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Report to Congress on the

Depreciation of Horses

Department of the Treasury
March 1990

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DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

March 1990

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

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 Treasury's authority to promulgate changes in class lives was repealed by Section 6253 of Public Law 100-647, the Technical and Miscellaneous Revenue Act of 1988.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 horses. The legislative history of the Tax Reform Act of 1986 indicates that such study was to be among the first conducted by Treasury.

I am sending a similar letter to Senator Bob Packwood.

Sincerely,

Kenneth W. Gideon

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

March 1990

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

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 Treasury's authority to promulgate changes in class lives was repealed by Section 6253 of Public Law 100-647, the Technical and Miscellaneous Revenue Act of 1988.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 horses. The legislative history of the Tax Reform Act of 1986 indicates that such study was to be among the first conducted by Treasury.

I am sending a similar letter to Representative Bill Archer.

Sincerely,

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Assistant Secretary
(Tax Policy)

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Chapter I. Introduction and Principal Findings

A. Mandate for This Study

This study of the depreciation of horses 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 assets. This mandate was incorporated in Section 168(i)(1)(B) of the Internal Revenue Code (IRC), as modified by the Tax Reform Act of 1986 (see Exhibit 1 of the Appendix). 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 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 (TAMRA) repealed Treasury's authority to alter asset classes or class lives, but the revised IRC Section 168(i) continued Treasury's responsibility to "monitor and analyze actual experience with respect to all depreciable assets" (see Exhibit 2 of the Appendix).

The *General Explanation of the Tax Reform Act of 1986* (the "Blue Book") indicates that, in choosing assets for study, the Treasury Department should give priority to those assets that do not have a class life. An Asset Depreciation Range (ADR) asset guideline class had existed for work and breeding horses (Asset Class 01.22, Horses, Breeding or Work), with an ADR guideline period of 10 years. Although Congress assigned in the Tax Reform Act a three-year Modified Accelerated Cost Recovery System (MACRS) recovery period to racehorses more than two years old when placed in service and to horses (other than racehorses) more than 12 years old when placed in service (IRC Section 168(e)(3)(A)), no class life exists for racehorses age two or younger, showhorses, and horses used for certain other business purposes.[1]

Moreover, under IRC Section 263A(e)(2) as promulgated in the 1986 Act, taxpayers electing to expense the pre-productive costs of raising certain animals (including horses) were required to use the Alternative Depreciation System, which calls for the use of straight-line depreciation over the asset's class life. Assets (such as racehorses) that do not have a class life are assigned a 12-year life for this purpose (IRC Section 168(g)(2)(C)). Believing that a 12 year recovery period is too long, the American Horse Council asked Treasury to study the depreciation of racehorses. In addition, the legislative history of the 1986 Act indicated a Congressional desire that Treasury give priority to a study of racehorses and older horses.[2]

In view of the priority required to be given to the study of assets not having class lives, the Depreciation Analysis Division responded to this request by announcing in the Federal Register its intent to study the depreciation of horses. It also held a public meeting at the Treasury Department on October 19, 1987 with interested parties (including representatives of the American Horse

Council) to determine the best way to collect the required information. While this study was being prepared, Congress repealed (in TAMRA) the uniform capitalization rules for certain producers of animals (including horses). Although this action appears to have addressed the primary concerns of the horse industry, the Depreciation Analysis Division has continued to carry out its Congressionally mandated responsibility to study the depreciation of horses.

The *General Explanation of the 1986 Act* indicates that the determination of the class lives of depreciable assets should be based on the anticipated decline in their value over time (after adjustment for inflation), and on their anticipated useful lives (see Exhibit 3 of the Appendix). Under current law, the *useful life* of an asset is taken to be its entire economic lifespan over all users combined, and not just the period it is retained by a single owner. For a group of assets, the Depreciation Analysis Division calculates the useful life as a weighted average of lives, with each weight set equal to the probability that members of the asset group will be retired upon attaining the corresponding life.

The *General Explanation* also indicates that, if the class life of an asset is derived from the decrease in market value as a function of its age, such life (which, to avoid confusion, is hereafter referred to as its *equivalent economic life*) should be set so that the present value of straight-line depreciation over the equivalent economic life equals the present value of the decline in value of the asset (both discounted at an appropriate real rate of interest). This formula must be modified in order to define a single depreciable life for a group of assets. Given that an asset group invariably possesses a distribution of retirements over several ages, a portion of the group will inevitably be retired before the group is fully depreciated for tax purposes. Under current tax law, such retirements result in loss deductions equal to the retired assets' remaining basis, less any salvage value. From the perspective of an investor recovering his or her capital costs, such loss deductions are equivalent to depreciation deductions. Therefore, the definition of an equivalent economic life should be modified to account for these deductions: the present value of all "cost recovery" deductions, determined by applying a straight-line formula to the equivalent economic life and by taking into account the probability of retirement of the asset at each age, must equal the present value of the average decline in economic value of the asset group.[3]

B. Principal Findings

The principal findings of this study are that the average useful life of all horses is 8.8 years, and their average equivalent economic life is 10.6 years. Both estimates assume that horses are first placed in service and begin depreciating at age two. These findings are primarily based on an analysis of thoroughbred horses acquired as yearlings. However, the available information regarding the level of investment in older horses, and an analysis of their equivalent economic lives, suggest that the current class life of 10 years for workhorses and breeding stock might reasonably apply to all horses, regardless of their age when placed in service or the use to which they are put. Accordingly, the current law three-year recovery period for racehorses and older horses should be repealed.

Two general issues related to the analysis and estimation of economic depreciation arose during this study, and their resolution affected the principal findings reported above. First, for many depreciable assets that decline rapidly in value, the application of the equivalent economic life formula is relatively straightforward, and the resulting equivalent economic lives of such assets are often significantly shorter than their useful lives. For a number of assets, however, the application of the equivalent economic life formula is not as straightforward, and the resulting equivalent economic lives of these assets may be comparable to or even greatly exceed their useful lives. This is particularly true in the case of horses. Some horses are very successful, and may greatly appreciate in value for a good portion of their useful lives, while others may be quite unsuccessful and are retired very quickly. The early appreciation for the very successful horses is significant enough to cause their average present value of economic depreciation to be quite small, or even negative. Where this occurs, the economic equivalent life may not be computable.

The 10.6-year equivalent economic life quoted above was obtained by simply ignoring the appreciation of certain "highly successful" horses. An alternative estimate of 12.7 years is obtained when this appreciation is taken into account as "negative economic depreciation." The treatment of this situation is described in greater detail in Chapter III.

An additional complication arises from the fact that most horses used for breeding have initially been used for racing. Under current law, racehorses can generally be depreciated over a three year recovery period. Because salvage value is no longer a relevant concept for tax depreciation purposes, these horses can be fully depreciated within a few years after starting their racing career, even though their market value as a breeding horse can sometimes be many times greater than their initial acquisition cost. If all racehorses were customarily sold when their use changed from racing to breeding, the current law distinction between horses used for racing and those used for work or breeding purposes might still be maintained. The sale would result in the recognition of a market asset value, and any "excessive" or "deficient" depreciation previously claimed with respect to such horses would be recaptured or allowed as a loss at the time of sale.

Although sales of shares or interests in horses occur frequently, the Depreciation Analysis Division was unable to obtain adequate evidence that the complete (or nearly complete) transfer of the ownership interests in a racehorse at the time its use changes from racing to breeding is the general industry practice.[4] Accordingly, the depreciation of horses over their entire careers was examined for this report; racing horses and breeding horses are thus not regarded as two distinct assets, in contrast to their classification under current law.

Despite repeated attempts to acquire more complete information from the American Horse Council, an umbrella organization representing the horse industry, and other industry representatives, the Depreciation Analysis Division was forced to rely on a limited set of publicly available information: (1) a 1972 article on the useful lives of thoroughbreds by Kent Hollingsworth, past editor of *The Blood Horse* (a journal published by the Thoroughbred Owners and Breeders Association), and (2) thoroughbred auction data for various years compiled and published in *The Blood Horse*. After a draft of this report was submitted for review to The American Horse Council, they provided some additional information, including information on other breeds of horses. In addition, they submitted a letter objecting to various aspects of the methodology used in this study.[5] The Depreciation Analysis Division believes that the additional information submitted does not alter the conclusions of the draft report. Nevertheless, where appropriate, notes have been added summarizing the views and data presented by the American Horse Council, so that Congress may judge for itself the extent to which this additional material might affect the principal findings of this report.

Chapter II. The Useful Life of Thoroughbreds

A. The Hollingsworth Study

In a very informative article entitled "So What is the Economic Useful Life of A Thoroughbred", which was published in *The Blood Horse* (March, 1972), Kent Hollingsworth reported the results of a very extensive study that traced the complete racing and breeding careers of all thoroughbred foals born in the years 1939-41 and registered with the Jockey Club. Because horses can live to 30 years of age, it was necessary for Hollingsworth to focus on such early vintages of foals. His study, which was performed with the assistance of the Jockey Club Statistical Bureau under the sponsorship of the Thoroughbred Owners and Breeders Association, provides statistical information based on the histories of 19,124 horses. In the absence of alternative data, the statistics obtained by Hollingsworth relating to the useful life of thoroughbreds are used in this study. Other data contained in the Hollingsworth study, such as the average lifetime earnings per horse, are likely to be no longer relevant, and are not used. Because of the growth in the number of horses (from approximately 6,500 thoroughbreds foaled and registered each year in the 1939-41 period to approximately 49,500 thoroughbreds foaled in 1988), and the potential impact of the Second World War on the Hollingsworth results, the useful life data may be somewhat out of date. Nevertheless, the Hollingsworth study was intended to provide helpful information to the Treasury Department in 1972 regarding the useful life of thoroughbreds, and should continue to be helpful today.

In obtaining the distribution of useful lives, Hollingsworth distinguished between racehorses and breeding stock. He also focused only on those racehorses that won race money. Since the useful life of an asset for tax depreciation purposes now refers to its economic lifespan over all users and uses, the separate useful life information for racehorses and breeding stock are combined in this study, as described in the following sections.

B. Determination of the Useful Life of Thoroughbreds

Because thoroughbred horses not trained for racing and those not raced for a full year before being sold or retired are not likely to be depreciated, such horses are excluded from this analysis. Although Hollingsworth did not publish statistics on those horses that were not trained for racing, or on those that did not "start" a race, the American Horse Council provided additional data indicating that between 30 and 40 percent of the 1939-41 crop of thoroughbred foals studied by Hollingsworth did not "start".

Based on the assumption that the fraction of "non-starters" applies equally to fillies, colts, and geldings, Hollingsworth's data imply that about 67 percent of "starting" fillies produce more than one foal, and thus may be assumed to be used for breeding. While some fillies that do not start are in fact used for breeding, it is believed that these constitute only a small percentage of all non-starters. In any event, the neglect of such horses should not significantly affect the results. Likewise, Hollingsworth's data indicate that 29 percent of all starting colts produce more than 5 foals in their lifetime, and thus may be assumed to be used for breeding.[6] The Hollingsworth data thus generally imply that a fair fraction of starting colts, and a large fraction of starting fillies, are subsequently used for breeding.[7]

The useful lives of those racehorses that are not subsequently used for breeding are determined from Hollingsworth's data on the ages at which racehorses earn their last race money. Since some horses may be unsuccessfully raced for a few years after the last race in which they earned race money, this approach tends to understate their useful lives.[8] On the other hand, it is also assumed that horses that start racing but do not earn any race money have the same distribution of useful lives as horses that do earn race money. Since horses that win no race money are more likely to have shorter useful lives, these two errors tend to offset each other.

In contrast to Hollingsworth's assumption that all racehorses begin racing in the year in which they win their first money, it is assumed in this study that all racehorses begin their racing careers at two years of age. Most thoroughbreds do start racing at this age, but more importantly, taxpayers generally claim that their racehorses are placed in service at this age, even if they do not actually enter a race until three years of age.

The useful lives of those racehorses that are subsequently used for breeding are determined from Hollingsworth's data on the ages at which broodmares produce their last foal, and the ages at which stallions sire their last foal. Because owners may attempt to use a horse for breeding after it has last been able to produce a live foal, this measure tends to understate the useful life of horses, and thus also offsets the assumption used in this study by applying the Hollingsworth statistics to racehorses that do not win any race money.

C. Distribution of Useful Lives

The following figures present useful life distributions for several types of horses. Figure 1 represents thoroughbred geldings, and is based entirely on the ages at which such horses last earn race money. The average useful life is 6.6 years. As expected, this exceeds the 5.1 "average number of seasons earned" noted by Hollingsworth, who considered the horse's useful life to begin when it won its first race money. The distribution of useful lives for colts/stallions is shown in Figure 2.

In this case, useful lives are determined either by the ages at which they last won race money (for the 71 percent of the starting colts that were not subsequently used for breeding), or by the ages when they sired their last foal. The average useful life is 7.9 years. Figure 3 shows the distribution of useful lives for thoroughbred fillies/mares Here also, useful lives are determined either by the ages at which they last won race money (for the 33 percent of the starting fillies that were not subsequently used for breeding), or by the ages when they produced their last foal. The average useful life is 11.0 years.

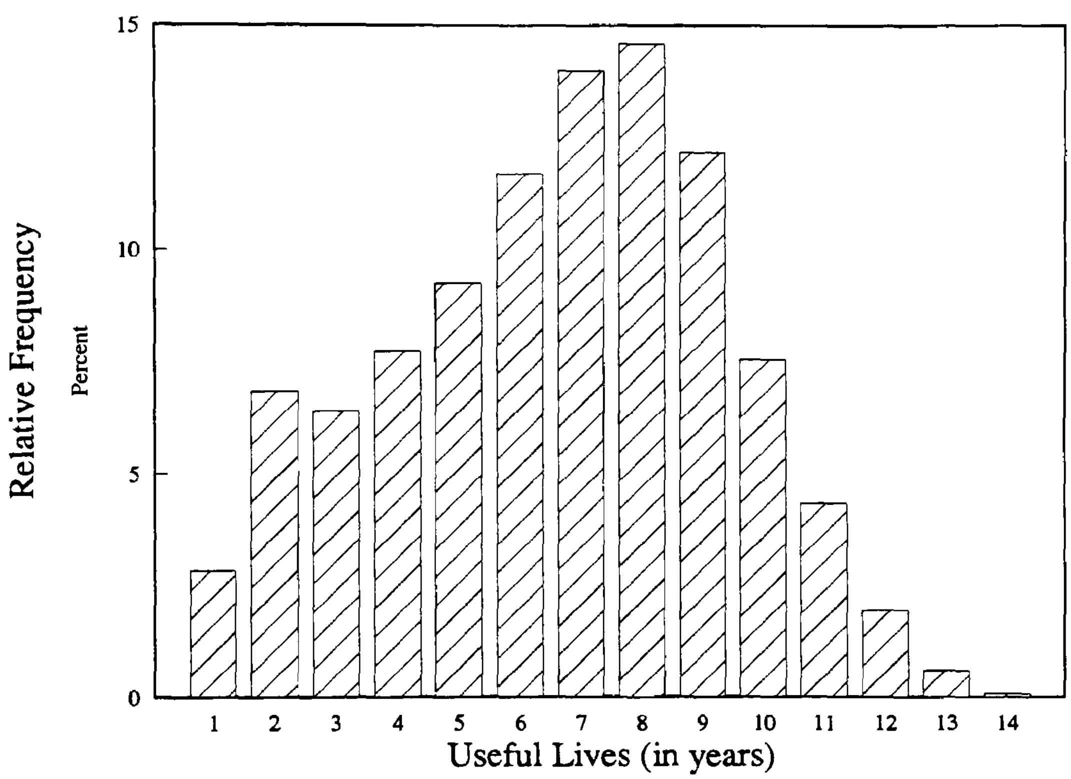

Figure 1. Distribution of the useful lives of starting thoroughbred geldings.

The auction data indicate that male yearlings cost about 16 percent more than female yearlings. Based on this statistic, and using distributions found in Hollingsworth, the following investment weights were derived: 39.5 percent for geldings, 14.0 percent for colts/stallions, and 46.5 percent for fillies/mares. The investment-weighted average useful life for all thoroughbred horses combined is 8.8 years.

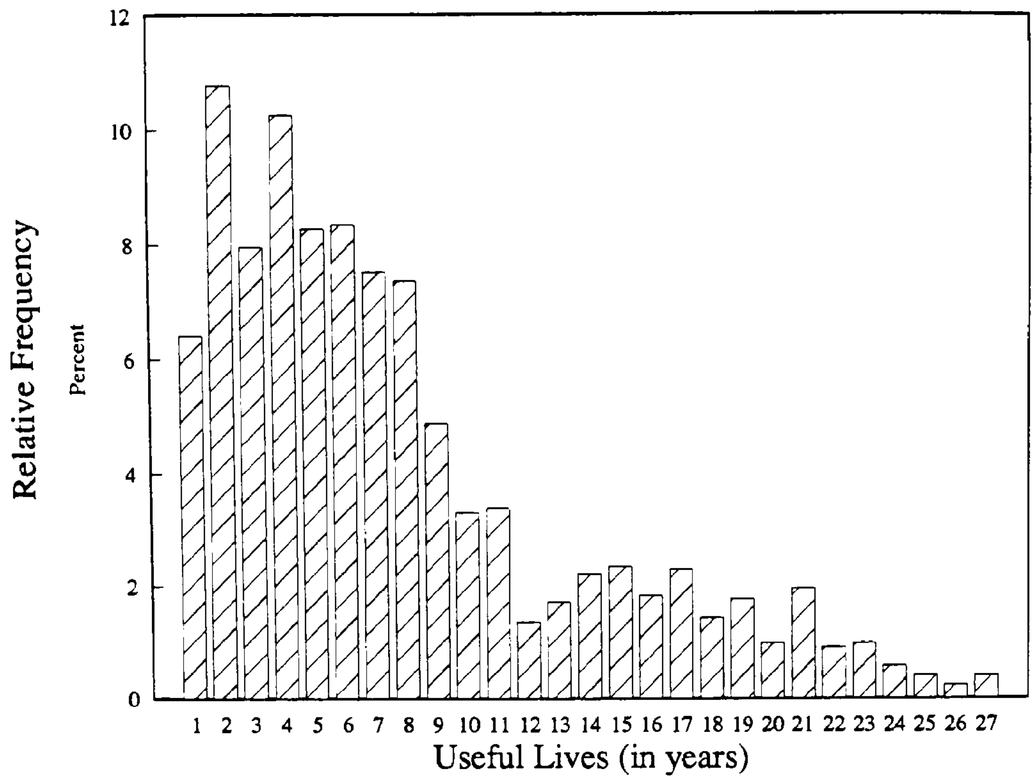

Figure 2. Distribution of the useful lives of starting thoroughbred colts/stallions.

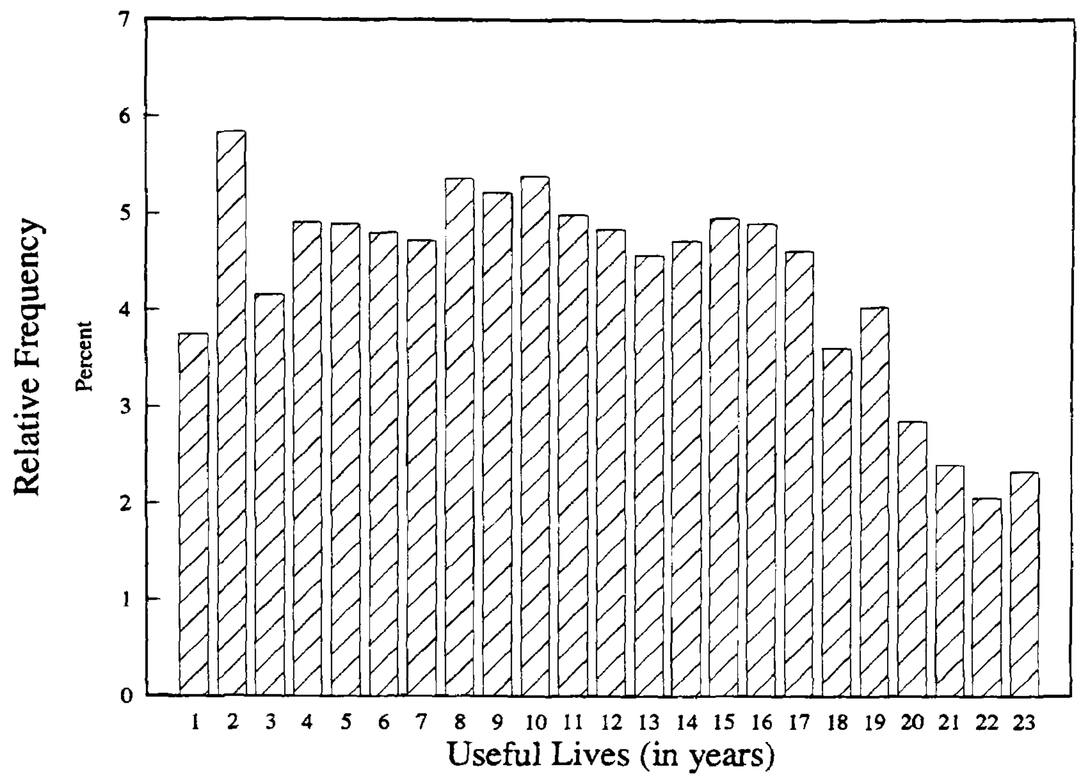

Figure 3. Distribution of the useful lives of starting thoroughbred fillies/mares.

Chapter III. The Economic Depreciation of Thoroughbreds

In this chapter, average age-price profiles, economic depreciation, and equivalent economic lives are derived separately for geldings, colts/stallions, and fillies/mares. Conceptual issues related to the treatment of gains and losses upon disposition of horses and the treatment of appreciating assets are discussed, and their implications for equivalent economic lives are shown. The estimation of the equivalent economic life of all thoroughbreds is discussed last.

A. The Average Age-Price Profile of Geldings.

Geldings are castrated male horses. In the Hollingsworth study, they outnumber colts by a ratio of nearly three-to-one. For convenience, it is assumed that the value of all racehorses not subsequently used for breeding (and this clearly includes geldings) declines linearly with the age of the horse once it starts racing, which as noted is assumed to occur when the horse is two years of age. No change in value is assumed to occur between the date of acquisition and the date the horse is placed in service. It is also assumed that the salvage value of a horse is five percent of the horse's value as a yearling, and that the imputed price of the horse declines to this value at the end of its useful life (i.e., when it is at the age at which it has won its last race money). Only the value of the horse relative to its acquisition cost is needed to determine its economic depreciation per dollar of investment. Thus, the assumption that the horse's salvage value is proportional to its price as a yearling allows the age-price profiles of horses of varying acquisition costs to be calculated as if they all had the same acquisition cost. For convenience, this cost is taken to be $6,500, which is the median price of all thoroughbred yearlings acquired at auction in 1987. The implications of investment in older horses will be discussed in Chapter IV.

Based on this $6,500 initial price, a five percent salvage value is $325. This may seem low, since healthy retired thoroughbred racehorses may be sold for recreational use for several thousands of dollars, and even lame horses may be sold for slaughter for about $450. On the other hand, the acquisition cost of some yearlings may exceed one million dollars, and the corresponding $50,000 salvage value may be somewhat high. For a horse costing $35,400 (the mean 1987 yearling auction price), the calculated salvage value is $1,770, which approximates amounts received for retired thoroughbred racehorses. A five percent salvage value thus appears reasonable.[9]

In summary, the age-price profile for all racehorses that are not subsequently used for breeding is assumed to exhibit a simple straight-line decline (starting at age two) from the assumed $6,500 initial value. However, different horses are assumed to have different straight-line patterns, as determined by the distribution of their useful lives (although they all have the same assumed $325 salvage value). Selected age-price profiles for geldings, for example, are shown below in Figure 4.

The relative fractions of geldings exhibiting each specific pattern is given by the frequency distribution of the useful lives for geldings (see Figure 1). The average age-price profile for all geldings is shown in Figure 5 below.

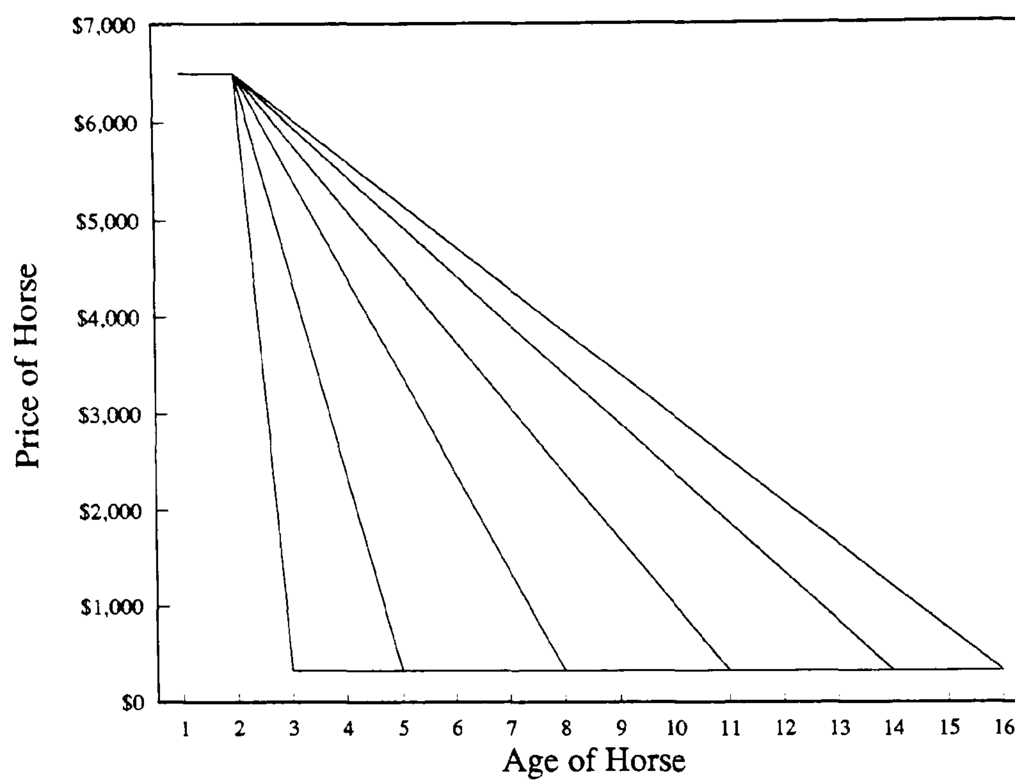

Figure 4. Selected age-price profiles of starting thoroughbred racehorses that are not subsequently used for breeding.

This method of estimating the average value of a set of non-homogeneous assets, each of which declines in value in a straight-line fashion, has been referred to as the Bureau of Economic Analysis method (see, for example, Hulten and Wykoff [1981]), and is known to result in an average age-price profile that resembles that for a single more rapidly declining asset (as is shown in Figure 5). The present value (as of the acquisition date of the horse) of the annual decline in value (i.e., "economic depreciation") for thoroughbred geldings is obtained by discounting each year's decline in the average value (starting at age two) from the middle of the year at a discount rate r:

$$(1) \quad PV = \sum_{i=3} \frac{[V(i-1) - V(i)]}{V(1)\,(1+r)^{(i-1.5)}}$$

where PV is the present value of economic depreciation, $V(1)$ is the acquisition price of the horse (assumed acquired as a yearling), and where $V(i)$ is the average value of those horses of age i that are still racing (as determined from the distribution of useful lives in Figure 1). If a four percent real discount rate, r, is used, a present value (as of age one) of 0.8058 is obtained.

