

The following examples indicate the scope of the conditions in paragraph 4 (b):

Example (3)

Facts:

A U.S. manufacturer has experience in the use of a process for manufacturing wallboard for interior walls of houses which is more durable than the standard products of its type. An Indian builder wishes to produce this product for its own use. It rents a plant and contracts with the U.S. company to send experts to India to show engineers in the Indian company how to produce the extra-strong wallboard. The U.S. contractors work with the technicians in the Indian firm for a few months. Are the payments to the U.S. firm considered to be payments for "included services"?

Analysis:

The payments would be fees for included services. The services are of a technical or consultancy nature; in the example, they have elements of both types of services. The services make available to the Indian company technical knowledge, skill, and processes.

Example (4)

Facts:

A U.S. manufacturer operates a wallboard fabrication plant outside India. An Indian builder hires the U.S. company to produce wallboard at that plant for a fee. The Indian company provides the raw materials, and the U.S. manufacturer fabricates the wallboard in its plant, using advanced technology. Are the fees in this example payments for included services?

Analysis:

The fees would not be for included services. Although the U.S. company is clearly performing a technical service, no technical knowledge, skill, etc., are made available to the Indian company, nor is there any development and transfer of a technical plan or design. The U.S. company is merely performing a contract manufacturing service.

Example (5)

Facts:

An Indian firm owns inventory control software for use in its chain of retail outlets throughout India. It expands its sales operation by employing a team of travelling salesmen to travel around the countryside selling the company's wares. The company wants to modify its software to permit the salesmen to access the company's central computers for information on what products are available in inventory and when they can be delivered. The Indian firm hires a U.S. computer programming firm to modify its software for this purpose. Are the fees which the Indian firm pays treated as fees for included services?

Analysis:

The fees are for included services. The U.S. company clearly performs a technical service for the Indian company, and it transfers to the Indian company the technical plan (i.e., the computer program) which it has developed.

Example (6)

Facts:
An Indian vegetable oil manufacturing company wants to produce a cholesterol-free oil from a plant which produces oil normally containing cholesterol. An American company has developed a process for refining the cholesterol out of the oil. The Indian company contracts with the U.S. company to modify the formulas which it uses so as to eliminate the cholesterol, and to train the employees of the Indian company in applying the new formulas. Are the fees paid by the Indian company for included services?

Analysis:

The fees are for included services. The services are technical, and the technical knowledge is made available to the Indian company.

Example (7)

Facts:

The Indian vegetable oil manufacturing firm has mastered the science of producing cholesterol-free oil and wishes to market the product world-wide. It hires an American marketing consulting firm to do a computer simulation of the world market for such oil and to advise it on marketing strategies. Are the fees paid to the U.S. company for included services?

Analysis:

The fees would not be for included services. The American company is providing a consultancy service which involves the use of substantial technical skill and expertise. It is not, however, making available to the Indian company any technical experience, knowledge or skill, etc., nor is it transferring a technical plan or design. What is transferred to the Indian company through the service contract is commercial information. The fact that technical skills were required by the performer of the service in order to perform the commercial information service does not make the service a technical service within the meaning of paragraph 4(b).

Paragraph 5

Paragraph 5 of Article 12 describes several categories of services which are not intended to be treated as included services even if they satisfy the tests of paragraph 4. Set forth below are examples of cases where fees would be included under paragraph 4, but are excluded because of the conditions of paragraph 5.

Example (8)

Facts:

An Indian company purchases a computer from a U.S. computer manufacturer. As part of the purchase agreement, the manufacturer agrees to assist the Indian company in setting up the computer and installing the operating system, and to ensure that the staff of the Indian company is able to operate the computer. Also, as part of the purchase agreement, the seller agrees to provide, for a period of ten years, any updates to the operating system and any training necessary to apply the

update. Both of these service elements to the contract would qualify under paragraph 4(b) as an included service. Would either or both be excluded from the category of included services, under paragraph 5(a), because they are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the computer?

Analysis:

The installation assistance and initial training are ancillary and subsidiary to the sale of the computer, and they are also inextricably and essentially linked to the sale. The computer would be of little value to the Indian purchaser without these services, which are most readily and usefully provided by the seller. The fees for installation assistance and initial training, therefore, are not fees for included services, since these services are not the predominant purpose of the arrangement.

The services of updating the operating system and providing associated necessary training may well be ancillary and subsidiary to the sale of the computer, but they are not inextricably and essentially linked to the sale. Without the upgrades, the computer will continue to operate as it did when purchased, and will continue to accomplish the same functions. Acquiring the updates cannot, therefore, be said to be inextricably and essentially linked to the sale of the computer.

Example (9)

Facts:

An Indian hospital purchases an X-ray machine from a U.S. manufacturer. As part of the purchase agreement, the manufacturer agrees to install the machine, to perform an initial inspection of the machine in India, to train hospital staff in the use of the machine, and to service the machine periodically during the usual warranty period (2 years). Under an optional service contract purchased by the hospital, the manufacturer also agrees to perform certain other services throughout the life of the machine, including periodic inspections and repair services, advising the hospital about developments in X-ray film or techniques which could improve the effectiveness of the machine, and training hospital staff in the application of those new developments. The cost of the initial installation, inspection, training, and warranty service is relatively minor as compared with the cost of the X-ray machine. Is any of the service described here ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the X-ray machine?

Analysis:

The initial installation, inspection, and training services in India and the periodic service during the warranty period are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the X-ray machine because the usefulness of the machine to the hospital depends on this service, the manufacturer has full responsibility during this period, and the cost of the services is a relatively minor component of the contract. Therefore, under paragraph 5(a) these fees are not fees for included services, regardless of whether they otherwise would fall within paragraph 4(b).