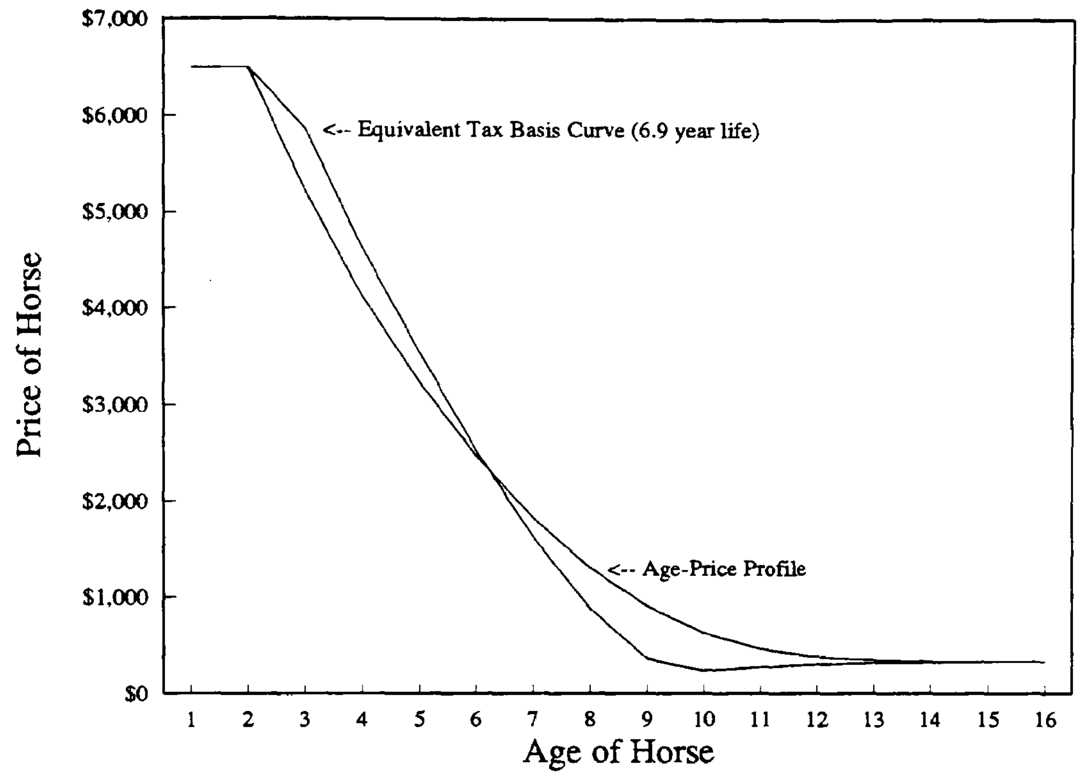

Figure 5. Average age-price profile for starting thoroughbred geldings and the corresponding average equivalent tax basis curve derived from an equivalent economic life of 6.9 years.

B. Translating Economic Depreciation into an Equivalent Economic Life

As noted in Chapter 1, the *General Explanation of the Tax Reform Act of 1986* provides a formula for translating the present value of economic depreciation into an equivalent economic life. In particular, the equivalent economic life is determined by equating the present value of straight-line depreciation (over the to-be-determined equivalent economic life) to the present value of economic depreciation. If this procedure is carried out using the same four percent real discount rate and a mid-year discounting convention, an equivalent economic life of 5.8 years is obtained for thoroughbred geldings. This result depends on the assumptions that all geldings are considered placed in service at age two, and that their training and maintenance costs are expensed. It further assumes that all geldings are identical in that they all retire at the same age.

Without this last assumption, a taxpayer would most likely incur a loss (or gain) when his or her horse was retired. This gain (or loss) would be measured by the difference between the remaining tax basis in the horse in the year it was retired and its salvage value. The Depreciation Analysis Division believes that these gains (which arise if the horse is retired later than "average") and losses (which arise if the horse is retired sooner than "average") are alternative ways (in addition to depreciation) of recovering the capital invested in the horse, and should be factored into the analysis. When this is done, the equivalent economic life of a gelding is found to be 6.9 years, which is close to its 6.6-year average useful life. The average equivalent tax basis for geldings is also shown in Figure 5. This curve is obtained by depreciating each horse using a straight-line formula and an equivalent economic life of 6.9 years, and by calculating appropriate losses and gains according to the estimated gelding retirement pattern shown in Figure 1.[10] The areas under the two curves in Figure 5, when discounted to a common age, are equal.

C. Equivalent Economic Life of Colts/Stallions

The age-price profiles for those colts that start but are not subsequently used for breeding are assumed to be similar to those for geldings; the relative fraction of such colts in each useful life class is obtained from the Hollingsworth data on the ages at which colts earned their last race money. The value of those colts that are subsequently used for breeding are, however, imputed from the stud fees which these horses can generate.

Following Hollingsworth, a distinction is made between two groups of breeding stallions. Although only those stallions that sire five or more foals in their lifetime are considered to be used for breeding, a more limited group of stallions (which shall henceforth be referred to as the "very successful" stallions) sire ten or more foals in a single season sometime during their life. The Hollingsworth study notes that only 1.3 percent of all males fall into this category. However, when both the males assumed not to start (and thus also assumed not to be used for breeding purposes) and the starting geldings are excluded, this statistic implies that as many as seven percent of the starting colts become very successful stallions. Likewise, from Hollingsworth's statistic that roughly five percent of all males are used for breeding, it may be inferred that about 21 percent of all starting colts become less than very successful (hereafter referred to as "less successful") breeding stallions.

The ratio of the value of seven-year old breeding stallions to their acquisition cost, RV, is obtained as the product of four factors:

(2) $RV = (Se/AC) \times (Sh/Se) \times N \times (1 - OC)$,

where (Se/AC) is the ratio of the value of a stallion season (the stud fee for servicing a single mare in a single season) to the acquisition cost of the horse (adjusted for inflation), (Sh/Se) is the ratio of the value of a share of the horse (the right to use the stallion to service a single mare each season for the remainder of the stallion's breeding career) to the value of a season (which reflects the discounted value of the number of future seasons the stallion is expected to serve), N is the estimated number of mares serviced per season, and OC is the ratio of the maintenance costs to the stud fees received.

From the 1988 auction data published by *The Blood Horse* (January, 1989), it was found that (Sh/Se), or the ratio of the price of a stallion share to that of a stallion season is about 4.4 for a seven-year old stallion, but this ratio declines thereafter (initially, at about 4.5 percent per year) with the age of the stallion. The Hollingsworth data also indicate that the very successful breeding stallions produce about 10.1 foals per crop at age seven, while the less successful breeding stallions produce about 2.75 foals per crop at age seven. Although the stud fees received are frequently contingent upon the birth of a live foal, this was not the case for most of the auction prices noted. Thus, an adjustment is made to reflect the fact that the number of foals sired might understate the mares serviced by a stallion in a season.[11] Based on a 69 percent breeding success rate (which the Hollingsworth data show to be appropriate for a seven-year old broodmare), the very successful seven-year old stallion appears to service about 14.6 mares per season (i.e., $N = 14.6$), whereas the less successful seven-year old stallion services about 4.0 mares per season (i.e., $N = 4.0$).

It is assumed that the current and future costs of maintaining a breeding stallion are about 20 percent of the fees received by a very successful stallion (i.e., $OC = .20$), and about 55 percent of the fees received by a less successful stallion (i.e., $OC = .55$). Because it was generally not possible to determine yearling values for those stallions whose seasons were sold at public auction, a less exact matching was used to estimate the ratio (Se/AC). From the auction data published in various issues of *The Blood Horse*, the average price was obtained for all yearlings sired by the stallion's sire and sold at auction in the year in which the stallion was a yearling.

When this price is substituted for the acquisition cost of the stallion, an average ratio of the value of a stallion's season to its inflation-adjusted acquisition cost of 11.7 percent is obtained (i.e., $(Se/AC) = .117$). This does not mean that purchasers of every yearling colt can necessarily expect to obtain such fees in the future. It does mean that, if the acquired colt should prove sufficiently successful to be used for breeding, and the relationship between prior yearling prices and current stud fees persists, fees of that magnitude may be expected.

Inserting these factors into Equation (2), the value of a very successful seven-year old breeding stallion is roughly six times its initial cost. Likewise, the value of a less successful seven-year old breeding stallion is about 0.9 times its value as a yearling. The decline in value of breeding stallions with age is taken to be the result of two factors--(1) a decline in the ratio of the value of a share to that of a season (which reflects the decline in the number of future crops anticipated), and (2) a decline in the number of mares serviced, as inferred from the Hollingsworth data on the decline with age in the number of foals sired by active stallions.[12] The resulting age-price profiles of both the very successful and the less successful breeding stallions are shown below in Figure 6. In obtaining these profiles, a linear increase (for the very successful stallions) or decrease (for the less successful stallions) between the value of the horse at age two and its value at age seven is assumed.

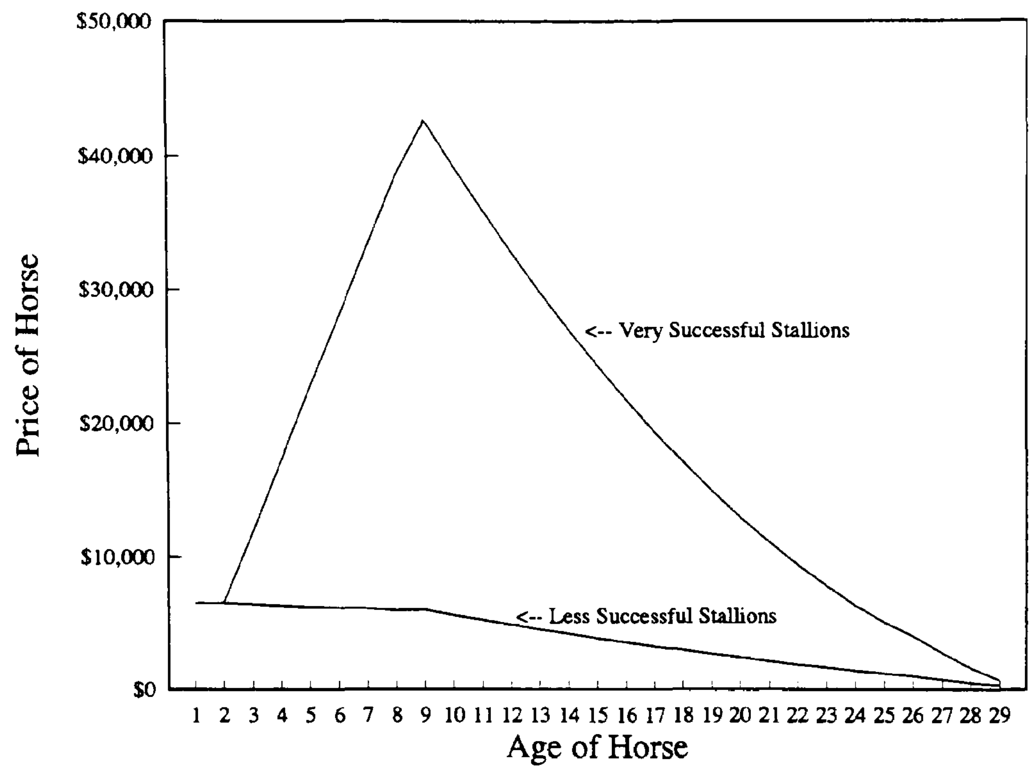

Figure 6. Estimated age-price profiles for unretired starting thoroughbred colts that are subsequently used for breeding stock.

The average age-price profile for all starting thoroughbred colts/stallions is obtained as a mixture of the values of those starting colts that are not subsequently used for breeding and the values of those that are so used. However, the retirement of the breeding stallions must also be considered. Here also, it is assumed that the salvage value of a retired stallion is five percent of its cost as a yearling. The decline in value of retired breeding stock is assumed to be very sudden; just prior to retirement the horse has the value noted in Figure 6, and a value of $325 immediately thereafter. The frequency of retirements may be obtained from the Hollingsworth data on the ages of stallions in the year they sire their last foal; separate statistics are noted for the very successful and the less successful stallions. When these factors are taken into account, the resulting retirement-adjusted average age-price profile shown below in Figure 7 is obtained. The sharp initial decline in the estimated price is due to the rapid retirement of the less successful racehorses, while the cusp at nine years of age reflects the assumed peak in the value of very successful stallions. The present value (as of the date of acquisition, at a four percent real rate, and with mid-year discounting) of the economic depreciation corresponding to this decline in value is 0.6579.

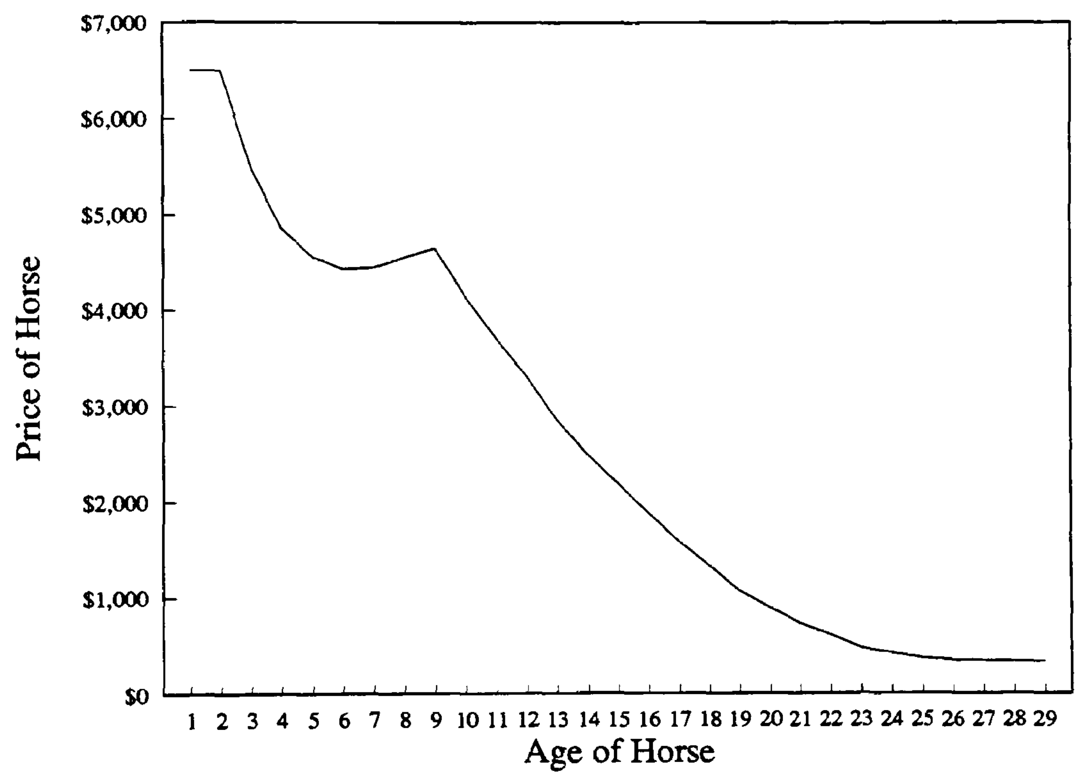

Figure 7. Estimated average age-price profile for starting thoroughbred colts/stallions.

If retirements are disregarded, an equivalent economic life for starting thoroughbred colts/stallions of 17.6 years is obtained. However, a finite equivalent economic life that accounts for the gains and losses incurred by taxpayers upon retirement of the horses cannot be obtained: with depreciation deductions set to zero, the present value of the loss deductions derived solely from the retirement of colts/stallions is 0.7012, which exceeds the present value of economic depreciation. Further "negative depreciation allowances" would be required to equate the present value of tax deductions with the present value of economic depreciation. This result, when combined with the equivalent economic life formula, implies that thoroughbred colts/stallions should not be treated as depreciable property. The problem arises due to the significant appreciation in the value of the very successful stallions and to the relatively rapid retirement of these horses over the first decade of economic life, despite the fact that only about seven percent of the starting colts ultimately belong in this category.[13]

D. The Treatment of Appreciating Assets

The determination of class lives using the formula of the *General Explanation of the Tax Reform Act of 1986* merits special attention in the case of assets such as very successful colts/stallions that appreciate over a portion of their useful lives. Although economic depreciation, which is simply the negative of the change in value of a depreciable asset during the year, may be negative as well as positive, tax policy considerations may require a distinction be made in the two cases. In the context of the equivalent economic life formula, negative economic depreciation may be viewed as giving rise to an effective tax on the taxpayer's accrued, but unrealized, holding gains. This is reflected in the fact that the asset's equivalent economic life in such cases is typically much greater than its useful life. Although this is simply the converse of allowing taxpayers to claim a depreciation deduction for their accrued but unrealized losses when their assets decline in value, it is not clear that such treatment reflects Congressional intent.

It clearly is not appropriate for taxpayers to effectively claim depreciation deductions during that period when their asset is appreciating in value. On the other hand, under current law, which looks to industry-wide or asset-wide evidence in the determination of a class life, to deny depreciation deductions for an asset such as a horse, which has a finite useful life, may also be viewed as inappropriate (even if the period over which any specific asset is retained by a given taxpayer may not be ascertainable).[14] The legislative history indicates that both the anticipated decline in the value of the asset (its "economic depreciation") and its anticipated useful life should be considered in the determination of its class life. The Depreciation Analysis Division generally views the asset's decline in economic value to be the more important factor, but this position may not be tenable when, as in the case of colts/stallions, an equivalent economic life based on the decline in economic value is so different from the asset's useful life.

An alternative approach, which shall be followed in this study, is to treat the value of the very successful stallions as equal to their initial value until their estimated price finally declines below the initial value. More specifically, in applying the formula of the *General Explanation* to thoroughbred colts/stallions, the economic depreciation of the very successful stallions is taken to be zero between ages 2 and 23. When this is done, the average age-price profile of thoroughbred colts/stallions is that shown below in Figure 8. The cusp-like behavior present in Figure 7 is absent, and the resulting present value (as of the date of acquisition) of economic depreciation is 0.7570.

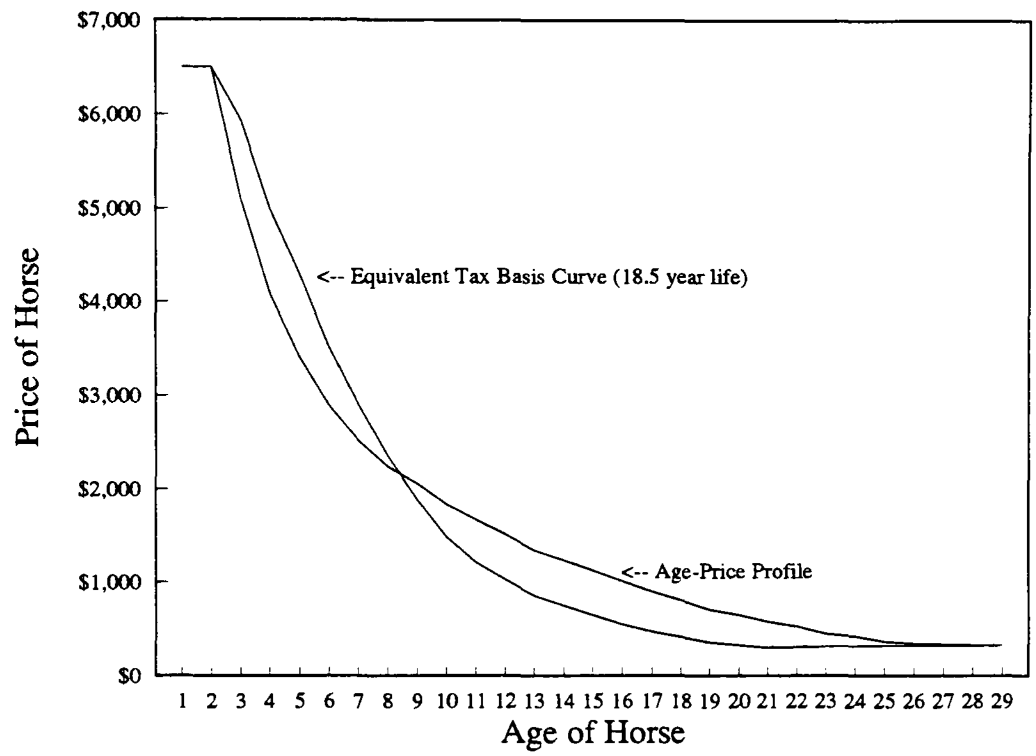

Figure 8. Average age-price profile for starting thoroughbred colts/stallions, ignoring the appreciation in value of the very successful stallions, and the corresponding average equivalent tax basis curve derived from an equivalent economic life of 18.5 years.

If asset retirements are taken into account, an equivalent economic life for starting thoroughbred colts/stallions of 18.5 years is obtained. The corresponding average equivalent tax basis curve is also shown in Figure 8. Finally, if both retirements and the appreciation in the value of the very successful stallions are ignored, the equivalent economic life is 9.3 years.

E. The Equivalent Economic Life of Thoroughbred Fillies/Mares

The determination of the equivalent economic life of thoroughbred fillies/mares introduces an additional complication: a fraction of broodmares are sold at auction at varying ages The availability of such market data, however, makes the estimation of their age-price profile somewhat more direct. Even in this case, though, the value of the mares must be inferred. Most broodmares sold at auction are believed to be in foal, and the price paid must thus be allocated between the potential future weanling and the mare itself.[15] In order to do this, the ratios of the average value of a weanling sired by the same stallion believed to have covered the mare, to the price of the mare in foal, were examined for a sample of about 250 mares sold at auction in 1988.

From these data, it is found that the average price of a weanling sired by the same stallion that covered the broodmare is about 43 percent of the average price of the broodmare. As noted, Hollingsworth's data indicate that live foals are produced by about 69 percent of all active seven-year old broodmares (this fraction declines with the age of the broodmare). It may thus be inferred that the value of the broodmare alone is about 70 percent (1.0 - (0.69)(0.43)) of the sales price of the broodmare. This fraction shall be used over the entire economic life of the broodmare, which tends to understate the value of the broodmare.

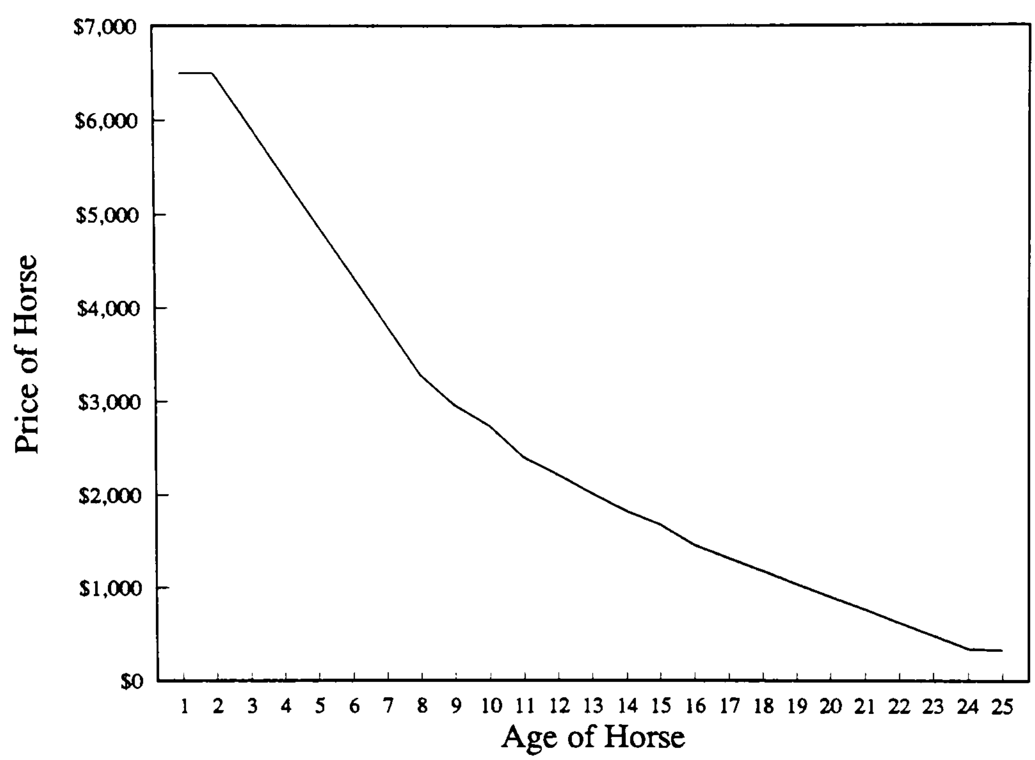

Figure 9. Age-price profile for unretired starting thoroughbred fillies that are subsequently used for breeding stock.

From a sample of about 200 broodmares sold at auction in 1988, the price of a seven-year old broodmare is about 72 percent of the average price paid six-years earlier for female yearlings sired by the same stallion that covered the mare, when adjusted for inflation. The average price of a seven-year old broodmare alone is thus estimated to be about 50 percent of its initial price as a yearling (0.70×0.72).

By regressing the auction prices of broodmares sired by a given stallion against the age of the broodmare, it is also found that the value of a broodmare (adjusted for inflation) declines with age from age seven (initially at about seven percent per year). In performing the regression, the prices of about 175 broodmares sired by some of the most prolific stallions were examined. In this study, the value of a broodmare is assumed to decline even faster: first by a uniform six percent per year, and then by a second factor reflecting the decline in fertility of broodmares with age, as determined from the Hollingsworth data. This procedure results in an average rate of decline in the price of unretired broodmares in excess of 12 percent annually.[16]

The resulting age-price profile for those fillies that are ultimately used for breeding (67 percent of the starting fillies) is shown in Figure 9. A linear decrease in value between ages two and seven is assumed. As in the case of thoroughbred colts, the average age-price profiles of the 33 percent starting fillies that are not subsequently used for breeding are assumed to decline in a linear fashion. Paralleling the treatment of stallions, a fraction of those mares that are used for breeding are assumed to retire at varying ages, as determined from the statistics given in the Hollingsworth study on the ages at which broodmares produce their last foal. It is likewise assumed that, when a broodmare is retired, taxpayers claim a loss (or gain) on the difference between their adjusted tax basis for the horse and its assumed $325 salvage value.

The estimated average age-price profile for the overall mix of starting racing fillies and broodmares is shown in Figure 10. The resulting economic depreciation has a present value (using a real 4 percent discount rate and a mid-year discounting convention) of 0.7569. Taking into account the gains and losses incurred by taxpayers upon the retirement of their horses, an equivalent economic life for thoroughbred fillies/mares of 12.0 years is obtained. As in the case of the geldings (but in contrast to that of colts/stallions), the equivalent economic life for fillies/mares is not much greater than their average useful life (11.0 years). Furthermore, if the taxpayer's retirement gains and losses are ignored, the equivalent economic life is 9.3 years.

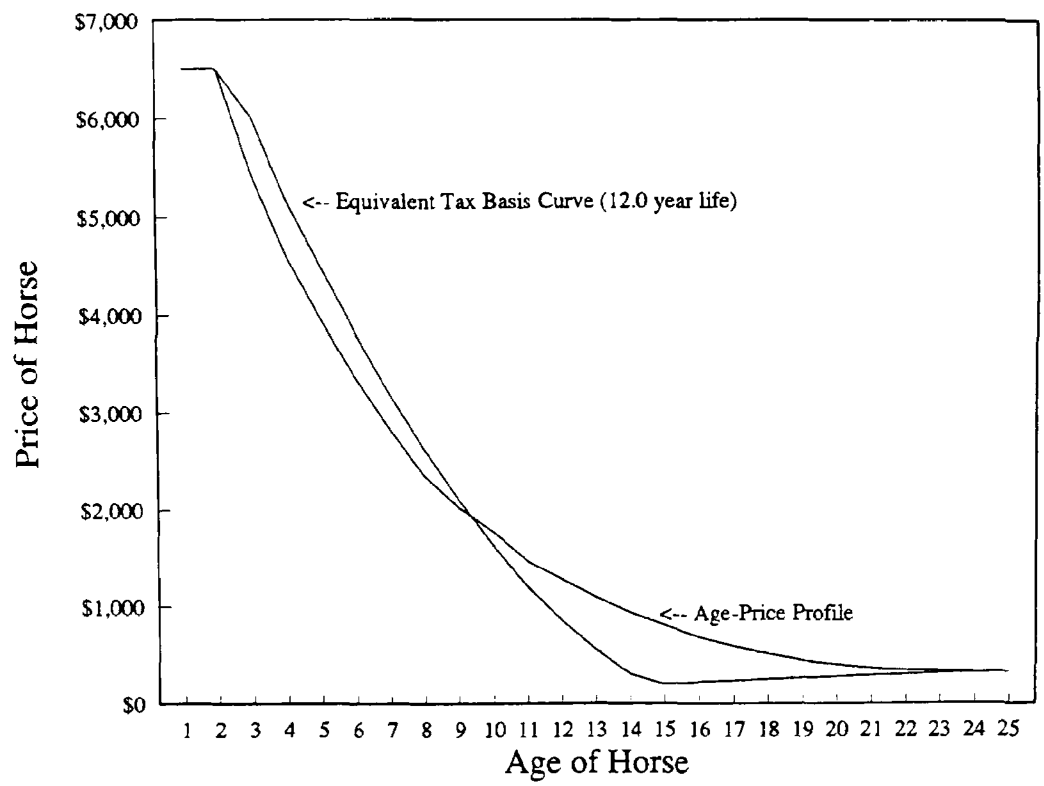

Figure 10. Average age-price profile for starting thoroughbred fillies/mares, and the corresponding average equivalent tax basis curve derived from an equivalent economic life of 12.0 years.

F. The Equivalent Economic Life of All Thoroughbreds

The data presented in the Hollingsworth study, when used in conjunction with public auction data, has allowed the equivalent economic lives of thoroughbred geldings, colts/stallions, and fillies/mares to be separately determined. The 6.9 year equivalent economic life of geldings, whose business use is confined to racing, is much shorter than that for colts/stallions and fillies/mares (18.5 years and 12.0 years, respectively, if the appreciation in the value of the very successful stallions is neglected).

Although it is possible to establish separate asset classes for each type of horse, the use of a single combined asset class (as under current law) would result in a less complicated asset classification system. Since many taxpayers own both male and female horses for business use, an average class life based on the economics of horses of both sexes should not unduly disadvantage one group of taxpayers over another. In determining the combined equivalent economic life for all thoroughbreds, it is appropriate to weight the present values of economic depreciation for each type of horse by the relative level of investment in that type of horse. As noted, the auction data indicate that the average price of male yearlings is 16 percent greater than that of female yearlings. When this factor is used to adjust the relative numbers of horses of each type, a single weighted average present value is obtained by:

(3) $Wtd\_Avg\_PV = .3946PV(g) + .1398PV(c/s) + .4656PV(f/m).$

Inserting the present values of economic depreciation for geldings, $PV(g)$, colts/stallions, $PV(c/s)$, and fillies/mares, $PV(f/m)$, into Equation (3) yields an investment-weighted present value of economic depreciation of 0.7762 if the appreciation in the value of the very successful stallions is ignored, and 0.7624 if it is not. Equating these present values to those for straight-line depreciation leads to an overall equivalent economic class life for all starting thoroughbreds of 10.6 years if the appreciation in value of the very successful stallions is ignored, and 12.7 years if it is not. These results take into consideration the gains and losses incurred by taxpayers on the retirement of their horses. Figure 11 below shows the corresponding estimated average age-price profile and the average equivalent tax basis curve for all starting thoroughbreds. In this illustration, the appreciation in the value of the very successful stallions is ignored. The 10.6 year equivalent economic life is not much greater than the current 10 year class life for work and breeding horses. In contrast to current law, however, this estimated life applies to all starting thoroughbreds.

A 10.6-year equivalent economic life is, of course, an average. Short-lived horses -- principally those that will not subsequently be held for breeding -- would be almost entirely retired before being fully depreciated, according to the available data. The present value of the deductions for such horses would be less than the present value of their economic depreciation. Breeding stock, on the other hand would tend to have useful lives that extended well beyond the tax depreciation period. These horses, therefore, would be treated relatively favorably. It would be possible, (but not necessarily desirable) to establish two classes -- distinguished by the horse's breeding status. For example, it would be straightforward to establish a separate category for geldings having a class life that reflected the 6.9-year equivalent economic life found for such horses. This would necessitate a longer class life for the remaining horses. An analysis of such horses yields an equivalent economic life of 12.8 years for non-gelded thoroughbreds, if we neglect the appreciation of very successful stallions, and 16.6 years, if that appreciation is taken into account.

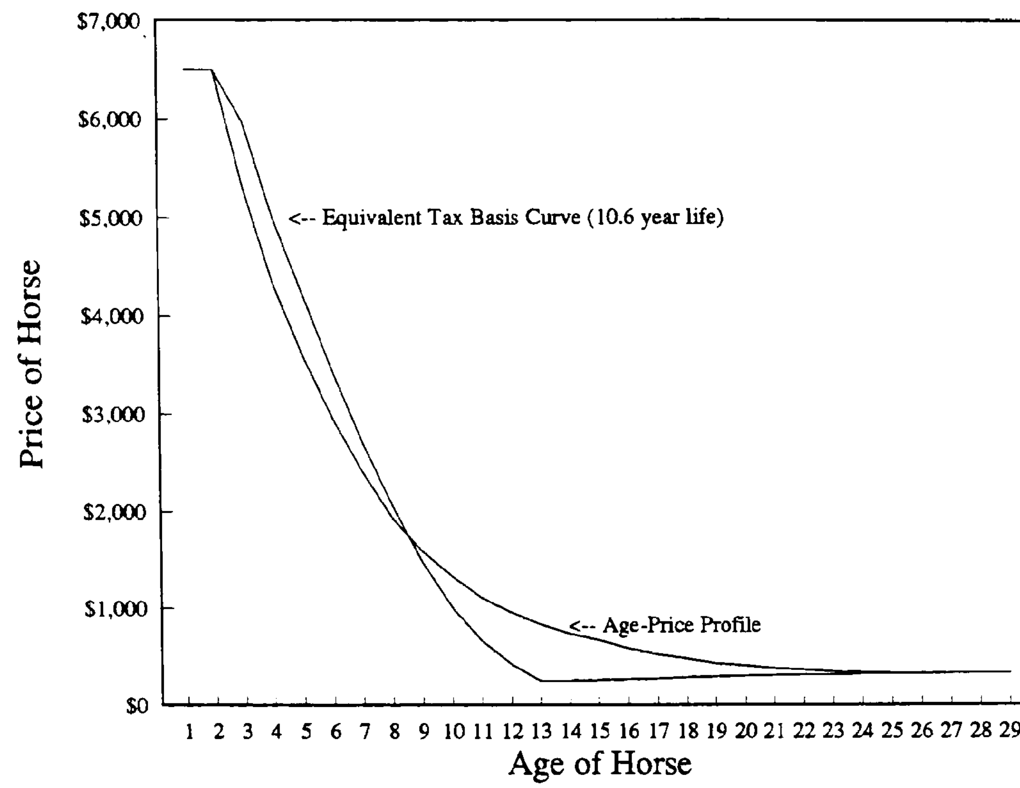

Figure 11. Average age-price profile for all starting thoroughbreds, with neglect of the appreciation in the value of the very successful stallions, and the corresponding average equivalent tax basis curve derived from an equivalent economic life of 10.6 years.

Establishing a second asset class that included all horses not eventually held for breeding would be much more complicated. This would require the classification of horses into breeding and non-breeding horses *at the time the horse is placed in service*. To prevent abuse, severe penalties would have to be created for later changing a horse's status from "non-breeding" to "breeding". Not only would adherence to this scheme place severe restrictions on horse owners, there is a question of whether such a classification system could be implemented properly and enforced. In any case, analysis yields an equivalent economic life of 6.4 years for "non-breeding" horses and 15.1 years for "breeding" stallions and mares. If the appreciation in value for certain stallions is included, this latter figure increases to 20.5 years.

The thoroughbred results are summarized in the table below.

Thoroughbred Results

(Lives are expressed in terms of years)

Category	Useful Life	Equivalent Economic Life (Includes the effects of retirements): Disregarding the Appreciation of Stallions	Equivalent Economic Life (Includes the effects of retirements): Including the Appreciation of Stallions
Geldings	6.6	6.9	6.9
Colts/Stallions	7.9	18.5	Not Computed
Fillies/Mares	11.0	12.0	12.0
Non-gelded Horses	10.3	12.8	16.6
"Breeding" Horses	14.3	15.1	20.5
"Non-breeding" Horses	5.8	6.4	6.4
All Horses	8.8	10.6	12.7

Chapter IV. The Implications of the Sale of Older Horses

The previous analysis has been based on the assumption that horses are acquired as yearlings, and are held by their owners until retired from racing or, if used for breeding, until retired from the breeding stock. The assumption that horses are acquired as yearlings appears to be reasonably validated by the auction records. *The Blood Horse* (January, 1989) indicates that 9,083 yearlings were sold at auction in 1988, while only 1,362 weanlings and 3,645 two-year olds were sold. Moreover, since depreciation cannot generally be claimed until the horse is at least two years old, the fact that some horses are acquired as weanlings or two-year olds should not appreciably affect the calculations of their equivalent economic lives. This is so despite the fact that the price paid for a weanling is expected to be lower than that paid for a yearling, and likewise the price paid for a two-year old is expected to be higher than that for a yearling. While the average 1988 auction price for weanlings was $16,044, which is about half of the $31,250 average for yearlings, the average price for two-year olds was only $16,464. This suggests that horses offered for sale as two-year olds may not be as promising as those retained by their owner. This problem, which has been discussed by Ackerlof (1970), is not an easy one to resolve. Although their lower auction prices make it likely that the equivalent economic lives of horses acquired as two-year olds may be somewhat shorter than the equivalent economic lives of horses acquired as weanlings or yearlings, the fact that the Hollingsworth data do not distinguish horses acquired as two-year olds from other horses precludes any detailed examination of this issue.

The fact that horses acquired as two-year olds may have different useful lives than those acquired at earlier ages is not, however, the issue that has concerned the horse industry. Rather, it is the problem of older horses that has long been of interest to this industry. Under the "facts and circumstances" depreciation system in effect prior to the Economic Recovery Tax Act of 1981, the period over which an asset was intended to be used by the taxpayer (its "useful life") determined its depreciation period (its "service life").[17] Because older horses are not expected to be used over as long a period as younger horses (their "useful life" is clearly limited by their mortality), the horse industry has long believed that the recovery period allowed for older horses should be much shorter than that for younger horses.

Based on the results of his study, Hollingsworth proposed special treatment for older horses. More specifically, he suggested that for racehorses acquired as a weanling or yearling, a five-year useful life be used for colts and fillies, and a six-year useful life for geldings. However, he also suggested that these useful lives generally be reduced by one year for each year of the horse's age (above the age of one) at which it was placed in service as a racehorse. Likewise, he suggested a useful life of 10 years for thoroughbred breeding stock placed in service before the horse is seven years old, and that this life also generally be reduced by one year for each year of age (in excess of six years) at which the horse is placed in service. As noted, current tax law reflects this suggestion to a limited extent by assigning a three-year recovery period to any horse (other than a racehorse) that is placed in service when more than 12 years of age.

Although the remaining useful life of nearly all depreciable assets (including horses) generally declines by one year with each year of the asset's life, it does not necessarily follow that its equivalent economic life behaves in a similar fashion. Nor does it necessarily follow that separate asset classes should be established for assets differing only by age. If (as appears to be the case for horses) only a modest fraction of used (older) assets are acquired, it is administratively convenient to factor the relative investment in these used assets into the calculation of a single class life for all assets of that type, regardless of their age when acquired. To do otherwise for all assets would require enlargement of the approximately 125 existing asset classes by a factor of perhaps 25 or more.

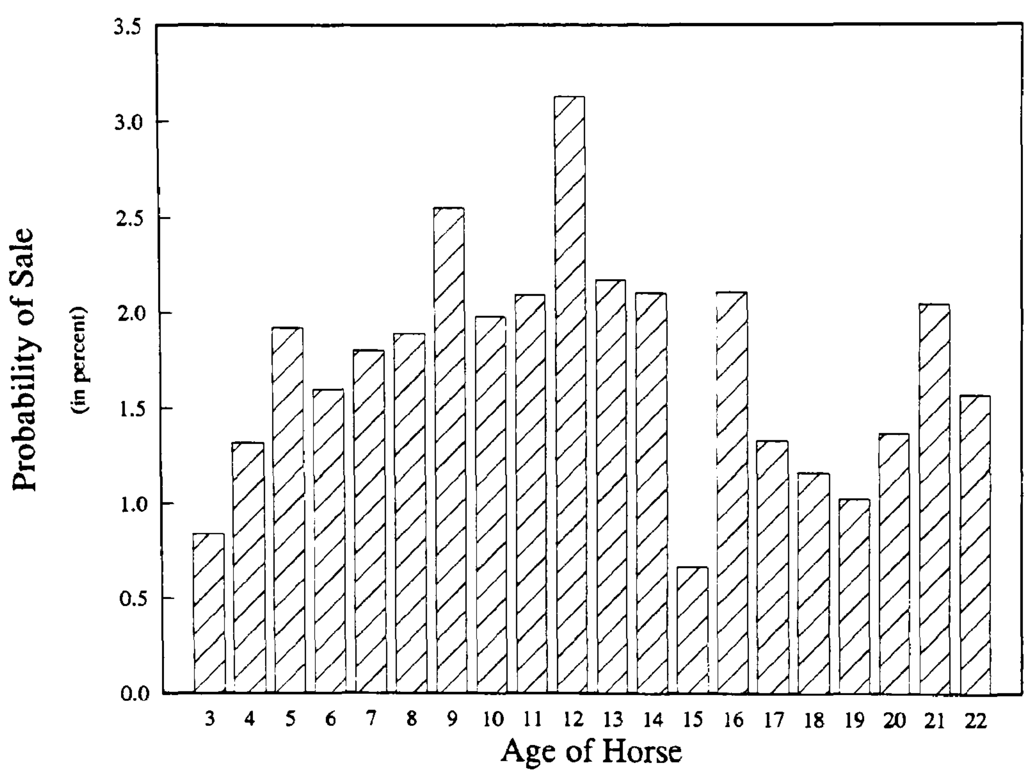

Figure 12. Estimated probability of an auction sale of thoroughbred broodmares as a function of the age of the broodmare.

While shares in a limited number of older stallions are sold at public auction (shares in 200 stallions were sold in 1988), only older broodmares appear to be sold at public auction in appreciable numbers (5,746 in 1988).[18] These mares represent less than 10 percent of all active thoroughbred broodmares (which, for 1985, are estimated by the American Horse Council to total about 65,000). Based on an analysis of the ages of a random sample of 250 broodmares sold at auction in 1988, the probability of an active broodmare being sold at any given age is shown in Figure 12. In obtaining this probability distribution, the growth in the numbers of yearlings registered each year, the relative numbers of the female yearlings that are ultimately used for breeding, and the fraction of broodmares that remain active at each age (as inferred from the Hollingsworth data on the ages at which broodmares produce their last foal) have all been considered. From Figure 12, it appears that broodmares are sold at all ages, rather than only when they have completed their racing career and are being converted into breeding stock.[19]

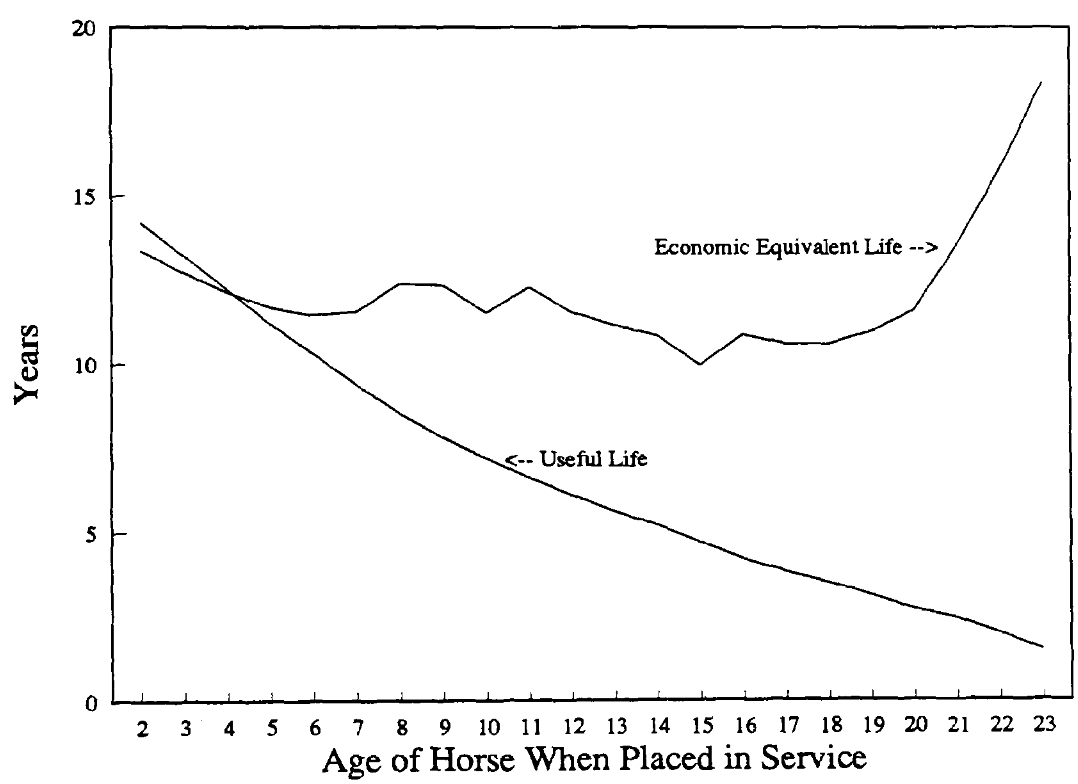

Figure 13. Equivalent economic life and useful life of a thoroughbred broodmare as a function of the age of the mare when placed in service.

Even though the level of investment in broodmares may not be sufficient to warrant the establishment of separate asset classes for horses placed in service at each age, the potential impact of these horses on the overall class life merits examination. The estimated useful lives and equivalent economic lives of thoroughbred broodmares acquired at ages two to twenty-three are shown in Figure 13. It may be noted from this figure that, while the useful life declines monotonically with the age in which the broodmare is placed in service, the equivalent economic life does not exhibit any particular trend. Indeed, it tends to *increase* at higher ages. This is due to the increasing importance of the salvage value relative to the acquisition cost for older horses. This salvage value provides a "floor" for the price of the horse, and thus limits the rate of economic depreciation. While alternative assumptions regarding the salvage value might lead to a decline of equivalent economic lives of thoroughbred broodmares with their age when placed in service, neither the existing evidence regarding the relative levels of investment in older horses nor the speed of the decline in their equivalent economic lives provide compelling evidence for modification of the overall 10.6-year equivalent economic life noted earlier for all thoroughbreds.[20]

Chapter V. Conclusion and Recommendations

The analysis has so far focused solely on the useful lives and equivalent economic lives of thoroughbreds. However, *The Blood Horse* (January, 1989) reports that about $532 million was spent in 1988 on the acquisition of thoroughbred weanlings, yearlings, two-year olds, and broodmares through sales at public auction. *The Harness Horse* (February, 1989) indicates that about $83 million was spent on auction sales of harness horse yearlings, and perhaps another $350 million was invested in 1988 on all other business-use horses. Because investment in thoroughbreds thus appears to account for over half of the total investment in business horses, the picture obtained from the study of this single breed may be reasonably representative of that for all breeds combined.[21]

Other information obtained indicates that the useful lives of horses generally do not exceed 16 years, but does not otherwise provide evidence on either average useful lives nor average equivalent economic lives. This information includes a letter from Mr. Peter Ruhlen, president of the Ruhlen Agency, Inc., which is considered to be the largest all-breed insurance underwriter in North America. The letter indicates that the Ruhlen Agency does not generally insure any horses over 16 years of age, and that the Ruhlen Agency has developed information indicating that a horse's productive life ends at 16. Another letter, from Mr. John Darnell, vice president of the First National Bank of Louisville, states that his bank feels comfortable financing broodmares, or using broodmares as collateral, up to the age of 16. For horses as old as 18 years of age, the bank takes precautions to minimize its risk.

This study shows that the current law distinction between racehorses and horses used for work or breeding is at variance with the general criteria established by the 1986 Act for determining class lives. It also shows that the equivalent economic lives of older broodmares fail to decline with age, and that the frequency of their purchase fails to support the establishment of a separate asset class for older horses.

This study finds that the average useful life of thoroughbreds is 8.8 years, and their average equivalent economic life is 12.7 years, by using the straightforward application of the *General Explanation* method. If, however, the appreciation in horse values is ignored, then this method yields an average equivalent economic life of 10.6 years. These lives appear to also represent reasonable approximations to the economic lives of other breeds of horses. An argument for creating multiple horse classes to reflect the diversity of actual useful lives does not seem compelling in light of the added complexity such classes would create. Thus, the Treasury Department recommends that the current five MACRS asset classes for horses (01.221, 01.222, 01.223, 01.224, and 01.225; see Rev. Proc. 88-22) be combined into a single class, and that the current 10-year class life for asset class 01.221 (any breeding or work horse that is 12 years old or less at the time it is placed in service) be assigned to the single new asset class. This would result in a seven-year MACRS recovery period for all horses. Treasury also recommends repeal of the current law assignments of a three-year MACRS recovery period for racehorses placed in service after two years of age and for horses other than racehorses that are more than 12 years old when placed in service.

These conclusions may, at first glance, appear unduly harsh, since only a limited fraction of all horses acquired for business purposes become very successful racehorses, or are used for breeding. Yet it is the prospect of such success that provides the incentive to invest. The increased value of these more successful horses, on average, roughly offsets their smaller numbers. Focusing only on less successful horses, as suggested by the American Horse Council, while allowing a depreciation pattern more closely matching the experience of the majority of horses, would be inconsistent with the basic economics of the horse industry.

Appendix

Exhibits Related to the Congressional Mandate

<u>Exhibit 1</u>

Section 168(i)(1)(B) of the Internal Revenue Code as Revised by the Tax Reform Act of 1986

(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.

<u>Exhibit 2</u>

Section 168(i)(1) of the Internal Revenue Code as Revised by the Technical and Miscellaneous Revenue Act of 1988

(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 the Treasury 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 a class 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 a class 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 life if 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.

Notes

1. Although the conventional age of a horse is usually derived from a fictional January 1 birthdate, the current classification of horses for depreciation purposes is dependent upon on their true ages. The analysis contained in this report, however, uses data which is based on the conventional age classification of horses. Thus, a horse classified as a "two-year old" can have an actual age between one and three years.

2. See the discussion between Senators McConnell, Ford, and Packwood, as reported in the Congressional Record of September 27, 1986 (p. S13953).

3. It is possible that retirements will result in *additions* to income where salvage value is a significant factor. This is particularly true for retirements that occur after the asset group has been fully depreciated for tax purposes. Such gains are treated as negative deductions.

4. The American Horse Council points to information from *The Blood Horse's Stallion Register for 1988* , which indicates that about 67 percent of the thoroughbred stallions listed are owned by a syndicate, and 33 percent are owned by an individual or farm. From these statistics, they conclude that the ownership of perhaps 75 percent of these stallions may have been transferred at the conclusion of their racing career. Unfortunately, their data do not indicate the fraction of ownership retained by the owner(s) of the racehorse, nor when the transfer took place. As noted in note 18 below, information from auction sales of stallion shares suggest that these caveats may be important. Even if the 75 percent figure were accepted, it would imply that, under current law, the owners of 25 percent of the more successful stallions could fully depreciate their horses over a three-year recovery period, despite their continued value for breeding purposes. Moreover, the establishment of a single asset class for all horses would not necessarily be inequitable even to those owners that actually sell their horses when their racing careers are over. As shown in Figure 6 and Figure 9, the average decline in value of such horses is not expected to be as rapid as the 200 percent declining balance depreciation over a seven-year recovery period allowed for assets with a 10-year class life In any case, the greater allowances that might otherwise have been claimed would have been recaptured when the horse was sold.

5. In particular, the American Horse Council believes this study should only cover racehorses (and not breeding and workhorses), objects to the inclusion in this study of data relating to the very successful horses (which they believe do not comprise more than a small fraction of the total population of racehorses), believes that the ability of taxpayers to claim a loss on the disposition of their horses should not be factored into the calculation of an equivalent economic life for horses, and in general believes that the depreciation of horses cannot be studied by an approach of the type used for other assets, because horses are considered too unlike all other assets. For the reasons noted in the text, the Depreciation Analysis Division does not concur with these views.

6. The American Horse Council argues that the presumed short economic life of the 40 percent of the thoroughbred foals that do not start should be considered in determining the useful life of a racehorse. (They also provide information that a correspondingly large fraction of standardbred foals do not start). The Depreciation Analysis Division believes, however, that only assets for which depreciation may be claimed should be considered when estimating appropriate class lives. Unfortunately, a breakdown is not available between those horses that are trained for racing (and are thus placed in service) but do not start, and those that are not placed in service. To the extent that the non-starters are depreciable business assets with relatively short lives, the useful lives reported in this study are somewhat overstated.

7. The American Horse Council believes that the fact that a mare produced a single foal does not necessarily indicate that the mare is being used for breeding purposes. Likewise, it does not believe that the fact that a stallion sired five foals in its lifetime does not necessarily imply that the stallion is being used for breeding. In their view, only about 5 percent of all thoroughbred males, 3 percent of standardbred males, and about 13 percent of quarterhorse males ever become breeding stallions.

They admit that a higher percentage of fillies become mares (they provide information showing that about 70 percent of all quarterhorse fillies and somewhat less than one-half of all standardbred fillies become mares), but also note that many mares produce relatively few foals. Unlike the statistics calculated by the Depreciation Analysis Division for thoroughbreds, the percentages suggested by the American Horse Council are not adjusted to reflect the fact that a significant fraction of foals do not start, and it is generally only those that do that are subsequently used for breeding purposes.

8. The American Horse Council believes that very few horses would be allowed to continue to race long after their last winning race.

9. The American Horse Council believes that it is more appropriate to assume that the salvage value is independent of the initial value of the horse (although it does not suggest what this value might be). As noted in the text, the primary motivation for the assumption of a fractional salvage value was the desire to be able to express the resulting economic depreciation as a fraction of the initial investment. The Depreciation Analysis Division does not believe that the use of an independent salvage value would have a significant effect on the calculated equivalent economic lives. Indeed, setting salvage to zero lowers the estimated equivalent economic life for thoroughbreds by less than one-half year.

10. A half-year convention was employed in applying the straight-line formula, i.e., the first year's deduction was set equal to one-half of the full straight-line deduction. In addition, the initial year's depreciation and loss deductions were each discounted by a half-year discount factor.

11. The American Horse Council believes that guaranteed breeding fees are less common than assumed, which suggests that the imputed value of the stallions may be somewhat overstated, and thus the calculated equivalent economic life also somewhat overstated.

12. The data on number of foals sired were first regressed against age in order to obtain a smoothed fertility-age curve.

13. Compare the retirement distribution shown in Figure 2 with those of Figures 1 and 3.

14. Of course, even if no depreciation is allowed, the taxpayer can recover his investment by claiming a loss upon the asset's retirement.

15. The American Horse Council believes that many fillies are bought off the track for breeding, and are thus not in foal. Since in this study a portion of the value of the mare is assumed to be allocated to the foal, to the extent this need not be done, the calculated values of the mares are understated, and the resulting equivalent economic life also understated.

16. The Hollingsworth data show a decline in fertility to age 16 and then a small general upward trend throughout the remaining life. This increase in fertility was ignored in the calculation of the age-price profile.

17. For a more detailed discussion of the pre-1981 "facts and circumstances" depreciation system and the concept of useful lives then in effect, see for example, Brazell, Dworin, and Walsh (1989).

18. Since the ownership of a stallion may be divided into as many as 40 shares, and on average only one or two shares in each horse was sold at auction, even the sale of shares in 200 horses represents only a very small transfer of ownership in breeding stallions. It might also be noted that these 200 horses were of varying ages, with an average age of 13.5 years. See note 4 above, however, for a contrary view of the extent to which racehorses are sold at the end of their racing career.

19. Notice, however, that the data in Figure 12 imply that only about one-third of all sales of broodmares occur at ages 3 or above.

20. The level of investment in older broodmares is not negligible. In 1988, thoroughbred broodmare auction sales totaled about $166 million out of a total of $532 million in auction sales of all thoroughbreds. Because their salvage value does not decline appreciably with age, however, only broodmares placed in service at 15 years of age or older have an equivalent economic life appreciably lower than the 12.4-year life noted for a yearling, as shown in Figure 13. As may be seen from Figure 9, the estimated price of such broodmares is much lower than for younger broodmares. Thus, when weighted by the level of investment, the contribution of these much older broodmares to the overall equivalent economic life of all thoroughbreds is quite small.

21. The American Horse Council suggests that some other breeds of horses, such as standardbreds and quarterhorses, may have somewhat shorter economic lives than thoroughbreds.