Neither the post-warranty period inspection and repair services, nor the advisory and training services relating to new developments are "inextricably and essentially linked" to the initial purchase of the X-ray machine. Accordingly, fees for these services may be treated as fees for included services if they meet the tests of paragraph 4(b).

Example (10)

Facts:

An Indian automobile manufacturer decides to expand into the manufacture of helicopters. It sends a group of engineers from its design staff to a course of study conducted by the Massachusetts Institute of Technology (MIT) for two years to study aeronautical engineering. The Indian firm pays tuition fees to MIT on behalf of the firm's employees. Is the tuition fee a fee for an included service within the meaning of Article 12?

Analysis:

The tuition fee is clearly intended to acquire a technical service for the firm. However, the fee paid is for teaching by an educational institution, and is, therefore, under paragraph 5(c), not an included service. It is irrelevant for this purpsoe whether MIT conducts the course on its campus or at some other location.

Example (11)

Facts:

As in Example (10), the automobile manufacturer wishes to expand into the manufacture of helicopters. It approaches an Indian university about establishing a course of study in aeronautical engineering. The university contracts with a U.S. helicopter manufacturer to send an engineer to be a visiting professor of aeronautical engineering on its faculty for a year. Are the amounts paid by the university for these teaching services fees for included services?

Analysis:

The fees are for teaching in an educational institution. As such, pursuant to paragraph 5(c), they are not fees for included services.

Example (12)

Facts:

An Indian wishes to install a computerized system in his home to control lighting, heating and air conditioning, a stereo sound system and a burglar and fire alarm system. He hires an American electrical engineering firm to design the necessary wiring system, adapt standard software, and provide instructions for installation. Are the fees paid to the American firm by the Indian individual fees for included services?

Analysis:

The services in respect of which the fees are paid are of the type which would generally be treated as fees for included services under paragraph 4(b). However, because the services are for the personal use of the individual making the payment, under paragraph 5(d) the payments would not be fees for included services.

September 23, 1989

STATEMENT OF THE GROUP OF SEVEN

The Finance Ministers and Central Bank Governors of Canada, France, the Federal Republic of Germany, Italy, Japan, the United Kingdom, and the United States met on September 23, 1989, in Washington for an exchange of views on current international economic and financial issues. The Managing Director of the IMF participated in the multilateral surveillance discussions.

The Ministers and Governors reviewed their economic policies and prospects. They noted that their economies were experiencing further solid growth this year and that the current expansion was expected to continue in the coming year. Moreover, inflation remains contained thanks to the implementation of appropriate policies, but vigilance is still required, particularly in those countries where inflationary pressures persist. Some further progress is also being made in reducing large external imbalances although adjustment has slowed. The Ministers and Governors considered the rise in recent months of the dollar inconsistent with longer run economic fundamentals. They agreed that a rise of the dollar above current levels or an excessive decline could adversely affect prospects for the world economy. In this context, they agreed to cooperate closely in exchange markets.

The Ministers and Governors reaffirmed support for the economic policy coordination process and stressed the importance of continuing to implement the economic policies which have produced 7 years of sustained growth with relatively low inflation. They encouraged the ongoing efforts of the United States to reduce the Federal budget deficit by implementing measures that will achieve the Gramm-Rudman-Hollings budget deficit targets. They also encouraged further deficit reduction in Canada and Italy, as well as the efforts of those countries and of the U.K. to reduce inflation. France will continue to promote savings so as to facilitate investment. The surplus countries, Japan and Germany, will continue to undertake economic policies aimed at promoting non-inflationary growth with a sufficient margin in the medium term between domestic demand and output growth to reduce substantially their large external imbalances. All need to implement reforms promoting economic efficiency, open their economies to foreign goods and services, curb subsidies and excessive regulations, and to take appropriate measures to foster savings where they are inadequate.

The Ministers and Governors reaffirmed the importance they attach to an early and successful conclusion of the Uruguay Round of trade negotiations. They expressed their determination to resist protectionism and to strengthen the open multilateral trading system.

The Ministers and Governors discussed the historic events now in progress in some of the countries of Eastern Europe, especially in Poland and Hungary, and expressed their strong support for plans to create more open and market-based economies. They urged the Polish Government to reach an early agreement with the IMF on a strong and sustainable program and they stand ready to support such a program through bilateral and multilateral actions, including Paris Club rescheduling.

The Ministers and Governors expressed their support for the strengthened debt strategy and recognized the substantial progress which has been achieved. They commended the Fund and the Bank for their prompt and effective response in developing the operational guidelines governing their support for debt and debt service reduction.

The Ministers and Governors reaffirmed the key role of commercial banks in resolving debt problems. They further agreed that diversified financial support from the banks is needed to support sound economic reform programs through a broad array of new lending and debt/debt service reduction mechanisms. They also noted that they had reviewed, in a manner consistent with maintaining the safety and soundness of the financial system, their regulatory, tax and accounting practices with a view to eliminating unnecessary obstacles to debt/debt service reduction transactions and that this review had helped to clarify procedures to facilitate such transactions.

The Ministers and Governors reemphasized the central importance of sustained implementation by debtor countries of macroeconomic and structural policy reforms in order to achieve sustainable growth, viable balance of payments positions, and restoration of normal access to private credit markets. They noted that complementary efforts to reverse capital flight and attract foreign investment were particularly important elements of Fund and Bank programs for countries seeking to gain access to support for debt and debt service reduction.

The Ministers and Governors also reviewed other issues to be discussed in the forthcoming meetings of the Fund and the Bank. The Ministers and Governors recalled that the Executive Board of the IMF has been urged to complete its work on the 9th Review of Quotas with a view to a decision on this matter by the Board of Governors before the end of the year.

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