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Acknowledgements

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Department of the Treasury
Washington, D.C. 20220

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Widely Held Partnerships: Compliance and Administration Issues

A Report to The Congress

Department of the Treasury
March 1990

DEPARTMENT OF THE TREASURY
WASHINGTON

March 1990

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

Dear Mr. Chairman:

Enclosed is a study of the compliance and administrative issues posed by publicly traded and other large partnerships. The study is required by section 10215 of P.L. 100-203, the Omnibus Budget Reconciliation Act of 1987, and has been prepared jointly by the Treasury Department and the Internal Revenue Service. The study concludes that the requirements of current law, as they apply to large partnerships, their partners and the Service, are overly complex and inefficient and that a new system to address these concerns is warranted. It is strongly believed that such a new system will significantly benefit all parties.

A copy of the study and a similar letter are being sent to Representative Bill Archer.

Sincerely,

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Fred T. Goldberg, Jr.
Commissioner
Internal Revenue Service

DEPARTMENT OF THE TREASURY
WASHINGTON

March 1990

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

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CONTENTS

SECTION I. INTRODUCTION

Section 10215 of the Omnibus Budget Reconciliation Act of 1987 directs the Treasury Department to conduct a study of (1) the issues of treating publicly traded limited partnerships (and other partnerships which significantly resemble corporations) as corporations for federal income tax purposes, including disincorporation and opportunities for avoidance of the corporate tax, and (2) the issues of compliance and administration with respect to publicly traded partnerships and other large partnerships.

This report, which is the product of a joint Treasury and Internal Revenue Service study, addresses the second set of issues in the requested study. It describes the compliance by and administration of widely held partnerships under current tax law, and discusses the problems faced by the Internal Revenue Service (the "Service" or "IRS") in monitoring compliance, determining additional tax due, and collecting tax deficiencies attributable to such partnerships and their partners. It concludes that the requirements of current law, as they apply to widely held partnerships, their partners and the Service, are overly complex and inefficient and that a new system to address these concerns is warranted. It is strongly believed that such a new system will significantly benefit all parties.

The report first sets forth the Treasury's analysis of the existing situation, and the reasons to provide new procedures in order to insure collection of tax attributable to the partners who are members of widely held partnerships.[1] The report then recommends the adoption of a new administrative system, applicable only to widely held partnerships. In general, the term "widely held partnership" would include partnerships with 250 or more partners, except for service partnerships such as accounting or law partnerships. See Section VII of this report for a more complete discussion of the definition of a widely held partnership. This report also discusses matters relating to withholding at the widely held partnership level, but does not recommend such withholding at this time. In addition, the report includes as Appendix I proposed revisions to the unified partnership audit rules applicable to all partnerships with more than 10 partners.[2]

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[1] The Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203 (the "1987 Revenue Act"), added section 7704 to the Internal Revenue Code of 1986, as amended (the "Code" or "I.R.C."). Section 7704 treats certain publicly traded partnerships as corporations for federal income tax purposes. This report discusses the administrative treatment of widely held partnerships that are not treated as corporations for federal income tax purposes.

[2] I.R.C. §§ 6221 et. seq. The unified partnership audit rules also apply to certain partnerships with 10 or fewer partners.

The proposed administrative system for widely held partnerships would have two principal features. First, widely held partnerships would use a simplified system for reporting income to the Service and partners. The current Schedule K-1 reporting form would be replaced by a new Form 1099-K on which widely held partnerships would report certain specified and limited information. Elections now made by partners would be made at the partnership level. Rules applicable in calculating taxable income, such as limitations on certain deductions, would be applied at the partnership level wherever possible. Transmissions to the Service would be made by magnetic media. The second principal feature of the system would be a consolidation of the tax audit and administration procedures at the partnership level, including payment of any tax deficiencies, interest and penalties at the partnership level.

Because of the administrative difficulties currently posed by widely held partnerships, it is reasonable to conclude that there may be significant loss of revenue to the government. This revenue loss is partially attributable to income reported by the partnership which is not included on a partner's return, whether through inadvertence, confusion, or conscious failure to report income. The revenue loss is also partially attributable to the underreporting of income by the partnership itself. We do not believe that clearly erroneous reporting positions are commonly taken by large partnerships. However, to a significant degree, our voluntary reporting system anticipates an adversarial relationship between taxpayers and the Service. A taxpayer may report a transaction or event as he or she deems appropriate and, if the Service disagrees with the taxpayer's analysis, the Service has the right and obligation to challenge the taxpayer's position. The unwieldy administrative rules currently applicable to widely held partnerships make it difficult for the Service to fulfill this role, and hampers the proper functioning of the voluntary reporting system.

It is reasonable to assume that the government will receive increased revenue as a result of a simplified reporting system and more efficient rules governing audits of widely held partnerships. We estimate that implementation of a new reporting system with respect to partnerships with 250 or more partners would raise between $85 million and $140 million over a five-year period, and implementation of a streamlined audit and assessment proposal would raise between $100 million and $200 million over a five-year period.

Moreover, apart from revenue considerations, there are sound tax policy reasons to alter the tax administration system with respect to widely held partnerships. Current law and procedures were developed in an era when partnerships were generally relatively small, and, to a significant degree, these procedures treat partnerships as aggregations of individual taxpayers. This approach makes little sense in an era where partnerships may have 500, 1,000, or an even larger number of partners. An individual partner's relationship to the partnership is similar to that of a shareholder to a large corporation. We do not assert that widely held partnerships should be taxed as corporations; however, we do believe that today's large partnerships represent a new type of entity that requires a new set of rules. These rules should be grounded on the similarity between widely held partnerships and corporate entities, and the need to achieve efficient administration. Like corporations, widely held partnerships should use a simplified system for reporting to the Service and their partners, and audits and assessments of deficiencies should be conducted at the entity level.

SECTION II. THE GROWTH OF WIDELY HELD PARTNERSHIPS

In recent years, the number of widely held partnerships has significantly increased. In 1978 some 671 partnerships had 500 or more partners; by 1987 the number had grown to 1,735. The greatest portion of the increase was attributable to partnerships with over 1,000 partners, the number of which grew from 288 in 1978 to 1,224 in 1987. During this period, there was a corresponding increase in the percentage of partners who held their interests in large partnerships. In 1978 only 15.1 percent of all partners held their interests in partnerships with 500 or more partners; by 1987 this percentage was 46.9 percent. Again, most of this growth was attributable to partnerships with 1,000 partners or more, which accounted for 44.6 percent of all partners in 1987, nearly four times the figure of 10.8 percent in 1978. Although comparable 1978 numbers are not available, in 1987 there were 3,459 partnerships with 250 or more partners accounting for 50.4 percent of all partners and 6,845 partnerships with 100 or more partners accounting for 53.2 percent of all partners in 1987.[3]

In 1987, sales of publicly offered partnership interests reached record levels.[4] Although sales since 1987 have declined sharply, they still are substantial in terms of dollars. Sales of partnership interests in public offerings, including traded and untraded interests, declined 44 percent from 1987 to 1989 and publicly traded interests in master limited partnerships declined a substantial 79 percent ($2.9 to $.6 billion). Total sales of all such partnership interests were $13.5 billion for 1987 and $7.6 billion for 1989.[5] Despite the decline in the rate of growth, sales of this magnitude will continue to materially increase the growing number of large partnerships.[6]

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[3] Internal Revenue Service, Statistics of Income--Partnership Returns: 1978 and 1980. 1987 figures from unpublished IRS data.

[4] *See* "Record Public Partnership Sales in 1987" The Stanger Register, February 1988, p. 13.

[5] *See* Table 1 "Public Partnership Sales" for 1988-1989 The Stanger Register, February 1990, p. 35.

[6] There are also substantial sales of partnership interests in private placements (so-called regulation D offerings exempt from certain Securities and Exchange Commission filing requirements). The estimated sales of such offerings for 1987, 1988 and 1989 amounted to $1.5 billion, $2 billion, and $1.4 billion, respectively (Source: Robert A. Stanger & Co.). Privately offered partnerships probably have less impact on the issues discussed in this report because they are less commonly widely held partnerships as the term is used herein.

This growth in the number of widely held partnerships is not surprising. Operating a business or investment activity in partnership as opposed to corporate form offers significant tax advantages, including the avoidance of an entity-level tax and the ability of the members to deduct losses from the activity on their own tax returns (subject to certain restrictions). Despite these advantages, a number of factors traditionally hampered use of the partnership form by widely held entities. Among these factors were the administrative complexity for the entity and members of applying the partnership tax rules to a widely held entity, the reluctance of small investors to invest through the less familiar partnership form, and a relative lack of liquidity for partnership interests.

In the late 1970s and 1980s, these limiting factors began to weaken. Computer programs and other procedures were developed for applying the partnership tax rules to widely held partnerships. Investors became more familiar and comfortable with limited partnership investments. In addition, the use of tax shelters greatly expanded in the late 1970s and early 1980s and widely held partnerships became an increasingly popular investment vehicle, in part because they made shelters accessible to smaller investors. Finally, a number of widely held partnerships began to offer partners a significant degree of liquidity, either through the offering of redemption or remarketing programs or, more notably, through the listing of partnership interests on stock exchanges. Prior to 1980, no partnerships were listed on any major stock exchange; as of December 31, 1989, 126 were listed.

The forces encouraging the growth of large partnerships have not been unchecked. In particular, the desirability of these investments has been limited by a series of tax law changes culminating in the enactment of the passive loss rules which limited the deductibility of losses by partnership investors,[7] and the enactment of section 7704 of the Code which limited the ability of publicly traded entities to qualify as partnerships for tax purposes.

Nonetheless, as long as income earned through partnerships is subject to a lower effective tax rate than income earned through corporations, we believe that the number of widely held partnerships will continue to grow. Moreover, we believe that interests in many of the widely held partnerships will experience significant levels of trading. For example, section 7704 grandfathers all existing publicly traded partnerships for a ten-year period,[8] and does not apply to partnerships earning certain

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[7] _See, e.g._, I.R.C. § 469.

[8] 1987 Revenue Act Section 10211(c).

types of qualifying income, including natural resource and real estate related income.[9]

Administrative difficulties faced by the Service will be exacerbated by any growth in the number of widely held partnerships and by significant trading levels of interests in such partnerships. In light of the recent and anticipated future growth in widely held partnerships, and the likelihood of continued significant trading, the issue of compliance and administration with respect to large partnerships is a timely and important subject.

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[9] I.R.C. § 7704(d).

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SECTION III. CURRENT SYSTEM AND REASONS FOR CHANGE

A. Reporting Compliance

Under current law, a partnership must file Form 1065, partnership return of income, for each taxable year. The return is accompanied by a Schedule K-1 for each partner, reporting the partner's share of allocable items of the partnership's income and deductions, credits and other specified information. A copy of the Schedule K-1, or a substituted form, is furnished to each partner to be used in reporting such items on the partner's income tax return.[10]

In the case of many partnerships, such reportings to partners are voluminous and complex due to the considerable number of passthrough items. On the 1989 Schedule K-1 there are nine different categories of passthrough items with more than forty possible individual amounts to be included in the partner's return or schedules related thereto. Comments received from taxpayers during various IRS Town Meetings held around the country during the 1989 filing season invariably included references to the complexity of the Schedule K-1. Furthermore, widely held partnerships frequently send out information to partners in a format which differs from the Schedule K-1. This is permissible as long as the official Schedule K-1, or an approved substitute Schedule K-1, is filed with the Service and the required information is provided to the partner. This lack of uniformity in information reporting forms is also a frequently mentioned matter of concern expressed when Service representatives meet with practitioner groups. Illustrative of the extent of this problem is a recently issued prospectus describing the proposed merger of two partnerships (assets over $300 million) into a corporation intended to qualify as a real estate investment trust. The prospectus states that one of the principal benefits of the merger is the ability to provide to investors a tax information form (Form 1099) which is less complex and easier to understand than the Schedule K-1 currently required to be provided.[11] The complexity of the Schedule K-1 as compared to

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[10]Schedule K-1 is an information return used to furnish information to partners pursuant to section 6031(b). The form lists specific types of income (11 entries), deductions (4 entries), 7 types of credits (12 entries), tax preference items (6 entries), investment interest (3 entries), self-employment amounts (3 entries), and recapture of investment tax and low-income housing credits (2 entries).

[11]Prospectus/Proxy Statement of CRI Liquidating REIT, Inc., and CRI Insured Mortgage Association, Inc., dated August 17, 1989, pages 1 and 11.

interest and dividend reporting on Form 1099s, may in and of itself discourage proper reporting by the partners.

The Service has insufficient data to determine the extent of underreporting of income by partners in widely held partnerships. However, statistics show a material level of noncompliance in the case of reporting of payments of interest, dividends and capital gains.[12] While an estimated 99.5 percent of wages and salaries were voluntarily reported in 1987 by individuals who filed tax returns, 94.5 percent of interest and dividends were reported[13] and only 88.3 percent of capital gains were reported. These figures do not include the failure to report such income by persons not filing a required tax return.[14] By analogy, it can be inferred that a material percentage of income from widely held partnerships is not reported by partners. Furthermore, even in cases where partners make good faith efforts to report items attributable to widely held partnerships, given the complexity of the Schedule K-1, it seems reasonable to conclude that some additional percentage of income attributable to widely held partnerships is not properly reported.

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[12]A Form 1099 information return is required to be filed by any person making payments of interest or dividends above a certain amount and by brokers upon certain sales of assets. I.R.C. §§ 6042, 6045, and 6049.

[13]See Table I-2, "Income Tax Compliance Research: Gross Tax Gap Estimates and Projections for 1973-1992," Publication 7285 (March 1988) ("Gross Tax Gap Estimates and Projections"). The 94.5 percent compliance figure resulted in underreported interest and dividends for 1987 of $13.2 billion.

[14]The Service is concerned that partners who hold their interest through nominees may not be receiving Schedule K-1s from the partnership or the nominees. The Service has anecdotal information that in the past some brokerage houses holding partnership interests as nominees destroyed information returns received from such partnerships instead of forwarding those returns to their customers. However, such information predates the enactment of section 6031(c). Section 6031(c), which was added by the Tax Reform Act of 1986, Pub. L. No. 99-514, requires any person who holds an interest in a partnership as a nominee for another person to furnish to the partnership information concerning such other person to the extent prescribed by the Secretary. This section is effective for taxable years beginning after October 22, 1986. Section 1015(a) of the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, extended the section 6722 penalty to cover returns required under section 6031(c).

The Service currently has the technical capability to match information reported to the Service by partnerships with the information reported by partners on their returns. However, the application of the matching program is significantly complicated by the fact that each partner's Schedule K-1 information may consist of numerous items (over forty separate items possible) which, in many cases, are limited or modified at the partner level and are required to be reported in a variety of different places on the partner's Form 1040 and related schedules. Furthermore, in contrast to corporations that file substantial numbers of information returns,[15] widely held partnerships are not required to use magnetic media filing to report Schedule K-1 information[16] and in almost all cases file such information on paper returns. The Service must manually transcribe paper returns before matching can occur. These systemic barriers mean that matching partnership data is more expensive and time consuming than matching other types of reported information.[17]

The reporting system for widely held partnerships is thus needlessly complex and inefficient. It is important to solve these deficiencies in the compliance system, not only to protect the fisc, but also to provide a system that is workable for the public and administrable by the Service. It is also important to recognize in our tax system the changing economic and capital structure of the country and to adapt the system to changes in order to protect the interests of the public and the government.

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[15]Notice 90-15, 1990-7 I.R.B. 23.

[16]Publication 1437 (Rev. 1-90).

[17]The difficulties in the operation of a matching program are also faced by the Information Returns Program ("IRP"). An IRP program involves the matching of data contained in information returns filed by payors and flow-through entities with the data reported on tax returns filed by payees and investors in flow-through entities. An IRP program normally results in assessment of additional tax in cases where a taxpayer agrees with the proposed adjustment to his or her reported income, and issuance of a statutory notice of deficiency in the event the partner fails to agree or respond. Under the unified partnership audit rules discussed below, the Service may be authorized to proceed directly to assessment under its authority to make a computational adjustment in a case in which a partner fails to report consistently with the partnership return and fails to disclose such inconsistency. I.R.C. § 6222. However, to institute the IRP procedure, the Service would have to locate and obtain the partners' returns for purposes of making the computational adjustment. The IRP procedure is not cost efficient under current law when applied to widely held partnerships.

A proposal for a simplified reporting system to help accomplish these objectives is discussed in Section IV below.

B. Administration of Widely Held Partnerships

1. Description of TEFRA Partnership Audit Rules

Prior to the enactment of unified partnership audit rules by the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), adjustments to items of income, gain, loss, deduction and credit relating to a partnership had to be made in separate proceedings with the respective partners. Similarly, settlements and judicial determinations were only binding on those partners that were parties to the agreement or judicial proceeding. This system was not an efficient means of auditing tax shelters and other large partnerships, because each partner was entitled to separate administrative and judicial review of partnership items that were common to all partners.[18] The TEFRA partnership audit rules consolidate the administrative and judicial review of all partnership items at the partnership level. Congress, noting the potential conflict between investors and tax shelter promoters, balanced the consolidated audit provisions with considerable protections for individual partners.

The TEFRA partnership audit rules apply to all partnerships, except for partnerships with ten or fewer partners in which each partner's share of any partnership item is the same as his or her share of every other item (e.g., there are no special allocations) and each partner is a natural person (other than a nonresident alien) or an estate.[19] The tax treatment of all partnership items is determined at the partnership level.[20] Generally, all partners must treat items on their individual

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[18]See General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 267-68 (hereinafter referred to as "TEFRA General Explanation").

[19]I.R.C. § 6231(a)(1)(B). All partners of a partnership for the partnership taxable year under audit generally are subject to the TEFRA partnership audit rules. However, under certain circumstances, the inclusion of a partner in a unified proceeding would interfere with the efficient enforcement of the tax law. I.R.C. § 6231(c). When special enforcement considerations exist with respect to a partner, that partner's partnership items will be treated as nonpartnership items and the partner is removed from the partnership proceeding. Examples of special enforcement situations include the filing of a bankruptcy petition naming a partner as the debtor or the criminal investigation of a partner. Id.; Temp. Treas. Reg. §§ 301.6231(c)-4T through 8T.

[20]I.R.C. § 6221.

returns consistently with the treatment of those items on the partnership return unless they notify the Service of an inconsistent treatment.[21] If the Service challenges a reporting position of a partnership subject to the TEFRA rules, it conducts a single administrative proceeding to resolve the issue with respect to all partners. Similarly, if a partnership decides to challenge an administrative determination of the Service, a single judicial proceeding will occur.[22]

The central figure in a TEFRA partnership proceeding is the tax matters partner ("TMP"). The TMP is the representative of the partnership who serves as a liaison between the partnership, the Service and the court with respect to the unified audit and litigation proceedings regarding the tax treatment of partnership items attributable to the partnership. As such, the TMP serves as the focal point for service of all notices, documents and orders on the partnership, and concomitantly has many rights and duties both at the administrative stage of the proceeding and in the course of litigation. The Code provides that the TMP is the general partner designated by the partnership to serve as the TMP or, if there is no such designation, the general partner having the largest profits interest as of the close of the taxable year involved.[23] If the Service determines that it is impracticable to apply the largest profits interest rule, the Service may select any partner to serve as the TMP.[24]

<u>The TEFRA partnership audit rules are described in detail in Appendix II.</u>[25]

2. <u>Description of Service Audit Procedures with Respect to Widely Held Partnerships</u>

The Service has elaborate procedures for auditing partnerships and assessing and collecting partner deficiencies after the amount of the audit adjustment has been finally determined. This section provides a detailed description of the steps that are followed in conducting an audit of a large partnership.

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[21] I.R.C. § 6222(a) and (b).

[22] <u>See</u> I.R.C. § 6226.

[23] I.R.C. § 6231(a)(7); Temp. Treas. Reg. § 301.6231(a)(7)-1T.

[24] <u>Id.</u>; <u>see</u> Rev. Proc. 88-16, 1988-1 C.B. 691.

[25] Proposals for amendment of these rules are described in Appendix I.

There are ten Internal Revenue Service Centers ("Service Centers") located throughout the country. Each Service Center processes income tax returns of individuals and entities which reside (or have their principal place of business) within the geographical jurisdiction of the center. The Service also has 63 district offices which may have jurisdiction over a single state or a smaller geographical area in more densely populated states. The primary functions of each district office are the examination of tax returns (Examination Division), the collection of delinquent tax (Collection Division), the enforcement of criminal penalties for tax crimes (Criminal Investigation Division), and the response to taxpayer requests for assistance (Taxpayer Service Division). The Appeals Division's field function is organized by region, with branches located in some but not all district offices. The Appeals Division is responsible for settlement of disputes between the Examination Division and the taxpayer based on the merits of a given case as well as the hazards of litigation. The Appeals Division is also responsible for settlement of some collection disputes.

When a Service Center receives a partnership return, certain return information is entered into a Service Center computer system[26] and transmitted to the Martinsburg Computing Center.[27] Partnership returns with high audit potential scores are then screened by classifiers at the Service Center in order to determine which returns should be audited.[28] Lists of returns with high audit potential are transmitted to their assigned district offices.[29] The district office then obtains the

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[26]After a period of time, depending on the return in question and on the available space at the Service Center, the tax returns are transported to one of several Federal Record Centers for further storage and ultimate destruction.

[27]The Martinsburg Computing Center is responsible for various data processing functions within the IRS.

[28]Partnership returns are assigned a "Discriminate Function" or DIF score at the Martinsburg Computing Center based on the values of various line items and the interrelationships of certain line items. DIF scores on partnership returns, just as on individual returns, are a numerical rating of the potential of significant errors being present on a particular return. If a return has a DIF score above a certain level, it goes into the DIF inventory and is ordered out by the Examination function as work is needed. It is then screened for audit potential by the Classification Branch at the Service Center where the return was filed.

[29]Partnership audits are generally assigned to the district in which the partnership has its principal place of business.

original partnership return (with any associated files), and the case is assigned to a revenue agent of the Examination Division.

The revenue agent sends the TMP a Notice of the Beginning of the Administrative Proceeding (which is required to be issued at least 120 days before a notice of Final Partnership Administrative Adjustment is mailed to the TMP).[30] The revenue agent then has 45 days to determine whether the items of the partnership are correctly reported.[31] If the revenue agent determines that there should be no changes to items as reported, the Notice of the Beginning of the Administrative Proceeding must be withdrawn within 45 days of its issuance (otherwise, a notice of Final Partnership Administrative Adjustment must eventually be issued).[32]

If the revenue agent determines that an audit is warranted, he or she reconciles all of the Schedule K-1s with the partnership return.[33] The information drawn from the Schedule K-1s regarding individual partners is forwarded from the district office to the Examination Support Unit[34] of the Service Center with jurisdiction over the partnership return (the "partnership's Service Center"). The Examination Support Unit then enters this information into the Partnership Control System computer programs, which automatically generates requests for all partner returns in the Federal Records Centers which are then transferred to the various Service Centers with jurisdiction over each partner's return (the "partner's Service Center").[35] It takes

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[30]I.R.C. § 6223(d)(1).

[31]Temp. Treas. Reg. § 301.6223(a)-2T(a).

[32]Id.

[33]Copies of the Schedule K-1s are filed with the original partnership return and continue to be associated with the original partnership return throughout the audit process. The reconciliation process involves adding the partner profits percentage indicated on each Schedule K-1 to determine whether the percentages total 100 percent (in order to ensure that all partners have been accounted for).

[34]An Examination Support Unit is located in each of the ten Service Centers. The units, which are part of the Examination Division, are principally responsible for coordinating the notice and assessment procedures with respect to individual partners of partnerships subject to the TEFRA partnership audit rules.

[35]If a partner's return is not currently under examination, the Examination Support Unit of that partner's Service Center may review this return for possible audit.

an average of two to three months from the date a return is ordered to locate and forward the return to the appropriate Service Center.[36] The Partnership Control System of the partnership's Service Center generates Notices of the Beginning of the Administrative Proceeding to each notice partner.[37]

When the examination of a partnership return is completed, the revenue agent arranges a conference with the TMP and any other partner who wishes to attend.[38] Prior to the conference, the revenue agent issues a preliminary report to the TMP summarizing the revenue agent's initial conclusions, which are subject to change as a result of legal or factual arguments presented at the conference.

At the conference, the revenue agent and the TMP (and any other partners present) discuss the issues raised in the audit. Even if the revenue agent and the TMP reach an agreement regarding a proposed adjustment, by statute the TMP is only authorized to bind non-notice partners,[39] and in practice will rarely exercise that authority. If, as is typically the case in an audit of a widely held partnership, the revenue agent does not obtain an agreement regarding a proposed adjustment that covers all of the partners of the partnership, the agent prepares a final report containing facts, analysis of law, statement of taxpayer's position, and the agent's conclusions on each issue.

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[36]If a partner is itself a pass-through entity, the procedure must be repeated with respect to its members. It takes approximately four to six months to locate all partner returns for each tier in a multi-tier partnership.

[37]All partners whose names and addresses have been furnished to the Service are entitled to receive such notice from the Service in partnerships having 100 partners or less. I.R.C. § 6223(a)(1). For partnerships having more than 100 partners, only partners having a one-percent or greater profits interest or the designated member of a group of partners who form a five-percent "notice group" are entitled to receive notice from the Service. I.R.C. § 6223(b). The TMP is under an obligation to forward such notices to non-notice partners (with certain exceptions including indirect partners who have not been identified to the TMP). Temp. Treas. Reg. § 301.6223(g)-1T(a).

[38]The burden of notifying all partners of the conference is placed on the TMP. Temp. Treas. Reg. § 301.6223(2)-1T(b)(1)(i).

[39]I.R.C. § 6224(c)(3)(A). However, under section 6224(c)(3)(B), a non-notice partner may file a statement with the Service providing that the TMP is not authorized to enter into a settlement on such partner's behalf.

This report may be reviewed by the Quality Review Staff[40] in the district office responsible for the partnership audit.

The Quality Review Staff then prepares a "60-day letter package" and forwards it to the Examination Support Unit of the partnership's Service Center. The Examination Support Unit then mails a copy of the package to the TMP.[41] The 60-day letter package contains a letter notifying the partners of the time period to protest the proposed adjustments to the Appeals Division. The package also contains a copy of the revenue agent's report and an agreement form for use by the partner in the event he or she decides to accept the proposed adjustments.[42] The TMP files his or her protest with the Quality Review Staff of the district responsible for the partnership audit. Other partners must file their protests with the Examination Support Unit of the partnership's Service Center. The Examination Support Unit forwards any protests it receives to the Quality Review Staff, which in turn forwards all protests to the Appeals Division office with jurisdiction over the partnership's district.

If no protest is received, the Quality Review Staff of the partnership's district office prepares a notice of Final Partnership Administrative Adjustment, which is reviewed by the District Counsel office for the district. Copies of the notice are mailed to the TMP and each notice partner or the designated member of each notice group by the partnership's Service Center. The TMP is required to forward copies of the notice to each non-notice partner within 60 days after the mailing by the Service.[43]

If a protest is received, an Appeals Division settlement conference is held at which any partner is entitled to participate. If a settlement covering all of the partners is not reached at the conference, the Appeals Officer prepares a settlement package which the Examination Support Unit of the partnership's Service Center mails to all partners who have not

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[40]The Quality Review Staff is a branch of the Examination Division with responsibility for review of completed audit reports in order to determine whether proper procedures have been followed and to review revenue agents' determinations.

[41]The TMP would then be responsible for notifying non-notice partners. Temp. Treas. Reg. § 301.6223(g)-1T(b)(1)(ii).

[42]A copy of the 60-day letter and the agreement form (Form 870-P or 870-L) is sent to all notice partners.

[43]Temp. Treas. Reg. § 301.6223(g)-1T(a)(2).

yet settled.[44] If not all partners accept the proposed settlement, the Appeals Division office prepares a notice of Final Partnership Administrative Adjustment, which is reviewed by District Counsel and sent to the TMP. Copies of the notice of Final Partnership Administrative Adjustment are mailed to each notice partner or the designated member of each notice group by the Examination Support Unit of the partnership's Service Center.[45] Although the Appeals Division may have developed a settlement position (under the above-described procedure), the notice of Final Partnership Administrative Adjustment generally will reflect the litigation position of the Service (rather than the settlement position).[46]

The TMP has 90 days from the date of mailing of the notice of Final Partnership Administrative Adjustment to file a petition with the Tax Court, the Claims Court, or a federal district court.[47] If the TMP fails to file a petition within the 90-day period, any notice partner or any group having in the aggregate a five-percent interest in profits may file a petition during the 60 days following the end of the 90-day period.[48] Every partner of the partnership is treated as a party to an action brought by the TMP or notice partner (or five-percent group), and is entitled to participate in the action, unless the partner's partnership items have been converted to nonpartnership items or the statute of limitations has expired with respect to that partner.

After a final determination has been made with respect to a partnership level adjustment, the Examination Support Units located in the partners' Service Centers are responsible for assessing deficiencies against the partners. The tax must be assessed with respect to each partner within one year of the date

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[44]The Appeals Division may determine in certain situations that it is not efficient to mail settlement packages to non-notice partners.

[45]I.R.C. § 6223(a)(2).

[46]If any settlement was entered into between a partner and the Service, any other partner may still obtain consistent terms by making a request within a prescribed time period. _See_ I.R.C. § 6224(c)(2).

[47]I.R.C. § 6226(a).

[48]I.R.C. § 6226(b)(1). The "five-percent group" for purposes of filing a petition need not be the same partners that were members of a five-percent "notice group." Temp. Treas. Reg. § 301.6223(b)-1T(e).

on which the adjustment became final as to that partner.[49] Each of these Service Centers reviews the returns of the partners within their jurisdiction, computes the deficiency, and mails a notice of computational adjustment to the partners. A computer generated notice of assessment and demand for payment is then mailed to each partner from the various partners' Service Centers within 60 days of the date of assessment of that partner. Payment is due within 10 days of the mailing of the first notice and demand for payment. If a partner fails to make payment within that time period, a tax lien is created by operation of law at the end of the 10 day period. The lien relates back to the date of assessment.[50] Shortly after the 10 day period, computer generated notices are transmitted to the partners who have not yet paid. Two to five notices (including the above-mentioned notice of assessment and demand for payment) are transmitted depending on the amount of money involved. The last notice, identified as "Final Demand and Notice of Intent to Levy," must be issued before enforced collection by levy can occur and must either be sent by certified mail to the partner's last known address, hand-delivered to the partner, or left at the partner's home or place of employment.[51] Absent exigent circumstances which would support the making of a jeopardy levy (usually the same circumstances that would support a termination or jeopardy assessment), the Service cannot levy for 30 days from the date of the final notice.

After the notices have been transmitted, if the amount of the deficiency is below a set tolerance level, no action is taken by Service personnel; however, any potential levy sources (such

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[49]The one-year assessment period must be calculated on a partner-by-partner basis, because some partners may settle their cases separately on different dates while other partners may choose to await the outcome of the litigation.

[50]If any person fails to pay the tax (including any related interest or penalty) after notice and demand, a statutory lien is created in favor of the United States upon all property and rights to property of that person. I.R.C. § 6321. The lien imposed by section 6321 arises as of the date of assessment and continues until the liability is paid or becomes unenforceable by reason of lapse of time (usually due to the running of the statute of limitation on collection six years after assessment). I.R.C. §§ 6322 and 6502.

[51]At this stage, the debt is classified as a "taxpayer delinquent account." The average cost to the Service to close such accounts during 1986, 1987 and 1988 was $196.04, $198.48 and $234.00, respectively. The amount of tax owed thus must be relatively substantial for collection of these accounts to be cost effective.

as refunds due) are identified by computer, and the amount of any such refund will be offset by the outstanding liability. A delinquent account with a balance due above the tolerance level is then entered into the Automated Collection System computer, which sets collection priorities based on potential yield (the amount of the liability is only one of several factors considered). After priorities have been set, revenue representatives of the Collection Division located at 21 locations throughout the country commence efforts to collect the liability. The revenue representatives telephone, and in some cases correspond with, the partners. Any information obtained from the partner or third party sources is entered into the Automated Collection System computer for future reference. If a revenue representative identifies a levy source, he or she may issue a notice of levy or file a notice of federal tax lien.

If the partner still has an outstanding liability at the conclusion of the above-described process, the account is placed into an automated queuing system. The automated queuing system is a computerized listing of outstanding accounts with priorities based on expected amounts of collection. If the amount of expected collection is high enough, the case is automatically transferred to the district where the partner resides and assigned to a revenue officer. Even if the amount of expected collection is not high enough to be immediately transferred to the district, the amount may be transferred and assigned later if circumstances warrant. However, many smaller accounts (even though above the set tolerance level) are never assigned to a revenue officer and therefore the amount due generally would not be collected.

After an account has been assigned to a revenue officer, the officer contacts the partner in an effort to collect the amount due. If this contact does not lead to payment of the liability, the revenue officer is empowered to take various collection actions, including seizure of the partner's property. If all efforts to collect are unsuccessful, a determination may be made that the debt is currently uncollectible.

The Service has similar, although less well developed procedures, for handling Requests for Administrative Adjustment ("RAA"), which are the TEFRA equivalent of a refund claim or an amended return. An RAA could be filed in the many situations in which a partnership level deficiency flowed through to partners in a TEFRA proceeding and leads to a related overpayment in another year for all such partners.[52] Many of the steps discussed above would essentially have to be repeated in such a case.

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[52]_See_ section III(B)(3)(6).

3. Problems Faced by the Service in Administering Widely Held Partnerships

The present audit and assessment system applies to all partnerships with more than ten partners (and in certain cases to even smaller partnerships). Because of the breadth of its coverage, the system provides procedural protections and rules that are generally desirable for partnership administration, but that may not be appropriate when applied to the type of widely held partnerships that are becoming common today. The sheer number of partners in a large partnership (one for instance had more than 90,000 partners in its first year of operation) may cause a myriad of problems in the areas of filing, audit, settlement, litigation, assessment and subsequent proceedings. The following is a summary of these problems.

(1) Partners may take filing positions inconsistent with the partnership return. Although in widely held partnerships this right may not be frequently exercised because the partner does not have adequate information to take such a position, the possibility does exist. If the Service is not notified by the partner as required, the inconsistent treatment in most cases will never be detected. If notified, the Service may challenge the inconsistency and conduct a partnership audit or deal with the items as nonpartnership items. In either case, there is a significant potential burden in trying to monitor inconsistent positions of partners in widely held partnerships absent a mandatory magnetic media filing requirement with a fully implemented matching procedure.

(2) To conduct an audit of a widely held partnership, the Service must obtain and monitor information concerning each individual partner. The actual audit of a large partnership's books and records ordinarily proceeds in a manner similar to an audit of a large corporation; however, in a corporate audit, the Service is not required to develop and track information concerning each shareholder.[53] In a partnership audit, the Service must first identify each partner. To do so, the Service must reconcile individual Schedule K-1s to determine that it has accounted for 100 percent of the interests in profits and losses in the partnership. This process is especially difficult in a publicly traded partnership because there may be numerous transfers of partnership interests during any taxable year. Furthermore, information provided by the partnership regarding

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[53]Generally, jurisdiction of the Service Centers is based on the residence of the partners (or principal place of business in the case of corporate partners). Several (and possibly all) Service Centers would necessarily become involved in auditing, assessing and collecting deficiencies from the partners of a widely held partnership.

individual partners is often incomplete or incorrect, thus requiring the Examination Division to expend considerable resources (particularly in the case of larger partnerships) in order to determine the proper identity of the partners and to develop sufficient information to make assessment possible.

The Service must then obtain the individual returns of all partners. It takes an average of two to three months to obtain the return of a partner once it is ordered from the appropriate Federal Records Center. If a partner is itself a passthrough entity, the process must be repeated. It takes approximately four to six months to obtain all partner returns for each tier of a multi-tier partnership. The Service also must keep track of the statute of limitations for every partner, because, for a variety of reasons, partners may have differing statutes of limitation. Thus, the Service is required to obtain and monitor a significant amount of information concerning each partner. In the audit of a large partnership, the cumulative effect of these monitoring and information-gathering activities offsets the efficiencies afforded the Service by the TEFRA rules.

(3) The TMP is authorized to extend the statute of limitations on behalf of all partners.[54] However, if the Service is unable to obtain a consent from the TMP which binds all partners to an extension of the statute of limitations for assessment, the Service must solicit a consent from each partner.[55] If one partner fails or refuses to extend the statute of limitations for assessment, the Service is forced to issue a premature notice of Final Partnership Administrative Adjustment (applicable to all partners) or else allow the statute of limitations to expire as to the nonconsenting partner.

(4) A settlement agreement entered into with the TMP will not be binding on notice partners and will only bind non-notice partners if the TMP expressly makes the settlement binding on such partners. Since the TMP of a widely held partnership will rarely, if ever, elect to bind other partners, the Service generally must deal with the individual partners if it desires to settle the entire case. As a result, as the size of the partnership increases, there is less incentive on the part of the Service to actively attempt to settle the case. This is because the Service cannot realistically expect to reach an agreement with all of the partners in a widely held partnership, even if the TMP agrees to the settlement offer. Since the refusal of just one partner to settle could force the Service to litigate the case, it would be in the Service's best interests to take a hard-line position in settlement negotiations. Consequently, in

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[54]I.R.C. § 6229(b)(1)(B).

[55]_See_ I.R.C. § 6229(b)(1)(A).

the context of a widely held partnership, the existing rules are an impediment to resolving the dispute through settlement and increase the likelihood of litigation.

If the Service does enter into a settlement agreement with any partner with respect to partnership items, any other partner may request consistent settlement terms within (1) 150 days of the mailing of the notice of Final Partnership Administrative Adjustment ("FPAA") to the TMP or, (2) if later, within 60 days after the settlement agreement was reached.[56] This right continues even if all settlement offers have subsequently been withdrawn. In widely held partnerships, if the Service follows a de minimis approach by not pursuing small adjustments, those with greater tax deficiencies may contend they are entitled to the same treatment of no adjustment. Thus, the consistent settlement rules add to the administrative complexity of dealing with widely held partnerships.

(5) Because each partner has the right to participate in both administrative and judicial proceedings, the Service may be faced with numerous representatives in a single partnership proceeding. This may result in considerable complexity and cause confusion both to the Service and the taxpayers' representatives.

(6) Once adjustments are finalized at the partnership level, the Service must compute the tax for each partner, including indirect partners, i.e., those holding an interest through a passthrough entity or nominee. After the notices are issued, a partner who disagrees with the computational adjustment must pay the tax, and then may file a claim for refund followed by a refund suit if the claim is disallowed. This again raises the potential for multiple actions resulting from a single partnership adjustment, although such actions are limited to the computational aspects of the adjustment.[57]

(7) Deficiencies in one year will frequently give rise to refund claims in subsequent years. This can result, for example, from timing differences or basis adjustments. The claims may be filed by each partner for the overpayment years, thus again opening up the possibility of handling large numbers of

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[56] I.R.C. § 6224(c)(2); Temp. Treas. Reg. § 301.6224-3T(c)(3)(ii). The TMP is required to forward a copy of the notice of FPAA to all non-notice partners within 60 days of the date the notice of FPAA was mailed to the TMP. The TMP is also required to provide non-notice partners with information regarding the Service's acceptance of any settlement offer within 30 days of receiving information of such acceptance. Temp. Treas. Reg. § 301.6223(g)-1T(b).

[57] I.R.C. § 6230(c).

individual cases that relate to a single or a few partnership adjustments.

(8) Penalties attributable to a taxpayer's investment in a TEFRA partnership must be asserted in separate proceedings with the respective partners following the conclusion of the partnership-level proceeding.[58] The assertion of penalties against the investors in a widely held partnership is administratively burdensome and significantly increases the inventory of cases both under audit and in the Tax Court. Moreover, since these penalty proceedings are generally duplicative, conducting a separate proceeding with each partner is an inefficient use of resources at both the administrative and judicial level and seriously undermines one of the principal objectives of having a unified, partnership-level proceeding to determine the tax treatment of items flowing from the partnership.

In summary, the audit and administrative procedures were not designed for nor do they effectively accommodate widely held partnerships. These procedures reflect a balancing between certain entity concepts and individual partner protections. This balancing is appropriate when applied to small to medium size partnerships, in which the number of partners is manageable from an administrative standpoint and where there is a substantial likelihood that most partners will have a significant investment in the partnership. However, when applied to widely held partnerships, the individual partner protections seem disproportionate to the rights in need of protection, and present significant administrative obstacles.

Widely held partnerships resemble large corporations in their method of operation and capitalization, i.e., a large number of partners contributing capital to a centralized operating organization. Each partner of a widely held partnership generally has an investment comparable to that of a shareholder in a comparably sized corporation in terms of dollars invested, role in management and rights under state law. In auditing a corporation, the Service does not need to deal with shareholders directly, but in auditing a widely held partnership, the Service must deal directly with hundreds or thousands of partners in order to complete an examination that results in even the simplest adjustment. Moreover, adjustments to the income of a widely held partnership that in the aggregate are substantial are relatively small when applied to the individual partners.[59]

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[58] I.R.C. § 6230(a)(2)(A)(i); N.C.F. Energy Partners v. Commissioner, 89 T.C. 741 (1987).

[59] The relative cost of making an adjustment with respect to a widely held partnership is likely to increase under the present system. In past years, partnership audits were mainly directed

The present system, when applied to widely held partnerships, creates a burden on and results in an inefficient use of the valuable and limited resources of the Service. Partners in these partnerships should be treated for administrative purposes in a manner similar to that of shareholders in a corporation (which is subject to entity-level audit), rather than receiving the same procedural protections accorded partners in small to medium size partnerships. Accordingly, a proposal for a new administrative system applicable to widely held partnerships is discussed in Section V.

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at tax shelters in which the average annual deficiency per partner was substantial (the average deficiencies for tax shelters audited from 1983-87 ranged from approximately \$18,500-\$22,000). As post-1986 years become subject to audit, due in large measure to the enactment of the passive loss rules of section 469, tax shelter audits will be reduced and should be replaced by audits of partnerships generating income, including widely held partnerships. In that setting, although overall partnership deficiencies may be substantial, the average deficiency on a per partner basis is likely to be relatively small. The average size of deficiencies may be further reduced with respect to partners in widely held partnerships that are actively traded in that interests are often held for short periods of time.

SECTION IV. PROPOSED SIMPLIFIED REPORTING SYSTEM FOR WIDELY HELD PARTNERSHIPS

A. Introduction

In order to simplify reporting for widely held partnerships, encourage correct reporting by partners and aid the Service in its compliance monitoring, a simplified system of reporting by widely held partnerships is recommended. Such reporting to the partners and Service would be accomplished by use of a Form 1099-K designed for use by widely held partnerships in lieu of the current Schedule K-1.[60]

The present Schedule K-1 is used by all partnerships to report their partners' distributive shares of partnership income, gain, loss, deduction or credit. The Schedule K-1 form and instructions are complex and result in voluminous amounts of paperwork being filed with the Service and sent to partners by widely held partnerships. While magnetic media filing of information returns is permissible, and generally required for corporations, few widely held partnerships use magnetic media to file with the Service. The volume of Schedule K-1 information and the manner in which it is reported on each partner's Form 1040 does not lend itself to efficient integration into the matching programs presently maintained by the Service. The use of a Form 1099-K with limited categories of information, as described in detail below, would encourage compliance due to its simplicity. In addition, reporting limited information would ease the reporting burden on widely held partnerships and requiring magnetic media filing would provide the Service with a more efficient means of matching partnership data with partner returns.[61]

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[60]Section 6031(b) currently requires that partners be furnished with either a Schedule K-1 or substituted form by the due date of the partnership return (April 15 for a calendar year partnership unless extended). If the proposal for the Form 1099-K is adopted, it is recommended that the due date for furnishing the Form 1099-Ks to partners be the same as provided in section 6031(b), rather than the January 31 due date applicable to other information returns.

[61]Although only the term "magnetic media" is used, it is meant to encompass any future improvements to include information transferred in machine readable form by other means, such as electronic filing.

B. Determination of Partnership Items at the Widely Held Partnership Level

1. In General

The key to simplification of the reporting of partnership income is reduction of the number of items that must be separately reported to partners. Under current law, the Code and regulations specifically enumerate many items that must be passed through separately to partners[62], and under regulations, any item not enumerated must also be passed through if separate treatment would affect the calculation of the partner's income tax liability.[63]

In the simplest of passthrough systems, an entity such as a widely held partnership could in theory pass through a single item of income or loss. In such a system, information reporting would be as simple as the reporting of interest and dividends under current law. For a number of reasons, this level of simplicity is not realistically achievable (and may not be desirable) at the present time for widely held partnerships. However, we believe it would be possible and desirable to significantly reduce the number of items to be separately passed through to partners of widely held partnerships.

Set forth in this section is an outline of a proposed simplified system for determining and reporting the distributive items of widely held partnerships. We recognize that legislation amending many sections of the Internal Revenue Code would be necessary to implement such a system and that the proposed changes would have a substantive impact on the calculation of a partner's tax liability. We also recognize that this outline does not address all questions that would arise in developing the system and in identifying legislative changes that will be required to allow for the simplified system. However, we believe that implementation of the general approach articulated below would represent a significant step towards rationalizing the reporting system for widely held partnerships.

2. Income and Deductions

Under the proposed approach, all income and expense, including capital gains and losses, would be netted at the partnership level. In calculating a partnership's net income, the application of any limitation with respect to a deduction would be determined at the partnership level. For example, under current law an election may be made under section 194 to amortize

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[62]*See* I.R.C. § 702(a) and Treas. Reg. § 1.702-1.

[63]Treas. Reg. § 1.702-1(a)(8)(ii).

certain reforestation expenditures over a seven year period. The maximum amount eligible for the election in any taxable year is $10,000.[64] In the case of a partnership, this maximum is applicable at both the partnership and the partner level.[65] Consequently, a partnership must separately report amortization deductions under section 194 to permit partners to calculate their individual limitations. Under the simplified reporting approach, the section 194 limitation would apply solely at the widely held partnership level. Thus, amortization deductions under section 194 would be reflected in the widely held partnership's net income reported to partners, and would not be separately reported.

Any elections relevant to deductible items would be made by the widely held partnership. For example, section 617 allows a taxpayer to elect to deduct certain mining exploration expenses. If the election is made and the mine eventually reaches the producing stage, the expenses must be "recaptured" by inclusion in income or by denial of depletion deductions.[66] Under current law, each partner independently decides whether to make the election under section 617.[67] Under the simplified reporting approach, the section 617 election would be made by the widely held partnership, and recapture of section 617 expenses would be determined at the partnership level. Thus, any deduction or recapture of section 617 expenses would be reflected in the widely held partnership's net income.

Where a limitation on a deduction results in a carryover of a deduction, the amount would be carried over at the widely held partnership level. For example, under section 175 a taxpayer is permitted to deduct soil and water conservation expenses. However, the deduction may not exceed 25 percent of the taxpayer's gross income from farming; any excess is carried over until the taxpayer has sufficient gross income from farming.[68] Therefore, a partnership is required to separately report its gross income from farming.[69] Under the simplified reporting approach the 25 percent limitation and any resulting carryover would be determined at the widely held partnership level.

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[64] I.R.C. § 194(b)(1).

[65] I.R.C. § 194(b)(2)(B).

[66] I.R.C. § 617(b).

[67] I.R.C. § 617(b)(2).

[68] I.R.C. § 175(b).

[69] _See_ Treas. Reg. § 1.702-1(c)(1)(iv).

Most interests in widely held partnerships are held by limited partners who are subject to the passive loss rules of section 469 because they do not materially participate in any of the partnership's activities.[70] Under current law, a widely held partnership's operations may be multiple activities for purposes of the passive loss rules. In that case, the partnership must separately report items of income and deduction from each of its activities. One reason separate reporting is necessary is that a partner who holds both passive and nonpassive activities through a partnership takes only the items from the passive activities into account in applying the passive loss rules.[71] In addition, a partner cannot compute the suspended loss allowed on the fully taxable disposition of the partner's entire interest in a passive activity conducted through the partnership unless the partnership has separately reported items from the activity.[72]

Under the simplified system, a limited partner's interest in a widely held partnership would be treated as a single activity for purposes of section 469. For passive limited partners, all items of income and deduction from widely held partnerships will be either passive or portfolio.[73] Thus, the only information the limited partner would need to apply section 469 would be the net passive income or net passive loss for the partnership as a whole, and the partnership would report this information rather than separately reporting items from multiple activities.

Portfolio income (*e.g.*, interest and dividends) would be reported separately from other income, and would be reduced by

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[70]Temp. Treas. Reg. § 1.469-5T provides that a limited partner's participation in an activity is material only if it exceeds 500 hours during the taxable year or satisfies one of two other tests that consider multi-year participation. It may be appropriate to provide that a limited partner's interest in a widely held partnership is always passive.

[71]This is a minor consideration in the case of limited partners because, as noted above, they typically do not materially participate in any of the partnership's activities.

[72]This is a concern only if the partnership is not publicly traded. Under section 469(k), the activities of a publicly traded partnership are treated as a single activity for purposes of this rule.

[73]Expenses that are not treated as passive activity deductions under Temp. Treas. Reg. § 1.469-2T(d)(2) and are not portfolio items under section 469(e)(1) would be treated as passive deductions for this purpose. For example, charitable deductions of a widely held partnership would be treated as passive.

portfolio deductions and allocable investment interest expense. Further, to reflect the 2 percent floor limitation imposed on miscellaneous itemized deductions at the individual level, it will be necessary to reduce such deductions by an arbitrary amount (e.g., 50 percent). To the extent there is excess investment interest, it would be carried over at the partnership level.

Netting of capital gains and losses would occur at the widely held partnership level. Thus, capital gains would be consolidated with other reported income, and an individual partner would not be able to net partnership capital gains and losses on his or her individual income tax return. Any excess of capital losses over capital gains would be carried over at the widely held partnership level. Therefore, an individual partner would not receive the benefit of the limited annual offset of capital loss against ordinary income allowed under current law. If a capital gains preference is enacted, a widely held partnership should be able to take advantage of a preferential rate without reporting its capital gains separately. If a deduction (or exclusion) is permitted for long term capital gains, as under pre-1987 law, the partnership would determine its long term capital gains, compute the appropriate deduction, and reduce net income to be flowed through to partners.

Alternative minimum tax adjustments and preferences would be combined and allocated to partners. To apply the passive loss rules, it will be necessary to report portfolio income minimum tax items separately from other minimum tax items. Tax-exempt interest would be shown as a passthrough information item because of its significance in the taxation of social security benefits.

3. Allocations

Under the simplified reporting system, a single amount of net taxable income or loss would be reported to each partner. Therefore, widely held partnerships would not be able to report to partners specially allocated items of income or deduction. This does not mean, however, that widely held partnerships would be required to allocate all items on a pro rata basis. Pro rata allocations would deprive partnerships of any flexibility in income allocations, and would cause serious transitional difficulties for existing partnerships.

A degree of flexibility could be achieved by allowing special allocations of those items which are separately reported on the Form 1099-K.[74] Taxable income would therefore be

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[74]Allocations would, of course, be required to satisfy the rules of section 704(b) and the regulations thereunder (e.g., the substantial economic effect test).

allocable on a bottom line basis. For example, assume Partnership X has $10 million of rental income, $3 million of depreciation deductions attributable to its rental activities, and no other items. On a bottom line basis, it would allocate $7 million of passive income among its partners. Portfolio income could similarly be allocated on a bottom line basis. Alternative minimum tax adjustments would be allocated in accordance with the allocation of passive and portfolio taxable income. Tax exempt interest and credits would be reported separately, so that separate allocation of these items should be feasible under the simplified reporting system.

Further flexibility could be achieved by allowing widely held partnerships to allocate gross income (whether portfolio or passive) and total allowable deductions as determined at the partnership level. Partnership X could therefore allocate the $10 million rental income and the $3 million depreciation deductions independently, although each partner would still be reported a single item of passive income or loss. Where a limitation on a deduction applies at the partnership level, it would reduce the total allowable deductions. This approach would permit a particular deduction to be effectively allocated to a particular class of partners, without requiring reporting of the deduction separately from the partners' share of other income or deductions reported on the Form 1099-K.

4. Credits

a. Consolidated Tax Credit

Under the proposed simplified approach, credits would generally be determined at the partnership level and would be passed through to partners as a single combined item on the Form 1099-K. Each credit typically has its own set of special rules (e.g., carryover provisions); these rules would have to be examined and altered where necessary to apply at the partnership level. We believe that in most cases it will be possible to restructure credit limitations to permit consolidation. In the case of credits which are consolidated for reporting purposes, recapture would necessarily occur solely at the partnership level, as a partner would not be able to determine his or her recapturable amount upon disposition of a partnership interest. Thus, recapture of any type of nonseparately-reported investment credit might occur if the partnership disposed of the property, but would not occur upon disposition of any partner's interest. It would also be possible to deem the transfer of a specified percentage of interests in a partnership to be a recapture event, although this approach would not be consistent with entity-level treatment of widely-held partnerships. The partnership could either offset credit recapture against current credits, satisfy any recapture liability itself, or could increase taxable income in the year of recapture by the amount necessary to recapture the credit assuming a partner-level tax rate.

It should be possible to consolidate many credits for reporting as a single item. However, at least three credits (low income housing credit, rehabilitation credit, and credit for withheld taxes) may require separate reporting. The foreign tax credit also poses a number of particular issues. These credits are discussed below.

b. Separately-Reportable Credits

The low income housing credit and the rehabilitation credit are subject to special favorable treatment under the passive loss rules.[75] It would be impossible for partners to take advantage of these rules without separate reporting of each credit. On the other hand, most widely held partnerships will not generate these credits. To keep the Form 1099-K as simple as possible in most cases, only partnerships which are significantly engaged in activities anticipated to generate these particular credits should be permitted to report them as separate items. For example, unless a partnership's assets are substantially comprised (e.g., at least 50 percent) of low income housing, it would not be permitted to separately report the low income housing credit. Similarly, unless a partnership's assets are substantially comprised of real property, it would not be permitted to separately report the rehabilitation credit. If a partnership not substantially engaged in the relevant activity were to generate one of these two credits, it would report the credit together with any other credits as part of the general tax credit (line 5) reported on the Form 1099-K.

Under the Partnership Collection Proposal, a partner may be entitled to a credit for partnership payments which would be refundable to the extent it creates an overpayment.[76] The refundability feature would distinguish this credit from other credits, and would require the credit for partnership payments to

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[75] Section 469(i) exempts these credits from the passive credit limitations to the extent they are equivalent in their effect on tax liability to a specified amount of deductions. The deduction equivalent of the credits allowed under this rule is generally $25,000, but the $25,000 amount is reduced by the amount of losses and the deduction equivalent of other credits allowed under section 469(i) and, in the case of the rehabilitation credit, by 50 percent of the amount by which adjusted gross income (computed with certain modifications) exceeds $200,000.

[76] See Section V (D) of this report.

be reported separately.[77] Since it will not be common for partnerships to have such a credit, the Form 1099-K will report this item only for partnerships that have had a final determination during the taxable year.

c. Foreign Tax Credit

Under current law, taxpayers have the option of choosing to deduct or claim a credit against U.S. tax for certain foreign taxes paid or accrued by the partnership.[78] Most taxpayers choose to credit their foreign income taxes against U.S. income tax. The credit option is subject to a complex set of limitations. Under section 904, creditable foreign taxes must be allocated to a specific basket or category of income, and within each basket the foreign tax credit is subject to a ceiling that is determined by reference to the amount of income in that basket. In determining the amount of income in each basket and the amount of foreign taxes paid or accrued with respect to that income, a partner of a partnership is treated as directly earning his or her distributive share of the partnership's income and directly paying the foreign tax, i.e., a partnership generally is treated as an "aggregate" rather than as an "entity" for this purpose. Under current law, each partner's distributive share of foreign taxes paid or accrued by the partnership is separately stated on Schedule K-1, in order to provide the partner with the information necessary to combine foreign taxes paid or accrued by the partnership with other foreign taxes paid or accrued by the partner in computing his or her foreign tax credit limitation.

Partnership Level Credit. In order to avoid the complexity associated with a separate listing of foreign taxes and income on Form 1099-K, the foreign tax credit limitations should be applied at the widely held partnership level. All elections and computations concerning foreign tax credits would then be determined at the partnership level, as are other elections and computations under the simplified reporting system. A widely held partnership would have an annual election to deduct or credit foreign taxes paid or accrued; any carryovers of such items would be at the partnership level. In order to apply this concept, the credit for foreign taxes paid or accrued would be determined by using an assumed U.S. tax rate for the partnership. The amount of foreign taxes paid or accrued by the partnership which could be claimed as a credit against U.S. tax on the income in a particular foreign tax credit limitation basket would be limited to an amount equal to U.S. taxes (calculated at the

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[77]The same issue would arise if in the future partnership withholding were to be instituted. See Section IV (G) of this report.

[78]I.R.C. §§ 901 and 903; I.R.C. § 164(a)(3).

assumed rate) on the foreign source income in that basket. All partnership income would be reported at the partner level as having a U.S. source.

This approach could be applied by using all of the limitations and separate baskets provided under current law. The foreign tax credit passed through to the partners would be the sum of all the separate foreign tax credit limitations. This sum would be included as part of the consolidated tax credit on the partners' Form 1099-Ks, and reported by partners directly on their tax returns.[79] The choice of an assumed tax rate for the partnership in making the foreign tax credit calculation would have a substantial effect on the partners. A low assumed rate would reduce the amount of foreign tax credits available to offset U.S. income tax liability of the partners and would be detrimental to those partners whose marginal rate is higher than the assumed rate. Conversely, if a higher assumed rate were used by the partnership, those partners who actually are subject to a lower marginal rate would receive the benefit of foreign tax credits to which they would otherwise not be entitled.

Partner Level Credit. As an alternative method, foreign income and foreign taxes paid could be reported separately to partners on the Form 1099-K. An additional line on the Form 1099-K would show the foreign source portion of any income item, and another line would show the amount of foreign tax paid or accrued (the amount which results from netting lines 17(e) and 17(f) of the current Schedule K-1).

As stated above, foreign taxes paid or accrued generally are creditable only against U. S. income tax on the specific baskets of income to which the foreign taxes relate. Special rules apply to limited partners (and corporate general partners) who own less than 10 percent of the value of the partnership (based on profits or capital interests). These partners must treat their distributive shares entirely as passive income for foreign tax credit purposes, regardless of the type of income earned by the partnership.[80] There are two exceptions under current law to passive income treatment which it may be possible to eliminate in order to facilitate simplified partner level reporting. Under the first exception, the distributive portion of each partner's interest income which is "high withholding tax interest" continues to be treated as such for foreign tax credit purposes. Under this rule, interest income which would otherwise be in the passive basket is placed in a separate basket if such income is subject to a foreign withholding tax of 5 percent or more. The

[79]With respect to the treatment of foreign partners of a widely held partnership, see footnote 104.

[80]Treas. Reg. § 1.904-5(h).

effect of the high withholding tax basket is generally unfavorable to taxpayers, because tax credits associated with such income cannot be used to offset U.S. tax on low-taxed or untaxed income in the passive basket. While some revenue loss would result from eliminating this exception, the effect would not be large if the proposal were applied only to a limited class of partnerships. Under the second exception to passive income treatment under current law, a distributive share from a partnership interest held in the ordinary course of the partner's active trade or business receives look-through treatment for purposes of section 904. This exception generally applies to small corporate general partners in the oil and gas industry, and is a special relief provision for those taxpayers. Eliminating this exception would adversely affect a small number of taxpayers. If these exceptions were eliminated for partners owning less than 10 percent of the partnership interests, reporting of foreign source income and foreign taxes would require no more than two additional lines on the Form 1099-K.[81]

5. Other Reporting Issues

As proposed, the Form 1099-K would not require the separate reporting of unrelated business taxable income ("UBTI"). Under current law, all income of a publicly traded partnership is UBTI,[82] but this is not the case for other widely held partnerships. To prevent evasion of the UBTI rules, it might be necessary to require separate reporting of income that would be UBTI to tax exempt partners or treat all income of any widely held partnership as UBTI.

Oil and gas issues present special concerns, in large part because of the unique treatment of oil and gas properties held by partnerships. Under the Code, percentage depletion is disallowed to certain taxpayers, and is significantly restricted for all other taxpayers.[83] Partnerships must allocate basis in and

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[81]These exceptions should probably not be eliminated for partners holding 10 percent or more of the interests in a widely held partnership. Thus, the treatment of the foreign tax credit may have an impact on whether large partners should be excluded from the simplified reporting system. See Section IV (E).

[82]I.R.C. § 512(c)(2).

[83]Retailers and refiners are prohibited from claiming percentage depletion with respect to oil and gas properties. I.R.C. § 613A(d). Other taxpayers are permitted to claim percentage depletion on production not in excess of the taxpayer's depletable oil quantity of 1,000 barrels of production per day, subject to a number of other restrictions. I.R.C. § 613A(c).

production from oil and gas properties to partners.[84] In addition, partnerships must report a significant amount of information on a property-by-property basis to each partner to permit the partner to calculate his or her depletion limitation.[85] These allocation rules are inconsistent with the basic goals of the simplified reporting proposal.

Detailed reporting of oil and gas items could be avoided by prohibiting the use of percentage depletion by widely held partnerships, and instead require cost recovery of their properties to occur through the generally less favorable cost depletion method. Alternatively, partnerships could be permitted to claim the amount of percentage depletion permitted a single taxpayer, with any remaining depletion calculated under the cost method. This alternative would allow the benefit of percentage depletion to partners who would not otherwise be eligible with respect to the partnership's properties, either because, for example, a partner is ineligible for percentage depletion or the partner's share of production from other properties exceeded the maximum allowable depletable production. This effect would, however, be relatively minor with respect to any partner, as a widely held partnership's percentage depletion deductions would be spread among its many partners. Under either method, items relating to depletion would not be reported separately. However, this would not allow depletion to be calculated by each partner, as under current law.

To permit partners in widely held partnerships to calculate percentage depletion separately as under current law, it would be necessary to design a special reporting form for widely held partnerships engaged in oil and gas exploration and production. Standards would have to be established to determine eligibility for this special reporting. The unique tax treatment of oil and gas properties held by partnerships may justify a more complex reporting form.

6. Reporting Form

To summarize, the following categories or spaces would appear on the simplified reporting Form 1099-K:

(1) Passive income (loss)
(2) Portfolio income (loss)
(3) Passive AMT adjustments and tax preferences (one amount)
(4) Portfolio AMT adjustments and tax preferences (one amount)

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[84] I.R.C. § 613A(c)(7)(D).

[85] *Id.* *See* Prop. Treas. Reg. § 1.613A-3(j).

(5) Tax credit
(6) Tax-exempt interest

All widely held partnerships would be required to provide a standard Form 1099-K to their partners. No substitute or alternative versions of the form would be permitted. Thus, partners in widely held partnerships would receive uniform information documents.

7. Possible Further Simplification

The simplified system discussed above represents a general approach to determining and reporting partnership income for widely held partnerships that would substantially reduce the reporting burdens of partnerships and their partners and the administrative burden of the Service. The particular items listed on the proposed Form 1099-K are illustrative of the suggested simplification. The list of separately reported items could of course be expanded, although at the cost of additional complexity. On the other hand, the number of items on the 1099-K could be further reduced. For example, the "Tax credit" line could be eliminated by converting the credit amounts into deductions. The net credit amount would be "grossed up" into a deduction at the partnership level by using an assumed tax rate. Thus, if a partnership had credits of $5,000, the grossed-up deduction would equal $22,727 if 22 percent were used as the assumed tax rate for this purpose (midway between the 15 percent and the 28 percent brackets).[86] This amount would be treated the same as any other partnership deduction and would be reflected as an adjustment to taxable income reported to partners on the Form 1099-K.

The "Tax-exempt Interest" item could also be eliminated, but only by treating such interest as taxable. If interest is tax-exempt, separate reporting is essential in order to provide individual taxpayers receiving social security benefits with the data necessary to calculate their separate tax liability.[87] Hence, the "Tax-exempt Interest" item could only be eliminated by removing the tax exemption on such interest for partners of these partnerships and by treating interest that is currently tax exempt in the same manner as other taxable interest includible in portfolio income. Separate reporting of the low income housing credit and the rehabilitation credit could also be prohibited for widely held partnerships, even those substantially engaged in

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[86] A higher assumed tax rate would result in a larger grossed-up deduction and a lower rate would result in a smaller deduction.

[87] Social security benefits become taxable when certain income levels are reached.

these activities. This would prevent partners from taking advantage of the special treatment afforded these credits under the passive loss rules. The resulting inability of partners to take advantage of the current law favorable treatment of tax-exempt interest and the low income housing and rehabilitation credits illustrates that there may be adverse consequences to further simplification of the reporting form.

8. Examples

The following examples illustrate the operation of the simplified reporting system in a number of fact patterns.

EXAMPLE 1 Assume the individual taxpayer receives a Schedule K-1 under present law which indicates the following items:

Ordinary income	$ 400	Investment interest expense	$90
Net rental loss	300	Charitable contribution	5
Dividends	55	Misc. portfolio deductions	20
Interest	125		
Net short-term capital losses	500		
Net long-term capital gains	400		

The individual is a limited partner and the ordinary income and rental loss result from passive activities. The capital losses and gains result from assets held for investment purposes and the miscellaneous deductions are subject to the 2 percent limitation. Assuming the net capital loss, charitable contributions and miscellaneous deductions can be fully deducted on the individual's return, taxable income of $65 would result under current law.[88] Under the proposal, the only reportable items would be passive income of $95 and portfolio income of $80, for a total taxable income of $175.[89]

The difference of $110 ($175-65) in the calculation of taxable income under current law and the proposal is due to the net capital loss of $100, which under the proposal carries over at the partnership level and can be used in a later year, and $10 representing the 50 percent adjustment to the miscellaneous deductions not allowed under the proposed treatment.[90] Both of

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[88]Current law: $400-300+(55+125)-(500-400)less(90+5+20)=$65.

[89]Proposal: $400-300-5=$95 Passive.
$55+125-90-10(20x50%)=$80 Portfolio.

[90]This represents an adjustment to reflect the 2 percent floor limitation on miscellaneous itemized deductions.

these items, the capital loss and the miscellaneous deduction, may or may not be deductible at the taxpayer level due to various limitations. In this example, two items would be reported on Form 1099-K versus nine on the present Schedule K-1.

EXAMPLE 2 The individual is a partner in a publicly traded partnership and the Schedule K-1 under present law indicates the following items:

Ordinary loss	$ 200	Misc. portfolio deductions	$100
Net rental loss	500	Investment interest expense	800
Dividends	400		
Interest	300		

The losses are passive and taxable income or loss under both the current and proposed system would be zero. There would be a passive activity loss carryover of $700 in both cases and an investment interest expense carryover of $200 under current law to the individual partner assuming no other interest to offset the expense.[91] Under the proposal there would be a carryover of $150 to the partnership due to the excess investment interest (because of the 50 percent allowance for miscellaneous deductions).[92] In this example, two items would be reported on Form 1099-K versus six on the present Schedule K-1.

EXAMPLE 3 The individual is a partner in a publicly traded partnership and the Schedule K-1 under present law indicates the following items:

Ordinary loss	$ 700	Foreign taxes paid	$ 5
Net rental loss	100	Foreign source income (included in ordinary loss)	150
Sec. 179 expense	70		
Targeted job credit	20		
Recapture of low-income housing credit	10		

The losses are passive and under current law the partner would report a passive activity loss of $870 (including the $70 section 179 deduction) and a disallowed passive activity credit of $20. The foreign tax credit is not subject to the passive loss rules.

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[91]Current law: $200+500=$700 Passive loss. $400+300-100-(800-200 carryover)= $0 Portfolio.

[92]Proposal: $200+500=$700 Passive loss. $400+300-50(100x50%)-(800-150 carryover) = $0 Portfolio.

The partner would incur a current recapture tax of $10.[93] Under the proposed system, the reportable items would include a disallowed passive loss of $875 and a disallowed passive activity credit of $10 (assuming the recaptured credit was offset against the jobs credit).[94] In this example, two items would be reported on Form 1099-K versus seven on the present Schedule K-1.

C. Elimination of Non-Income Items

The present Schedule K-1 reports a substantial amount of non-income information. Items A through J of Schedule K-1 report information concerning each partner, including whether the partner is general or limited, a domestic or foreign person, the type of entity, the partner's share of liabilities, the partner's percentage interest and acquisition date. In addition, the form requests the following information about the partnership: where the return was filed, Tax Shelter Registration Number, if any, whether publicly traded, foreign countries to which taxes were paid, and whether the current Schedule K-1 is an amended one. As proposed, none of these items would be reported on the Form 1099-K. The only non-income information reported on the Form 1099-K would be the taxpayer's name, address and taxpayer identification number and the same information for the partnership.[95] Any additional relevant information could be furnished upon examination or on separate schedules with the partnership return of income.

Item K on the present Schedule K-1 records the partner's capital account activity for the year. The amounts in the capital account analysis reflect various additions and deductions to the account during the taxable period, including contributions of capital and distributions to the partner, as well as taxable income or loss and other amounts reflected on the return. The capital account information is probably not necessary for an individual partner's computation of his or her separate tax liability. In contrast, it is necessary for partners to maintain information as to the bases of their partnership interests. Although neither basis nor capital account information is included on the Form 1099-K, partnerships

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[93]Current law: $800+70=$870 Passive loss. This assumes the section 179 deduction is not limited by section 179(b) at the partner level.

[94]Proposal: $700+100+70+5=$875 Passive loss. $20-10=$10 Disallowed credit. The result in the example assumes that the partnership has elected to deduct foreign taxes paid.

[95]We recognize that in implementing this proposal certain other non-income items may be determined necessary for inclusion on the Form 1099-K.

should be required to separately provide basis information. Similarly, partnerships should be required to reflect any section 743(b) adjustments in computing the partners' shares of taxable income. Even without a specific requirement, however, we assume that partnerships would generally provide the information necessary for partners to compute and substantiate their tax bases in their partnership interests.[96]

D. Magnetic Media Filing

Each widely held partnership would be required to provide Form 1099-K data to the Service by magnetic media. Partnerships are now permitted, but not required, to use such means for filing.[97] Once a partnership is required to file using magnetic media under this provision the requirement would continue indefinitely, as a partnership that meets the definition of a widely held partnership will continue to be treated as such until the Commissioner grants permission for a change in status.[98]

The instructions for the Form 1099-K would cover the items mentioned above and key each item, where appropriate, to a specific line on Form 1040 and its schedules or to a special schedule which would be used to accumulate Form 1099-K information from partnerships and thus facilitate the matching of information from widely held partnerships to the partner's return.

E. Treatment of Large Partners

It is not clear whether partners holding significant percentage interests in a widely held partnership should participate in the simplified reporting system. Interests held by such partners are excluded from the current assessment system proposed by this report,[99] but the considerations are somewhat different under the reporting system. The calculation of taxable

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[96]Currently, no complete basis information is provided to the partners. The capital account information included on the Schedule K-1 may correspond to a partner's tax basis (excluding the partner's share of liabilities) in his or her partnership interest.

[97]Although this recommendation of mandatory filing by magnetic media would apply only to widely held partnerships, no inference should be drawn with respect to whether such filing may be required of other partnerships in the future.

[98]See Section VII of this report.

[99]See discussion at Section V (D) (1) and V (D) (5) of this report.

income may become substantially more complex if the income reported to partners with at least a five or ten percent interest is determined separately from the income reported to the remainder of the partners. On the other hand, if large partners were allowed to use the simplified reporting system, they might in some cases be able to use widely held partnerships to avoid various restrictions. For example, depending on the manner in which the foreign tax credit is calculated by widely held partnerships, taxpayers may derive a material advantage from generating certain income through such a partnership. Until the precise rules of the simplified reporting system have been formulated, it is difficult to predict the extent to which simplified reporting for large partners would present opportunities for tax abuse. Accordingly, this report makes no recommendation with respect to the treatment under the simplified reporting system of partners holding significant interests in widely held partnerships.

F. Summary of Simplified Reporting Issues

The potential advantages of a simplified reporting system are threefold:

(1) The widely held partnership would experience a significant reduction in the number of forms and correspondence sent to the Service and to partners with a corresponding reduction in associated costs.

(2) The partner would receive a one page form, similar to other information forms such as a Form W-2 for wages or the Form 1099 used for interest, which would be familiar and relatively simple. Such a system would be more understandable than the present system and would thus encourage compliance.

(3) The Service would receive data by magnetic media which would be used to provide a more efficient matching of data to the information reported by partners on their returns and would thereby enhance compliance with reporting requirements.

By implementing a simplified reporting system, the calculation of income and related items would be altered with respect to widely held partnerships. The goal of these proposed changes is not to increase or decrease the overall tax due with respect to such partnerships. Rather, the goal is to produce a simplified system that, within the constraints of a radically simplified Schedule K-1, approximates the current law calculation of taxable income and related items as closely as possible. Nonetheless, we recognize that the total income tax attributable to a partnership subject to the simplified reporting system would almost certainly vary to some degree from the total income tax under the current rules. This raises two principal concerns.

The first concern is that, given the recent history of tax law changes that have adversely affected investment partnerships, the redefinition of the calculation of a widely held partnership's income will be structured to increase the overall tax due. That is not the intent of the proposed simplified reporting system. The goal of the proposal is to simplify the reporting system rather than to raise revenue, other than revenue attributable to improved compliance.

The second concern is that certain partnerships will be able to take advantage of any variations in income calculation by selecting the most beneficial system. For example, a partnership with 200 partners might restrict entry of new partners if it feared that the simplified reporting system would significantly increase overall taxable income. If the system is properly designed, any income calculation advantage or disadvantage to a partnership will be minimal, thus reducing this incentive to target growth for a marginal tax advantage.[100] Furthermore, once a partnership becomes subject to the simplified reporting system as a widely held partnership, it will not be able to withdraw from the system without permission of the Commissioner.[101] Therefore, partnerships will not have the ability to move in and out of the simplified system at will. These factors should minimize the impact of any variations in income calculation that may arise under the simplified reporting system.

G. <u>Withholding</u>

As a general matter, in tax administration, it is axiomatic that if third parties report to the Service the income they pay to individuals, compliance in reporting that income markedly improves. Withholding of tax at the source has generally proven to be an even more effective means of assuring compliance. At present, withholding is mainly imposed on certain limited categories of items, including wages, tips, supplemental unemployment benefits, and gambling and lottery winnings. Dividends and interest are subject to information reporting, but not withholding unless the backup withholding provisions apply.[102] Not

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[100]Nonetheless, as noted above, the possibility of differences in income calculation may necessitate the exclusion of large partners from simplified reporting.

[101]See Section VII of this report.

[102]I.R.C. § 3406. In certain instances, withholding is voluntary (<u>e.g.</u>, pension distributions, annuity payments, sick pay). I.R.C. §§ 3402 and 3405.

surprisingly, Service studies indicate that compliance levels are highest in areas in which withholding is imposed.[103]

Partnership distributions are different from wages, interest or dividends, in that partnership distributions may consist not only of current income, but also advances on estimated income (drawings), or return of capital. Under current law, neither income nor distributions of a domestic partnership are subject to withholding, except as to nonresident alien partners.[104]

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[103]Gross Tax Gap Estimates and Projections, at 5-6.

[104]"Inbound transactions," that is transactions giving rise to income from U.S. sources paid to foreign persons, are subject to a reporting and payment system which operates in addition to and independently of the reporting system applicable to partners generally. The reporting and withholding system applicable to foreign partners is beyond the scope of this report and will not be affected by the proposals made herein.

Section 1446, as amended in 1988, currently requires a U.S. or foreign partnership with effectively connected taxable income allocable to a foreign partner to pay a U.S. withholding tax with respect to that partner's allocable share of that income in the time and manner prescribed by the Service. Rev. Proc. 89-31, 1989-20 I.R.B. 136 (May 15, 1989), implements this section and provides that affected partnerships must generally pay a withholding tax, without regard to distributions, on a quarterly basis based upon 28 or 34 percent of the effectively connected taxable income allocable to foreign noncorporate and corporate partners, respectively. The Revenue and Reconciliation Act of 1989 amended section 1446 to clarify that the Service is authorized to apply the corporate estimated tax rules and penalties to partnerships to compute and enforce the quarterly payment requirement. Publicly traded partnerships are allowed to withhold on distributions at a flat 28 percent rate, but these partnerships may elect to make quarterly payments without regard to distributions.

Section 1446 withholding overrides section 1445(e)(1) withholding. Under section 1445(e)(1), a domestic partnership is required to withhold 34 percent of a foreign partner's net gain attributable to the partnership's disposition of a U.S. real property interest. Generally, section 1445(e)(1) withholding is to be made by the partnership within 20 days of the disposition of U.S. real property, but publicly traded partnerships and any other partnerships with more than 100 partners generally defer the payment of the section 1445(e)(1) withholding tax until a distribution attributable to the sale proceeds is made.

We do not recommend withholding for widely held partnerships at this time. Under the proposed reporting system with required magnetic media filings, it is expected that the Service will be able to include the Form 1099-K information in its document matching program and the Information Returns Program procedures. Moreover, the ability of partnerships and the Service to determine the identity of persons holding interests has been significantly improved through the enactment of the nominee reporting system of section 6031(c).[105] Thus, the Service should be able to more efficiently match Form 1099-K information with that reported on the partner's return.

The Service continues to evaluate the level of compliance by partners of widely held partnerships and the possibility of recommending the institution of withholding, if necessary, to ensure that adequate standards of reporting and collection are maintained.

H. Ownership Changes

The issues arising under subchapter K of the Code that have particular relevance to widely held partnerships generally relate to the tax impact of ownership changes of interests in these partnerships. The ownership change issues are especially important to publicly traded partnerships because interests may be frequently traded and must remain fungible in the marketplace. This section will briefly discuss the subchapter K issues with respect to (1) fungibility, (2) constructive terminations, (3) accounting conventions for allocations of income, and (4) information reporting.

1. Fungibility

For partnership interests to be fungible, any interest purchased must possess the same tax characteristics to the buyer, regardless of the tax characteristics that interest had in the hands of the seller. Under current law, application of certain technical rules of subchapter K can result in buyers holding

[105]Under I.R.C. § 6031(c)(1), any person who holds an interest in a partnership as nominee for another person is required to furnish to the partnership the name and address of such other person, and any other information for such taxable year as may be prescribed by form and regulation. The nominee is also required to furnish such other person with the information provided by the partnership on the Schedule K-1.

partnership interests that are identical, as an economic matter, but that possess substantially differing tax characteristics depending on the identity of the seller of each interest.

In general, under subchapter K, the purchaser of a partnership interest takes a basis in partnership assets equal to his or her pro rata share of the partnership's basis in those assets. If an election is made under section 754, however, the purchaser's basis in partnership assets will be adjusted under section 743(b) to reflect the purchase price of his or her partnership interest. The basis adjustment is made with respect to the purchaser only, and does not affect any other partner's proportionate share of basis in partnership assets. Under the regulations for section 743(b), the purchaser partner's share of basis in partnership assets prior to adjustment is determined by reference to the transferor partner's share of basis in those assets. Publicly traded partnerships typically make a section 754 election so that purchasers will not inherit tax attributes (e.g., unrealized appreciation) unrelated to the purchase price of their units. Moreover, under current law, a section 754 election may be necessary to prevent different units in a publicly traded partnership from having different tax attributes, i.e., to make the units fungible.

Under section 704(c), income, gain, loss, and deduction with respect to contributed property must be shared among partners so as to take account of the variation between the basis of the contributed property in the partnership and its fair market value at the time of contribution. The object of that section is to prevent gain or loss inherent in property at the time of contribution from being shifted from the contributing partner to noncontributing partners.[106] As a result of section 704(c), partnership units may have different tax attributes because they are subject to different allocations under section 704(c). A basis adjustment under section 743(b), however, generally will eliminate any difference between partnership units caused by section 704(c) unless the "ceiling rule" has affected the application of section 704(c).

The "ceiling rule" of section 1.704-1(c)(2) of the regulations may prevent section 704(c) allocations from eliminating the disparity between adjusted basis and fair market value

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[106]The principles of section 704(c) are also to be applied when a partnership revalues its property for purposes of section 704(b) upon the occurrence of certain events, including the admission of a new partner. Treas. Reg. § 1.704(b)-1(b)(4)(i). See also Treas. Reg. §§ 1.704(b)-1(b)(2)(iv)(f) and (g). Allocations made pursuant to such a revaluation are frequently referred to as "reverse section 704(c) allocations," and the discussion herein applies equally to such allocations.

of contributed property over time. Under the ceiling rule, the total depreciation, depletion, or gain or loss allocated to the partners cannot exceed the amount of gain or loss realized by the partnership or the depreciation or depletion allowable to the partnership. If the ceiling rule applies, allocations under section 704(c) cannot prevent gain or loss inherent in contributed property from being shifted to noncontributing partners. Moreover, a basis adjustment under section 743(b) cannot eliminate differences between partnership units caused by the application of the ceiling rule. Accordingly, if the ceiling rule limits the allocations that may be made under section 704(c), different units carry different tax characteristics even after section 743(b) adjustments have been made, and the units thus are not fungible.

Regulations under section 704(c) may address the problems caused by application of the ceiling rule.

2. <u>Constructive Termination Under Section 708</u>

Section 708(b)(1)(B) provides that a partnership will be considered as terminated[107] if within a 12-month period there is a sale or exchange of 50 percent or more of the total interests in partnership capital and profits. The regulations[108] clarify that multiple sales of the same interest during the 12-month period are treated as the sale of a single interest for purposes of applying the 50 percent rule. In addition, a disposition of a partnership interest by gift, bequest or inheritance, or the liquidation of a partnership interest is not a sale or exchange for purposes of section 708(b)(1)(B).

Because it is generally impractical for publicly traded partnerships to match transferors and transferees of particular units traded on the securities market, publicly traded partnerships in many cases will be unable to determine whether a termination under section 708 has occurred during a given year.[109] Moreover, the administrative proposals recommended

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[107]Treas. Reg. § 1.708-1(b)(1)(iv) provides that in a constructive termination under section 708(b)(1)(B) there is a deemed distribution of all partnership property and a deemed contribution of such property to a "new" partnership.

[108]Treas. Reg. § 1.708-1(b)(1)(i).

[109]Publicly traded partnerships generally will be unable to determine whether a particular unit has been transferred more than once during a year, or whether a transfer was made by gift, bequest or inheritance. In certain situations, however, publicly traded partnerships will be able to determine whether a termination under section 708(b)(1)(B) has taken place (<u>e.g.</u>, if

herein disregard terminations under section 708(b)(1)(B) for audit and collection purposes. Accordingly, consideration should be given to narrowing or eliminating the application of section 708 to widely held partnerships.

3. Accounting Conventions

Under section 706(c)(2), the taxable year of a partnership closes with respect to a partner who disposes of his or her entire interest in the partnership. Section 1.706-1(c)(2)(ii) of the regulations provides that the distributive share of a partner whose entire interest is sold may be computed either through an interim closing of the books[110] or, by agreement among the partners, through a proration method.[111] Under section 706(d), added by the Tax Reform Act of 1984, each partner's share of income, gain, loss, deduction or credit must be determined by taking into account his or her varying interests in the

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there was a large block transfer of over 50 percent of the interests during the year, or if less than 50 percent of the interests were transferred during the year).

[110]Under the interim closing of the books method, the partnership traces all partnership items to the particular segment of the partnership taxable year in which such item arose.

[111]Under the proration method, partnership items are allocated to portions of the taxable year (e.g., days, months) by prorating the entire year's items regardless of when the item arose. The regulation provides that the proration may be based on the portion of the taxable year that has elapsed prior to the sale (i.e., a daily convention) or "under any other method that is reasonable."

partnership during the partnership taxable year.[112] Certain items are required to be allocated on a daily basis.[113]

It appears that most widely held partnerships have adopted a monthly convention for determining when a purchaser of a unit becomes a partner both in the case of partial and complete dispositions of partnership interests. Thus, widely held partnerships typically treat transfers of interests occurring at any time within a month-long period as if all such transfers had occurred on a specified day within that period.[114] An interim closing of the books or use of a daily convention is probably impractical in the context of publicly traded partnerships.

Because publicly traded partnership interests are normally transferred in anonymous transactions over a securities market, there does not appear to be significant potential tax avoidance resulting from the use of a monthly convention as long as the convention is uniformly applied. Partnerships that are not publicly traded within the meaning of section 7704(b) typically will not have sufficient trading activity to create material distortion. To provide for the unusual case where tax avoidance is of concern, the Conference Committee Report to the 1984 Act states that the Service "may deny the use of any convention when the occurrence of significant, discrete events (e.g., a large, unusual gain or loss) would mean that use of a convention could result in significant tax avoidance." Regulations might also prevent the application of a convention to large block transfers

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[112]The Conference Committee Report to the 1984 Act expresses an expectation that regulations under section 706(d) will provide for a monthly convention, apparently only with respect to dispositions of less than an entire partnership interest. H.R. Rep. No. 861, 98th Cong., 2d Sess. 858 (1984). In News Release IR 84-129, the Service permitted the use of a semi-monthly convention in the case of a partial disposition of a partnership interest for partnerships using the interim closing of the books method. The news release did not change the general requirement of a daily convention for partnerships using the proration method. The Blue Book to the 1984 Act, referring to dispositions of less than an entire partnership interest, stated that the use of any "reasonable convention" would be permitted until regulations are issued under section 706(d). Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 221-222 (1984).

[113]I.R.C. § 706(d)(2).

[114]The specific methods vary among partnerships. For example, some partnerships treat all transfers during a month as occurring on the first day of that month or the first day of the following month.

(e.g., transfers in excess of 5 percent of outstanding interests) where the potential for tax avoidance may exist in connection with an extraordinary transaction.

4. Information Reporting

It is difficult or impossible for widely held partnerships, and especially publicly traded partnerships, to comply with a number of information reporting and gathering requirements applicable to partnerships generally. Under section 6050K and the regulations thereunder, upon certain transfers of partnership interests subject to section 751, a partnership is required to file Form 8308 reporting both the transferor and transferee of the interest.[115] This requirement cannot be satisfied for transactions occurring on an exchange because the buyer and seller of any given interest cannot be matched. Similarly, widely held partnerships may be unable to comply with certain requirements imposed under the tax shelter registration rules. For example, the seller of an interest in any partnership which is classified as a tax shelter under section 6111 must furnish a document containing specified information to the purchaser of the interest; this requirement cannot be satisfied for a transfer on a securities exchange.[116] Additionally, any partnership subject to registration under section 6111 is required to maintain a list of all investors in the partnership which must be available for inspection within 10 days of a request by the Service.[117] The 10-day requirement cannot be satisfied by any partnership in which interests are owned through nominees. To the extent these provisions continue to be imposed by the Code,[118] consideration

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[115]Treas. Reg. § 6050K-1(b)(1). Under Treas. Reg. § 1.605K-1(a)(2), a partnership need not file a Form 8038 with respect to any transfer which must be reported under Code section 6045 (reporting by brokers, etc.). However, many types of transfers are exempted from reporting under section 6045. See Treas. Reg. § 5f.6045-1(c)(3).

[116]Temp. Treas. Reg. § 301.6111-1T, Q & A 51 et. seq. In addition, the required tax shelter list must specify the transferor of any interest held by a transferee partner. Temp. Treas. Reg. § 301.6112-1T, Q & A 17. Again, this type of matching of buyers and sellers is not possible for a publicly traded entity.

[117]Temp. Treas. Reg. § 301.6112-1T, Q & A 21.

[118]The recently completed study of civil tax penalties made no recommendation with respect to the tax shelter registration rules, concluding that the "area should continue to be monitored to assure that the registration requirement continues to be needed." Report on Civil Tax Penalties by Executive Task Force,

should be given to amending the regulations so that widely held partnerships will be able to comply.

Commissioner's Penalty Study, Internal Revenue Service, 1989, at VI-28.

SECTION V. PROPOSALS FOR CURRENT ASSESSMENT OF DEFICIENCIES WITH RESPECT TO WIDELY HELD PARTNERSHIPS

A. Overview

Much of the administrative inefficiency and complexity facing the Service in the administration of widely held partnerships stems from the fact that a deficiency must be assessed against taxpayers who were partners in the year in which the understatement of tax liability arose. This requires the Service to locate and monitor the returns of all taxpayers who were partners in that year, and eventually assess each former partner's share of the deficiency. If an adjustment covers several years, the complexity of the task is compounded.

These administrative burdens could be partially alleviated, from the point of view of the Service, by requiring the partnership to perform many of the tasks required to convert a partnership level adjustment into assessments with respect to individual partners. The partnership could be required to file amended returns for the years to which the adjustment relates, and issue amended Form 1099-Ks, including penalties and interest, to the partners in those years. The filing of amended returns and the issuance of amended Form 1099-Ks would be required within a reasonable period from the date of the final determination. As under current law, taxpayers who had related adjustments in subsequent years would be entitled to file refund claims based on their overpayments of tax in those years.

This approach cannot be viewed as a satisfactory means of improving the administration of widely held partnerships. Although part of the burden of tax administration would be shifted to partnerships and partners under this approach, the Service would still face the prospect of handling claims for refund from thousands of partners upon an adjustment with respect to any sizable partnership, and would be responsible for monitoring compliance by both partnerships and partners. Furthermore, there would be no net reduction in the overall effort necessary to achieve assessment and collection of deficiencies with respect to widely held partnerships.

The key to streamlining the assessment of deficiencies with respect to widely held partnerships is to devise an assessment system that significantly reduces this overall effort. This section of the report reviews proposals for achieving this goal. The first proposal discussed was considered in connection with the formulation of the 1987 Revenue Act; this report concludes that this proposal would not materially reduce complexity and thus should not be enacted. Other proposals, the Partnership Collection Proposal and the alternative current assessment proposals, have been developed in the preparation of this report. While this report concludes that the Partnership Collection

Proposal is the preferred approach, it is believed that the enactment of any of these current assessment proposals would produce a system under which it would be feasible to conduct audits of widely held partnerships.

B. House Proposal

1. Description

The bill originally passed by the House of Representatives[119] during formulation of the Revenue Act of 1987 contained a proposal for collecting deficiencies from certain partnerships (the "House Proposal"). Under the House Proposal, underpayments of tax resulting from "applicable return adjustments" with respect to certain partnerships would have been collected either from the partnership or from each partner. For this purpose, an "applicable return adjustment" meant a final partnership administrative adjustment (if no court proceeding had been timely commenced), a court decision that had become final, an amended return filed by the partnership, or a settlement agreement binding on the partners. Any "shortfall" (*i.e.*, any understatement of taxable income, overstatement of taxable loss, overstatement of credits, or any combination thereof for a given partnership taxable year) resulting from an applicable return adjustment would have been subject to notice and demand by the Service in the same manner as if the tax were originally imposed on the partnership. The partnership would have been required to pay tax at the highest rate (individual or corporate) applicable for the taxable year of the shortfall. The amount of the shortfall would have been reduced to the extent the partnership could have proven that a partner had reported consistently with the applicable return adjustment in the partner's original or amended return.

Under the House Proposal, the payment of tax by the partnership would have been treated as payment of tax by each partner of his or her allocable share of the payment determined in accordance with his or her interest in the partnership in the year to which the adjustment related. To the extent the payment by the partnership created an overpayment with respect to any partner (*e.g.*, where the partner's marginal tax rate was lower than the rate paid by the partnership), that partner would have been entitled to file a claim for credit or refund of the overpayment. The partnership would have had the right to recover the amount of payment made on behalf of a partner from that partner.

Neither the House Bill nor the House Ways and Means Committee Report specified the capital account or basis

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[119] H.R. Rep. No. 3545, 100th Cong., 1st Sess. (1987).

adjustments to be made in connection with a partnership payment. Presumably, the partners' capital accounts would have been adjusted for the redetermined amounts of income, deductions, or credits in the year of the shortfall. The payment of tax by the partnership presumably would have been treated as a partnership distribution, with the partners in the year to which the adjustment related receiving a credit for the amount of tax paid. The House Proposal treated adjustments on a year-by-year basis, with no reference to related offsetting adjustments in other years. The House Proposal did not include any provision for the payment of interest and penalties with respect to a partnership deficiency.

The House Proposal would have applied to any partnership with interests required to be registered under federal or state laws regulating securities, or sold under an exemption from registration requiring the filing of a notice with a federal or state agency regulating the offering or sale of securities.[120]

2. Examples

The following examples illustrate the application of the House Proposal.

EXAMPLE 1 In its return for the 1992 taxable year, partnership X understates its income by $1 million, with no offsetting adjustments in later years. In 1998, a final assessment is made. X would pay tax at the highest applicable rate for 1992 (assume 34 percent for purposes of these examples). The applicable return adjustment would be allocated among X's 1992 partners in accordance with their interests in the partnership. The 1992 partners would be entitled to file a claim for refund for any excess tax paid on their behalf (*e.g.*, amounts attributable to marginal tax rate differentials). X would have a right to seek reimbursement from partners, including former partners, of tax paid on their behalf by X. The partners' bases and capital accounts would presumably be adjusted to reflect the allocation of additional income. Presumably, the payment of tax by X would be treated as a deemed distribution to the partners. The net effect of these adjustments would be to increase the adjusted bases of the partnership interests as of the end of 1992. Consequently, any 1992 partner who sold an interest in the partnership between 1992 and 1998 presumably would be entitled to file a claim for refund of tax for the year of sale to reflect reduced gain or increased loss from the sale.

EXAMPLE 2 In 1992, Partnership Y reports a deduction of $1 million that should have been reported in its 1993 taxable year. In 1998, a final assessment is made. Because the House Proposal

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[120] *Id.*

applies on a year-by-year basis, it would not permit an offset of underpayments and related overpayments occurring in different years. Thus, the results would be identical to those described in Example 1 above, with Y paying tax on the deficiency for 1992 at the highest rate in effect for that year (34 percent). Y's 1993 partners would be entitled to file claims for refund for their overpayments in that year.

EXAMPLE 3 In 1992, Partnership Z deducts $1 million that should have been amortized on a straight-line basis over ten years. In 1998, a final adjustment is made. The result would generally be the same as in Example 2 above. The applicable return adjustment to be paid by Z for 1992 would equal $900,000 ($1 million minus $100,000 allowable amortization). Z's partners from 1993 through 1997 would be entitled to file claims for refund for their overpayments (attributable to Z's $100,000 deduction understatement in each year) in those years.

3. Analysis

The House Proposal attempted to address problems that exist under current law in assessing and collecting deficiencies from partners of widely held partnerships by collecting the deficiency directly from the partnership. Under the House Proposal, the tax paid by the partnership would have been treated as paid by persons who were partners during the year to which the adjustment related, and any partners who had a marginal tax rate that was less than the maximum tax rate applicable under sections 1 or 11 would have been entitled to file claims for refund. Since the maximum corporate rate currently exceeds the maximum individual rate, apparently all individual partners would have been due such refunds. In addition, the proposal would not have offset understatements of income with directly related overstatements of income, resulting in refunds due to partners who had a directly related negative adjustment to income in a different taxable year. Thus, thousands of potential refund claims would have been created with respect to partnerships with substantial numbers of partners. A significant paperwork burden would have been imposed on the Service and taxpayers to the extent these refund claims were pursued; to the extent the refund claims were not pursued, the proposal would have resulted in the collection of more tax than the government was due. The House Proposal would have imposed further record maintenance responsibilities on the Service by permitting a reduction of a shortfall to the extent the partnership could have demonstrated that its partners reported the matter on their own returns consistently with the applicable return adjustment. Thus, while the House Proposal provided greater assurance of collection of partnership deficiencies, it might have actually increased the Service's paperwork burden. Furthermore, because it involved collection of deficiencies directly from the partnership, the House Proposal would have created the same partnership liquidity problem discussed below in connection with the Partnership Collection Proposal.

The House Proposal endeavored to continue to impose the burden of payment of the tax deficiency on the partners who originally benefited from the understatement of income. This was accomplished by providing that the partnership would be entitled to recover from those persons who were partners in the year to which the adjustment related any amounts paid on their behalf. We do not believe it appropriate for the Internal Revenue Code to grant a private right of action. Furthermore, it often would have been difficult or impossible for a widely held partnership to obtain reimbursement from former partners for tax payments. The difficulty and expense of locating these partners, combined with the partners' probable unwillingness to reimburse the partnership voluntarily, would have likely rendered the right of reimbursement merely theoretical in most cases. Thus, notwithstanding the reimbursement provisions under the House Proposal, the tax on deficiencies would have been borne chiefly by the persons who held partnership interests during the year in which the final partnership adjustment occurred, and not those who held interests during the year to which the shortfall related. Yet the House Proposal did not provide the partners in the year in which a final adjustment occurred with any credit for tax paid or with any increase in the bases of their partnership interests. Thus, the House Proposal would have had the effect of attributing income to current partners without providing the adjustment to basis normally afforded partners who recognize income.

Furthermore, the House Proposal did not eliminate the administrative difficulties of assessing and collecting tax deficiencies of partners in partnerships covered by the proposal--it merely shifted the initial burden of dealing with these difficulties to the partnership. In cases where the amount of the deficiency for the average partner was small, partnerships would have been unlikely to have sought reimbursement from former partners, and partners with potential refund claims would have been unlikely to have filed them. Just as the Service may avoid the administrative problems of current law by not attempting to assess deficiencies with respect to widely held partnerships, such partnerships and their partners would have been expected to avoid them under the House Proposal by acquiescing in the collection of excessive amounts of tax. In cases where partnerships and partners would have decided to pursue refund claims, the Service would have continued to be faced with a paperwork burden that is similar to that existing under current law. For these reasons, we do not recommend that Congress adopt the House Proposal.

C. Deficiencies with Respect to Widely Held Partnerships Should be Borne by Current Partners

The House Proposal would not have materially reduced complexity because it retained the current law approach of looking back to prior-year partners as ultimately responsible for adjustments. This approach may be logical with respect to smaller partnerships, which correspond to the traditional view of partnerships as aggregations of individual taxpayers; however, widely held partnerships are best viewed as entities in this context and it is not necessary to treat the adjustments as personal to prior partners. The present system has the effect of isolating current partners from the impact of adjustments made with respect to the business of the partnership. Contrast this with the treatment of a shareholder in a large corporation. Assume that a shareholder owns stock from 1990 through 1992 in a corporation which substantially understates its taxable income for 1990. In 1993, a deficiency is assessed, and causes the value of the corporation's stock to drop materially. Meanwhile, the original shareholder has sold his stock. The cost of the deficiency is borne by the stockholder who purchased in 1992.

This report proposes an assessment structure for widely held partnerships which treats partners in a manner roughly comparable to the treatment of current and former shareholders in corporations. A current partner would bear the risk of tax adjustments relating to prior years; if a partnership interest is purchased without knowledge of the possibility of a substantial tax adjustment, the purchaser may pay too much for the partnership interest. It is important to note, however, that the basis adjustment rules of section 705 would mitigate both the "windfall" to the former partner and the unanticipated burden to the purchasing partner. Any deficiency to be collected from current partners would be adjusted to take into account offsetting adjustments in years other than the year of the shortfall. Offsetting related adjustments would greatly simplify the administration of widely held partnerships.

This proposal would involve a significant departure from traditional subchapter K principles. However, we believe that such a departure is warranted in view of the substantial costs and difficulties faced by both the Service and partnerships in applying these subchapter K principles to widely held partnerships.

D. Partnership Collection Proposal

1. Description

The central features of the Partnership Collection Proposal are: (1) the treatment of a partnership shortfall in a prior year as a current item of income in the year in which a final determination of the adjustment is made; (2) the collection of tax, interest, and penalties with respect to the shortfall directly from the partnership; and (3) the netting of related adjustments in other years. As under the House Proposal, a shortfall is defined as any understatement of taxable income, overstatement of taxable loss, overstatement of credits, or any combination thereof for a given taxable year.

Under the Partnership Collection Proposal, a widely held partnership would be treated as the taxpayer with respect to any partnership shortfall. The partnership would pay tax and interest as if it were a corporate taxpayer subject to tax at the highest rate applicable under section 1 or 11 for the year of the final determination. In computing the tax, interest, and penalties that would be paid by the partnership with respect to a partnership shortfall, the Partnership Collection Proposal would allow an offsetting adjustment for any directly related over-statement of taxable income, understatement of taxable loss, or understatement of credits for any other taxable year intervening between the taxable year to which the shortfall relates and the year in which the final partnership adjustment is made.[121] The offsetting adjustment would be computed by treating the partner-ship as if it were a corporate taxpayer that had paid tax on the related overstatement at the maximum rate applicable under section 1 or 11 of the Code for the year of the final determination.

The Partnership Collection Proposal would treat a partnership shortfall attributable to an understatement of taxable income or an overstatement of taxable loss (less any offsetting adjustment) as a positive adjustment to the taxable income of the partnership for the taxable year in which the final partnership adjustment is made. Each partner's share of the adjustment would be reported on the partner's Form 1099-K and included in the partner's income for such year. The income would be deemed to have arisen pro rata throughout the year, so that all partners during the year of the final determination would share the income. Any tax paid by the partnership with respect to such shortfall would be treated as tax paid by such partners, effectively treating the tax paid by the partnership as a credit allowable to the partners which would be refundable to the extent an overpayment can be established. Thus, although tax would be withheld at the maximum rate (and interest would be calculated on such basis), the tax would actually be imposed at the marginal rates of the partners in the year the final adjustment is made. The partnership would also pay interest and penalties with respect to the shortfall based on tax calculated at the maximum rate. Interest and penalties would not be refundable and would be nondeductible by the partners.

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[121] See I.R.C. § 6601(f).

A constructive termination of a partnership under section 708(b)(1)(B) would not affect the Service's right to make an entity-level assessment against the partnership for a taxable year preceding the year of termination. In addition, regulations would be authorized to govern the application of these rules to partnerships that have been liquidated, and exclude partnerships or their partners from the operation of these rules in appropriate or abusive situations. Partners holding a significant percentage of interests (e.g., at least five percent or ten percent) in a partnership in the year of the understatement would be excluded from the current assessment system. Thus, such partners would continue to be responsible for their allocable share of deficiencies even if they sold their interests prior to the final determination. The remainder of the deficiency would be allocated among all other current partners.

2. Basis and Capital Accounts

For purposes of maintaining the partners' capital accounts and determining the bases of their partnership interests, a partnership shortfall would usually be treated as a positive adjustment to the partners' capital accounts and bases,[122] any tax paid by the partnership would be treated as a distribution of cash to the partners, any interest or penalty paid by the partnership would be treated as a nondeductible partnership expense.

3. Overstatements and Amended Returns

If an audit determines that an overstatement was made in reporting a prior year's taxable income, the adjustment could also be treated as a current item by allowing a deduction in the year of the final determination. Related understatements would be offset against overstatements to produce a single adjustment. Interest due on such an overpayment (determined after application of section 6601(f)) would be calculated on the basis of an assumed rate and paid directly to the partnership. Appropriate basis and capital account adjustments would be made.

[122]Partners' bases and capital accounts would not be adjusted where a final determination relates to an item that has already been reflected in their bases and capital accounts. For example, when a partnership reports tax exempt interest, a partner's basis and capital account are increased by his or her share of the interest. See I.R.C. § 705(a)(1)(B). Therefore, upon a determination that the interest was not tax exempt, no further basis or capital account adjustment would be appropriate.

Amended partnership returns[123] would pose a number of issues under the Partnership Collection Proposal, regardless of whether the amended returns sought to increase or decrease previously reported income. If a partnership were allowed to treat an adjustment resulting from an amended return as a current item, partnerships arguably would have a measure of flexibility in determining when to claim a deduction or to report income. For example, if it were known that tax rates would increase in the next year, a partnership might fail to claim a deduction in the current year and then amend its return the next year to claim the deduction when it was worth more to its partners. This tactic would probably be successful only where there existed some legitimate uncertainty concerning the allowance of the deduction in the initial year, as the initial return might otherwise be found to contain a false statement. However, it is not improbable that in certain situations partnerships would be able to manipulate the system to use amended returns to their advantage if such returns were to produce a current adjustment. On the other hand, if adjustments arising from amended returns were to relate back to prior year partners, management of a partnership might be faced with a conflict of interest if it were aware at the commencement of an audit that a reporting position in a prior year is likely to result in an adjustment, regardless of whether the adjustment were an increase or decrease in taxable income. If management were to file an amended return, the adjustment would accrue to prior owners, while if the audit were allowed to run its course the adjustment would accrue to current owners. One possible solution would provide that amended returns would relate back to prior years, but that no such return could be filed after an audit has commenced. This would, however, place a great deal of significance on the commencement date of the audit. If the Partnership Collection Proposal is enacted, specific rules would be needed to deal with amended returns.

4. Insolvent Partnerships

A mechanism for collection from partners is necessary for situations in which a widely held partnership is unable to satisfy a deficiency. Our recommended approach would permit the Service to proceed against both current and former partners to collect the amount owed, but would also take into account the partners' tax status in determining ultimate liability. Under this approach, current partners would be required to pay amounts of tax liability not collected from the partnership, in effect requiring them to pay tax on the deficiency at a 34 percent rate. The amounts could be collected either by sending the current partners notices of deficiency or by reporting the liability as

[123] As noted above, an RAA is the procedure applied under the unified partnership audit rules for filing an amended return or refund claim.

an amount owed on the Form 1099-K. This flat percentage liability would be collected from all current partners, including tax exempt partners, regardless of their personal tax rates. A procedure should also be established to take into account the partners' individual tax status. This might be accomplished, for example, by having the partners add their share of the deficiency to their income for the year of the final determination or a subsequent year, and allowing a refund to the extent their payment exceeded the amount of tax owed on that income computed at their actual marginal tax rate.

If within a specified time period the amount of tax collected from the partnership and current partners was less than the amount owed by the partnership using the 34 percent rate, taxpayers who were partners in the year of the understatement (and who had since sold their interests) would be liable for their share of the amount owed (again applying a 34 percent tax rate).[124] In addition, a rule could be provided under which a former partner who was neither a partner in the year of the understatement or in the year of the final determination would be liable if his or her interest was transferred to a dummy or in any other transfer designed to reduce the overall tax liability or to avoid payment of the deficiency. The procedure would be similar to that described for current partners. Tax would be collected at the flat percentage tax rate based on their interests in the partnership, and a mechanism would be provided to take into account their actual tax status. While the collection approach described above would be somewhat cumbersome, it would permit collection of deficiencies with respect to insolvent partnerships even when interests are held at the time of determination by dummy or sham partners.[125]

Under the proposed collection approach, a general partner would essentially be treated the same as the other partners. Thus, the general partner would not be liable for more than the share of the underpayment attributable to his or her interest in

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[124]This would apply to partners other than those holding a significant percentage interest in the year of the shortfall. As discussed above, those partners would be excluded from the current assessment system.

[125]There are, of course, alternative approaches for proceeding against partners directly. If the Service is unable to fully collect a deficiency from the partnership, the current partners could be responsible for payment of any additional amounts owed under rules similar to the partner collection method discussed below. The current partners' tax liability would then be entirely determined by their individual tax status. Under this approach, collection against former partners probably would only be pursued in cases involving abusive transfers.

the partnership[126] and would not be liable for unpaid taxes on behalf of all current partners.[127]

5. Examples

The following examples illustrate the application of the Partnership Collection Proposal.

EXAMPLE 1 In its return for the 1992 taxable year, partnership X understates its income by $1 million, with no offsetting adjustment in a later year. In 1998, a final assessment is made. X would pay a tax at the highest applicable rate for 1998 (assume for purposes of these examples that the maximum tax rate is 34 percent), plus interest from 1992. In X's partnership return in 1998, $1 million would be added to partnership income, and the partners would be treated as having received a distribution of cash equal to the amount of tax paid ($340,000). The partners' bases and capital accounts would be adjusted to reflect the allocation of additional income and interest expense and the deemed distribution. The partners also would be given a refundable credit for the tax paid on their behalf. Thus, a partner whose marginal tax rate is less than 34 percent would use this credit to satisfy his or her tax liability on other income or would claim a refund.

EXAMPLE 2 In its return for the 1992 taxable year, partnership Y reports a deduction of $1 million that should have been reported in its 1993 taxable year. In 1998, a final assessment is made. No additional liability for tax would be imposed in 1998. However, Y would pay the interest imposed on the underpayment of tax in 1992 under section 6601, taking into account any credit against the underpayment under section 6601(f) as a result of the overpayment of tax in 1993. Any interest on

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[126]Of course, in certain cases, the rules described above regarding transferee liability would apply to general partners following a transfer of partnership assets out of partnership solution.

[127]Even though not personally liable for an underpayment of a deficiency, a general partner could have increased exposure to personal liability for partnership business obligations as a result of collecting the tax from the partnership. For example, partnership funds used to satisfy the deficiency would not be available to satisfy other debts of the partnership for which the general partners might be personally liable. Analogously, the collection of deficiencies from the partnership may have a disproportionate impact as between classes of limited partners with different interests in partnership allocations and distributions.

the 1992 underpayment would be treated as a nondeductible partnership expense.

EXAMPLE 3 In its return for the 1992 taxable year, partnership Z reports a deduction of $1 million for an expenditure that should have been amortized on a straight-line basis over 10 years. In 1998, a final assessment is made. The understatement of taxable income by Z for 1992 would be offset in part by Z's overstatement of taxable income for the taxable years 1993 through 1997. The adjustment in tax would equal 34 percent of the amounts previously expensed and not yet properly amortized ($400,000). In addition, Z would pay the interest imposed on the underpayment of tax in 1992 under section 6601, taking into account any credit against the underpayment under section 6601(f) as a result of the overpayment of tax in 1993 through 1997. In Z's partnership return for 1998, $400,000 would be added to partnership income, and the partners would be treated as having received a distribution equal to the amount of tax paid ($136,000). The partners' bases and capital accounts would be adjusted to reflect the allocation of additional income and interest expense and the deemed distribution. The partners also would receive a refundable credit for the tax paid. Any interest on the 1992 underpayment would be nondeductible.

6. Discussion

In General. The Partnership Collection Proposal would simplify the administrative process by treating a prior year deficiency and any related overstatements as an adjustment for the year of the final determination of the deficiency. The Partnership Collection Proposal may also offer the Service greater assurance than under current law that a tax deficiency attributable to a widely held partnership will in fact be paid. As in the case of full withholding, partner-level noncompliance would be avoided by collecting tax directly from the partnership. In addition, the Partnership Collection Proposal may be preferred by some partnerships to the "partner collection" method discussed below because of the fact that tax attributable to prior years would not be imposed directly on current partners.

Shifting of Tax Liabilities and Manipulation Concerns. Under the Partnership Collection Proposal, tax liabilities would follow ownership of a partnership interest and would not, as under current law, be personal to the owner of the interest in the year of the understatement. This approach would represent a divergence from normal partnership tax principles. The most significant consequence of this divergence is the potential shifting of tax liability among taxpayers. This raises two principal concerns.

The first concern is that such a rule appears to give a windfall to a partner who held a partnership interest in the year income was understated and to impose an unfair burden on a partner buying into the tax liability. Although this is a valid concern, the windfall and burden are less than initially appear. Because the failure to report income generally will result in an understated basis, the windfall to the selling partner is limited to a change in the character of income and deferral of the tax from the year of the understatement to the year of the sale of his or her interest.[128] Similarly, the burden to the purchasing partner generally will be limited to the interest and any penalties imposed on the understatement, the delay in utilizing the tax benefit represented by the positive basis adjustment produced by the allocation of income, and possible character differences. This burden is not fundamentally different from that resulting from other liabilities that are assumed by a partner purchasing a partnership interest (including unaccrued tax liabilities on items such as built-in gains of a partnership that has not made a section 754 election). As a result of these basis adjustments, the detriment to a partner who buys into a tax liability of a widely held partnership under the current assessment approach would be less than the detriment to a shareholder who buys into a corporation with a similar tax liability.

The second concern is that taxpayers may be able to manipulate the rules to avoid payment of tax. As an initial matter, it should be noted that it would not be possible to avoid taxes by simply distributing partnership assets. Since widely held partnerships would be treated comparably to corporate taxpayers for this purpose, the partnership level deficiencies should have the same status as deficiencies with respect to corporate taxpayers. Thus, for example, in order to collect a deficiency from a widely held partnership, the Service could apply the summary assessment, levy and seizure procedures of section 6331. In addition, section 6901 would be amended to provide that transferees of partnership assets (including partners) would be subject to transferee liability. Hence, distribution of partnership assets would not prevent the government from collecting taxes due.[129]

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[128]Under section 705, a partner's basis in his partnership interest is increased by the allocation of both taxable and tax-exempt income. Consequently, if a partnership, rather than underreporting income, mischaracterizes taxable income as tax-exempt, the selling basis will not be understated and his or her windfall will not be so limited.

[129]As discussed in section V(D)(4) above, we recommend that procedures be adopted to collect from current and former partners when the partnership is unable to satisfy a deficiency.

Since in general the amount of liability under the Partnership Collection Proposal is ultimately dependent on the tax status of the partners in the year of the final determination, the central manipulation concern would be the potential for shifting of tax liabilities from high bracket taxpayers to low bracket taxpayers. To achieve a material reduction in a widely held partnership's tax liability, a significant portion of the interests would have to be transferred to lower bracket taxpayers (including tax exempts). The likelihood of such transfers would be reduced by the exclusion from the current assessment approach of any partner holding a significant percentage of interests (e.g., at least five percent or ten percent) in a widely held partnership in the year of the understatement. As under current law, such a significant owner would be liable for his or her allocable share of a deficiency even if the interest were sold prior to the year of final determination. The remainder of the deficiency would be allocated among the current partners. The Service would be able to administer adjustments with respect to the large partners covered by this exclusion. Because these partners will be more likely to know of an impending adjustment and to arrange transfers to lower bracket taxpayers, opportunities for manipulation will be reduced if these partners are not permitted to shift tax liability by transferring their interests.

Even though adjustments with respect to interests held by large partners will be excluded from the current assessment system, a problem would arise if a significant portion of interests were transferred to lower-bracket taxpayers, and in particular tax-exempt entities, through normal market transactions. Existing constraints reduce the likelihood that tax-exempt entities would acquire a significant percentage of interests in a widely held partnership through such transactions. If the partnership is publicly traded (within the meaning of section 7704), tax-exempt investment would be discouraged by section 512(c)(2), which characterizes all income from a publicly traded partnership as unrelated business taxable income. If a widely held partnership is not publicly traded, section 7704 in many cases would discourage the transfer of a significant percentage of partnership interests in any given year.[130]

Even with the adoption of anti-manipulation rules such as those discussed above, it is possible that the collective tax rate of partners in the year of final determination would be

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[130] _See_ Notice 88-75, 1988-27 I.R.B. 29. However, under section 7704, partnerships which derive substantially all of their income from certain types of investment activity (_e.g._, real estate, oil and gas) will not be taxed as a corporation even if they are publicly traded.

somewhat lower than that in the year of an understatement. Collection of interest on deficiencies at the partnership level, calculated on the assumption of a high effective rate of tax, would reduce the impact of such a rate shift. It would also be possible to impose a punitive interest rate on deficiencies, as is done under the Regulated Investment Company ("RIC") and Real Estate Investment Trust ("REIT") deficiency dividend rules, to further minimize the effect of a rate shift.[131]

Section 704(b). Adjustments under section 704(b) may present difficulties under the Partnership Collection Proposal; while certain partners would effectively have their distributive shares of income increased, the corresponding decrease in other partners' distributive shares would result in no overall partnership level deficiency (except as to any differential in interest rates on deficiencies and overpayments). One answer would be to simply conclude that section 704(b) adjustments would have to be handled under current law. However, if enforcement of section 704(b) with respect to widely held partnerships must proceed under an extremely unwieldy system while other adjustments that arise under audit can be processed through a simplified system, the government might be essentially forfeiting enforcement of section 704(b) in these cases. If the Partnership Collection Proposal were to be enacted, further consideration will need to be devoted to the treatment of section 704(b) adjustments under the system.

Liquidity Issues. Because it involves entity-level collection, the Partnership Collection Proposal might create liquidity problems for certain partnerships. Liquidity problems are of particular concern to rental real estate partnerships, many of which experience deficits in the early years of operation, are highly leveraged, and have insufficient cash reserves to finance tax liabilities without selling off partnership assets. Some partnerships would presumably be able to borrow against assets; in some cases, however, a partnership could be forced to sell assets to satisfy a deficiency. A forced sale of assets at an inopportune time could result in significant losses to the partnership. While this may be a significant concern for partners in existing partnerships, partnerships formed after the effective date could presumably establish reserves for possible tax liabilities.[132]

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[131] See I.R.C. § 860(c)(1). Under these rules, interest is calculated based on the amount of the deficiency, rather than based on the amount of tax owed.

[132] See Section VIII of this Report concerning effective date issues.

Summary. The Partnership Collection Proposal would eliminate several fundamental problems that severely hamper the Service's ability under current law to audit and collect deficiencies attributable to widely held partnerships. The proposal would eliminate the need to obtain and monitor the individual returns of partners for the year to which the audit relates and to assess and attempt to collect deficiencies for that year. It would also avoid creating offsetting refund claims in later years. Collection of deficiencies would be greatly simplified. Adoption of the proposal would dramatically reduce the Service's burden in auditing widely held partnerships.

E. Alternative Proposals

Much of the simplification offered by the Partnership Collection Proposal could be achieved under a number of alternative current assessment approaches. The adoption of any of the approaches discussed below would significantly improve the administration of widely held partnerships.

1. Partner Collection Method

The treatment of deficiencies with respect to widely held partnerships as current income items could also be implemented by collecting deficiencies directly from current partners. This approach is referred to in this report as the "partner collection" method. In most respects, these rules would parallel those discussed above in connection with the Partnership Collection Proposal. The following discussion focuses on areas where the two approaches would differ.

Under the partner collection approach, understatements arising from erroneous reporting positions taken by a partnership in prior years (less any offsetting adjustments) would be: (1) included as an income item on the partnership's return (Form 1065) in the year a final adjustment is made; (2) included on the Form 1099-Ks sent to the partners in that year; and (3) reflected as an item of income on the partners' income tax returns (Form 1040 or 1120) in that year. Thus, under the partner collection approach, tax on prior year partnership deficiencies would be paid by the partners in the year of the final determination at the marginal tax rates in effect in that year. To the extent tax rates changed between the year of the understatement and the year of the final determination, the tax owed with respect to a deficiency would likewise vary from that which would have been due had the income been properly reported in the year of understatement. A shortfall reflecting an overstatement of credits in a given year (less any related understatement of credits in a different year) would be included as a separate item on the partnership's return in the year a final determination is made and would be similarly included in the partners' Form

1099-Ks in that year. Thus, the partners in the year of the final determination would be responsible for the repayment of credits as part of their separate tax liability.

Interest and penalties with respect to a deficiency could either be passed through to partners or paid directly by the partnership. If interest and penalties were to be passed through to partners along with the underlying deficiency, a system could be devised under which each partner's interest and penalties were calculated with respect to the partner's actual tax on the deficiency. However, this would require the partnership to provide the partner with an interest rate and a penalty rate to be applied to the partner's tax. While this approach would tailor each partner's interest and penalties to his or her actual tax, deficiency income would need to be reported to partners separately from other income and guidance would be required to determine the amount of each partner's total tax liability that would be treated as attributable to the deficiency income. Only then could the partner use the special interest rate and penalty rate to determine his or her interest and penalties. It is not clear that this approach could be efficiently administered within the partnership's normal reporting system. Furthermore, it would not be possible to apply computer matching to these amounts since the Service would not be independently reported the amount of any partner's interest and penalties. The alternative approach to passing interest and penalties through to the partners would be to calculate the amount of interest and penalties by assuming a partner-level tax rate and showing the resulting interest and penalties as tax due on the partners' Form 1099-Ks. The Service would be able to match these amounts. However, while partners would be likely to properly report additional income shown on a Form 1099-K, they are more likely to be confused by and object to a Form 1099-K that reports additional tax attributable to interest and penalties attributable to a prior year deficiency. Thus, this approach could result in new compliance problems. It would also require partners not otherwise subject to tax to pay penalties and interest on a deficiency.

The passthrough of interest and penalties to partners is perhaps the most significant barrier to designing a pure passthrough of partnership deficiencies and related items. An alternative would be to have partnerships pay interest and penalties, while deficiencies were flowed through to partners. This would lessen the administrative savings from passing deficiencies through to partners as part of the normal deficiency process, and would require the use of an assumed tax rate. Assuming partners were not permitted to seek refunds of penalties and interest, this approach would be relatively simple. Therefore, if the partner collection method were to be adopted, it would be preferable to have partnerships pay interest and penalties.

For purposes of maintaining the partners' capital accounts and determining the bases of their partnership interests, an increase in taxable income would be treated as a positive adjustment to the partners' capital accounts and bases of their interests, and any interest or penalty paid by the partnership would be treated as a nondeductible partnership expense.[133] Interest or penalties paid by a partner would be treated as any other interest or penalties paid by a taxpayer with respect to a tax deficiency.

Like the Partnership Collection Proposal, the partner collection method would simplify the administration of widely held partnerships by providing for a single entity level determination that would eliminate the need for the Service to obtain and monitor returns of each prior year partner, and by combining related adjustments as a single current item. The partner collection approach would not offer the Service the opportunity to satisfy a deficiency from a single source. It would also raise a number of the same concerns as the Partnership Collection Proposal, including questions of transferring tax liability and fairness to incoming partners.[134] On the other hand, the partner collection method would not pose the concerns raised by illiquid partnerships under the Partnership Collection Proposal, although payment of interest and penalties by the partnership would raise such issues to a lesser degree. Furthermore, it is arguable that the partner collection method would represent less of a shift from current law as the collection of deficiencies could be entirely subsumed within the normal reporting procedure.

2. Non-Flowthrough Method

The current assessment system could also be implemented by collecting deficiencies from the partnership without treating the adjustment as current income. The partnership would pay tax at a fixed rate (*e.g.*, the maximum individual rate). Income would not flow through to partners, no partner-level credit would be

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[133] *See* I.R.C. § 162(f); Treas. Reg. § 1.162-21(b)(1)(ii).

[134] Under the partner collection method, the possibility exists that an understatement of income for an earlier year could result in a tax liability for the current partners that exceeds the value of their partnership interests. This could also occur under the Partnership Collection Proposal in the case of an insolvent partnership. In the case of widely held partnerships, we believe this possibility is remote. Partners in these partnerships are unlikely to incur a tax liability that is disproportionate to the size of their investment (particularly where related amounts are offset). Moreover, a special rule could be provided for such a situation.

allowed for taxes paid by the partnership, and no adjustments would be made to the bases of partners in their partnership interests (although capital accounts would be adjusted).

This non-flowthrough approach would be relatively simple to administer, because partnerships would need to make few adjustments as a result of a partnership deficiency. As a consequence of the absence of basis adjustments, however, the approach could cause partnership income with respect to a deficiency to be taxed twice. Conversely, allowing a partnership to claim a refund under this method for an overstatement of partnership income could result in a double benefit to the partners.

Double taxation of a deficiency could be avoided by using the non-flowthrough method with basis adjustments. Deficiency income would not flow through to partners, and partners would not receive a credit for their allocable share of taxes paid by the partnership. However, partners would receive a basis adjustment for their share of the deficiency income, less tax paid by the partnership. Although at first glance it might appear anomalous to adjust a partner's basis even though the partner was not allocated taxable income, similar adjustments are made under current law for certain items that are not reflected in a partnership's taxable income (e.g., tax-exempt interest income).[135] Basis adjustments would also prevent a double benefit to partners if refund claims are treated as giving rise to current adjustments.

Whether or not basis adjustments are made, the non-flowthrough approach would tax a partnership's deficiency income at a single rate, regardless of the rates of its partners. By not taking the varying tax rates of its partners into account, this approach would not seek to place the partnership and its partners in approximately the same position they would have been in had the income been properly reported initially. As a result, unlike the Partnership Collection Proposal, it would not permit the reduction of tax due by a shift in the composition of the partners toward tax exempt entities or other lower bracket taxpayers. In addition, the non-flowthrough method would establish a fixed amount of tax due (independent of partner tax rates) which could be collected first from the partnership, second from the current partners, and third from former partners.[136]

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[135] See I.R.C. § 705(a)(1)(B) and (C).

[136] Unlike the Partnership Collection Proposal, no adjustment procedure would be required to reflect the partners' actual marginal tax rates.

By taxing deficiency income at a single rate, the non-flowthrough approach would, to a certain degree, reflect an entity treatment of widely held partnerships. If basis adjustments were permitted, the approach would recognize the flowthrough nature of a partnership and would not tax deficiency income twice, nor provide a double benefit for a refund on an overstatement. On the other hand, basis adjustments would add a measure of complexity to an otherwise extremely simple entity-oriented system.

On balance, we believe an assessment method that taxes a deficiency at the rates of the partners is the preferable approach, and have therefore recommended the Partnership Collection Proposal. However, as discussed above, taxing a deficiency at the partners' rates opens up the possibility that deficiency income may escape taxation through a shift in the composition of the partners. If it is concluded that the anti-manipulation rules discussed in connection with the Partnership Collection Proposal will not act as sufficient deterrent, serious consideration should be given to the non-flowthrough approach to taxing deficiencies of widely held partnerships, either with or without basis adjustments.[137]

3. Nonrefundable Credit

The current assessment approach could also be implemented with a nonrefundable partner-level credit for taxes paid by the partnership with respect to a deficiency, in contrast to the refundable credit under the Partnership Collection Proposal. Under the nonrefundable credit approach, taxes would be collected from the partnership at a single rate. Income attributable to a deficiency would flow through to partners and would be reported on their Form 1099-Ks, along with a nonrefundable credit for the partner's share of tax paid by the partnership with respect to the deficiency. Partners would have their bases and capital accounts adjusted to reflect the additional income (less tax paid by the partnership).

This method is similar in effect to the non-flowthrough method discussed above, except that taxable investors with a rate lower than the rate at which the partnership paid tax would be able to use the nonrefundable credit to offset tax on other income during the year, and, if the credit could be carried to other years, to offset tax on income in other years. Thus, under a system using a nonrefundable credit, depending on their individual circumstances and whether the credit could be carried

[137]A rule could be provided that basis adjustments would only be made with respect to deficiencies exceeding a certain size.

over, taxable partners might be able to achieve full use of the credit (at least over time). Fully tax-exempt partners would never be able to benefit from the credit. Thus, a partnership's deficiency income would be taxed at a rate which might exceed the collective tax rate of its partners.

4. Elective Payment of Deficiencies by Partnerships

It might also be possible to combine the Partnership Collection Proposal and the partner collection method by making payment of deficiencies by the partnership optional. Thus, if a partnership were determined to have a relatively small deficiency, management might prefer to pay the deficiency directly rather than allocate it as income to the partners. In cases where management determined that this was not a viable alternative, such as in the case of an illiquid partnership, the deficiency could be flowed through to partners as additional income. This approach might, however, create conflict of interest issues for the management of a partnership. If an election approach were adopted, it would be necessary to determine whether the election could be made on a case-by-case or year-by-year basis or whether it would be a more general (perhaps binding) election. It would also be necessary to provide specific rules for making the election and notifying the Service.

F. Comparison to Deficiency Dividend Procedures

While the treatment of adjustments as current items would represent a departure from subchapter K principles, the Code does provide analogous treatment of other widely held passthrough entities. This section discusses the deficiency dividend rules of section 860 of the Code under which the tax attributable to a prior year's deficiency is borne by current investors. Under these rules, a RIC or a REIT may declare a dividend in the year in which a deficiency is finally determined with respect to a prior year.[138] A deficiency dividend is treated as if it had been paid in the prior year for purposes of determining the dividends-paid deduction of the RIC or REIT for the prior year.[139] This permits the RIC or REIT to ensure it has satisfied the applicable minimum distribution requirements with respect to the prior year and to avoid any corporate level tax for that year.[140] This procedure places the cost of the prior-year deficiency on current RIC or REIT shareholders. For example, assume that a RIC determines that for 1984 its ordinary income prior to allowance of a deduction for dividends paid is $900. The RIC distributes $900

[138] I.R.C. § 860(f).

[139] I.R.C. § 860(a).

[140] I.R.C. § 852(a)(1).

to shareholders, thus apparently reducing its taxable income to zero. X, who owns 1 percent of the stock in the RIC, sells his stock to Y on December 31, 1985. In 1986, when Y still owns the stock, the RIC is determined to have understated its income for 1984 by $100. The RIC declares in 1986 a deficiency dividend of $100, which is taken into account in determining the RIC's dividends-paid deduction for 1984 and allows the RIC to satisfy the distribution requirement and to reduce its taxable income to zero. If the RIC's 1984 income had been properly reported, X would have received a distribution of $1 more than he actually received, and the value of X's interest in the RIC would have been correspondingly reduced by $1; therefore, the incorrect reporting position permitted X to convert $1 of ordinary income to capital gain on the sale of the stock. Meanwhile, the distribution of the deficiency dividend causes Y to recognize $1 of ordinary income in 1986 and creates an unrealized $1 capital loss in Y's RIC stock (assuming no other change in asset value). Furthermore, interest and penalties with respect to the deficiency must be paid by the RIC, which further reduces the value of Y's stock.[141]

Under the deficiency dividend procedure, current shareholders in a RIC or REIT bear the tax cost of a prior year deficiency. While not providing an exact analogy to the Partnership Collection Proposal or any of the alternatives, these rules demonstrate that federal income tax already employs a current assessment approach for certain passthrough entities.

G. Audit Procedures

Under the Partnership Collection Proposal or any of the alternatives discussed above, deficiencies with respect to widely held partnerships would be determined and assessed on an entity-wide basis rather than on a partner-by-partner basis. To facilitate this process, it will be necessary to provide a new audit system which is separate from and independent of the current TEFRA partnership audit rules of Code sections 6221 through 6233. This new audit system would be applicable only to widely held partnerships which are subject to current assessment, and would not otherwise affect the application of the TEFRA audit procedures. This section briefly outlines the approach to be followed under such an audit system.

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[141]A RIC or REIT utilizing the deficiency dividend procedure is subject to a penalty interest charge. Specifically, interest and penalties are charged on the gross amount of the dividend, rather than on the additional tax that would be imposed on receipt of the dividend. I.R.C. § 860(c)(1).

In general, the authority of the TMP to act as the partnership's representative in tax matters would be greatly expanded while the rights afforded each partner under the TEFRA rules generally would be eliminated. Partners would be required to report consistently with the partnership return, and a penalty would be imposed for failure to do so.[142] Notification of the commencement of an administrative proceeding and of a final adjustment would be provided only to the TMP, who would no longer be required by the Code to keep partners informed of proceedings. Partners would have no right to participate in administrative proceedings. Partners would have no right to file suit independently or otherwise participate in proceedings before a court. They would have no right to seek a refund independently with respect to a partnership item.

Only the TMP would be permitted to participate in the decision to extend the statute of limitations. The TMP would control any litigation relating to partnership deficiencies and refund claims. Settlements of administrative or judicial proceedings with respect to partnership items could be made only by the TMP, and would be binding on all partners. Thus, the TMP would no longer have the option to refuse to bind other partners, and other partners would no longer have the right to prohibit the TMP from settling on their behalf. Naturally, it would be necessary to provide protections for partners and the partnership in the event a designated TMP failed to take certain actions or in the event there was a conflict of interest between the TMP and the other partners.

It is unlikely that the removal of these statutory rights and protections would render individual partners powerless in the determination of deficiencies. First, the TMP undoubtedly would have a duty to treat other partners reasonably and fairly. Second, it is likely that partnership agreements will replace these statutory rights with comparable contract rights. Thus, a partnership agreement might require the TMP to keep all partners informed of administrative or judicial proceedings. A partnership agreement might also provide for a committee to advise or control settlement actions of the TMP. All partners might have the right to have some input through the committee in settlement or litigation decisions. It is possible that such provisions would complicate the task of the TMP, but if complexity is

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[142] It would be necessary to provide some type of relief from the consistent reporting rule for taxpayers who receive a clearly erroneous Form 1099-K (e.g., a Form 1099-K incorrectly reflects a partner's ownership of 60 partnership units rather than his or her actual ownership of 50 units). This exception would apply only if the partner disclosed the inconsistent position, and only to items relating to a partner's personal tax position and not to items relating to overall partnership income.

inherent in the system it should burden the partnership and the TMP rather than the Service.

These proposals would invest significant power and responsibility in the TMP. This would in turn exacerbate the problems that have been caused under normal TEFRA rules where there is confusion as to which partner is the TMP,[143] or where a partner has been unwilling to serve as TMP.[144] Furthermore, the increased power of the TMP would add to the conflict of interest issues that face the Service when it appoints a TMP.[145]

By limiting the authority of each partner to act independently of the partnership as to the reporting and determination of partnership items, this type of audit system would reflect the fact that a widely held partnership should be treated as a single entity for purposes of deficiencies. Such an audit system is essential to the implementation of the Partnership Collection Proposal or any of the alternative current assessment approaches.

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[143] See, e.g., PAE Enterprises v. Commissioner, 55 TCM 875 (1988); Sente Investment Club v. Commissioner, 55 TCM 1565 (1988).

[144] See, e.g., Computer Programs Lamba Ltd. v. Commissioner, 90 T.C. 1124 (1988).

[145] See I.R.C. § 6231(a)(7); Rev. Proc. 88-16, 1988-1 C.B. 691.

SECTION VI. PENALTIES

A. Overview

A significant amount of the administrative cost and logistical difficulty in performing an audit of a widely held partnership stems from the fact that penalties are not partnership items and thus are not covered by the TEFRA audit procedures.[146] Penalties must be applied to the partners individually, and therefore must be asserted on a partner-by-partner basis through the use of the statutory notice procedures.[147] Furthermore, the assertion of penalties must await the completion of the related TEFRA proceeding.[148] The implementation of a system for the efficient administration of widely held partnerships should include provisions to facilitate the imposition of penalties where appropriate.

An erroneous reporting position, as to a matter of either law or fact, that leads to the assertion of penalties in the widely held partnership context is realistically the position taken by the partnership. In almost all cases, a partner in a widely held partnership will not have sufficient information to reasonably take a position different from that of the partnership. The Partnership Collection Proposal and the alternative current assessment approaches each represent a shift away from an aggregate approach and towards an entity approach with respect to the administration of widely held partnerships. Consistent with this shift in focus, it is recommended both from the standpoint of fairness and efficiency that penalties related to underpayments of tax by partners of widely held partnerships generally be determined and imposed at the entity level.

B. Accuracy-Related Penalty

1. Background

The Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239 (the "1989 Act") consolidated into one part of the Code the major penalties relating to the accuracy of tax returns.[149] The penalties consolidated as the "accuracy-related penalty" were the negligence penalty, the substantial understatement penalty, and the valuation penalties. These consolidated penalties were

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[146] See I.R.C. § 6231(a)(3).

[147] I.R.C. § 6230(a)(2)(A)(i).

[148] N.C.F. Energy Partners v. Commissioner, 89 T.C. 741 (1987); Maxwell v. Commissioner, 87 T.C. 783, 792 (1986).

[149] I.R.C. § 6662.

also coordinated with the fraud penalty.[150] The accuracy-related penalty is imposed at a rate of 20 percent and, as relevant to widely held partnerships, applies to the portion of any underpayment that is attributable to (1) negligence, (2) substantial understatement of income tax, or (3) substantial valuation overstatement.

This section will discuss the accuracy-related penalty as related to widely held partnerships. In general, it is recommended that the penalty be determined at the partnership level and imposed against the partnership. The amount of the addition to tax would be determined by applying the 20 percent penalty against the partnership underpayment attributable either to negligence, substantial understatement or substantial valuation overstatement. The amount of the partnership underpayment would be deemed to equal the product of the net adjustment to partnership income or deductions multiplied by the maximum tax rate (either individual or corporate) for the year of the final determination.

2. <u>Negligence</u>

If part of an underpayment is due to negligence or disregard of rules or regulations, a penalty is imposed on the portion of the underpayment attributable to negligence.[151] Negligence includes any careless, reckless, or intentional disregard of rules or regulations, as well as any failure to make a reasonable attempt to comply with the provisions of the Code.[152] In addition, the 1989 Act repeals the presumption under prior law that an underpayment is attributable to negligence if the underpayment is due to a failure to include on an income tax return an amount shown on an information return.[153]

Under current law, even following the enactment of the 1989 Act, the penalty for negligence is determined at the partner level. This treatment seems inappropriate when applied to partners of widely held partnerships who report their income consistently with the partnership return. In that case, the penalty relates to the position taken or course of conduct of the partnership, and should be assessed at the partnership level and collected from the partnership. In certain instances, however, the penalty for negligence should continue to be imposed on the

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[150] I.R.C. § 6663.

[151] I.R.C. § 6662(b)(1).

[152] I.R.C. § 6662(c).

[153] Such presumption was formerly included in I.R.C. § 6653(g).

partners directly. A partner of a widely held partnership generally should be subject to a negligence penalty (and possibly a fraud penalty in some cases) if he or she fails to report partnership income on a return or takes a position on a return that is inconsistent with that taken by the partnership.[154]

3. Substantial Understatement of Income Tax

The accuracy-related penalty also applies to underpayments attributable to a "substantial understatement" of income tax.[155] An understatement generally means the excess of the amount of tax required to be shown on a return over the amount of tax which is shown on the return.[156] A "substantial understatement" is defined as an understatement that exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. In the case of a corporation (other than an S corporation or a personal holding company), the test is applied by substituting $10,000 for $5,000.[157] As applied to a partner in a partnership, the determination of whether an understatement exists and whether that understatement is substantial is based on the partner's individual or corporate overall tax liability, rather than on the taxable income generated by the partnership.

The amount of the understatement is reduced by the portion thereof attributable to (1) the tax treatment of an item as to which there is or was substantial authority, or (2) any item with respect to which there was adequate disclosure of the relevant facts on the return or in a statement attached to the return.[158] For this purpose, disclosure of the tax treatment of partnership items is generally made on the partnership's return.[159] The test relating to adequate disclosure does not apply to a tax shelter investment. The term "tax shelter" includes a partnership or other entity whose principal purpose is the avoidance or evasion

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[154]As discussed above, it would be necessary to provide some type of relief to a partner who receives an erroneous 1099-K in certain cases.

[155]I.R.C. § 6662(b)(2).

[156]I.R.C. § 6662(d)(2).

[157]I.R.C. § 6662(d)(1).

[158]I.R.C. § 6662(d)(2)(B).

[159]Treas. Reg. § 1.6661-4(e). Because the statute has not been changed on this point, the regulation probably reflects current law. A partner may also make adequate disclosure with respect to a partnership item by attaching a statement to his or her return.

of federal income tax. In the tax shelter context, the taxpayer must demonstrate that (1) substantial authority exists or existed for the position taken on the return, and (2) the taxpayer reasonably believed that the position taken on his or her return was more likely than not the correct position.[160] The determination of whether a partnership item is related to a tax shelter is based on the principal purpose of the partnership, not the partner.[161] With respect to tax shelters, the actions taken by the partnership will be deemed to have been taken by the partner and will be considered in deciding whether the partner reasonably believes that the tax treatment of an item is more likely than not the proper tax treatment.[162]

Under section 6664(c)(1), no accuracy-related penalty will be imposed with respect to any portion of an underpayment if it is shown that there was reasonable cause for such portion and that the taxpayer acted in good faith. In the case of an understatement related to a partnership item, the good faith (or lack thereof) of the partnership generally will be imputed to the partner.[163]

Most of the issues relating to the imposition of the accuracy-related penalty related to substantial understatements are resolved at the partnership level. In particular, the partnership makes the determination as to whether a reporting position is supported by substantial authority. Nevertheless, the penalty currently is applied separately with respect to each partner. In view of the administrative difficulties this treatment creates with respect to widely held partnerships, the penalty for substantial understatements (like the other relevant parts of the accuracy-related penalty) should be treated as a

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[160] I.R.C. § 6662(d)(2)(C).

[161] Treas. Reg. § 1.6661-5(a)(1) and (2).

[162] Treas. Reg. § 1.6661-5(e). In general, a taxpayer may establish reasonable belief if (1) the taxpayer analyzes the relevant facts and authorities and reasonably concludes that there is a greater than 50 percent likelihood that the tax treatment will be upheld in litigation if challenged; or (2) the taxpayer in good faith relies on the opinion of a professional tax advisor, provided the opinion is based on the tax advisor's analysis of the pertinent facts and authorities and unambiguously states that the tax advisor concludes that the tax treatment of an item will be upheld if challenged. Treas. Reg. § 1.6661-5(d).

[163] Treas. Reg. § 1.6661-6(b). Any good faith imputed to a partner as described above may be refuted by other factors showing the partner's lack of good faith. _Id._

partnership item for partners of widely held partnerships, and the partnership should in effect be treated as a taxpaying entity.

Under either the Partnership Collection Proposal or the other approaches, the penalty would be collected from the partnership and treated as a nondeductible expense by the partners.[164] Determinations with respect to the reasonable cause exception (and imposition of the penalty with respect to tax shelters) would be made at the partnership level. For purposes of applying the penalty to widely held partnerships, an "understatement" would be defined as the net adjustment to partnership income or deductions, multiplied by the highest marginal rate under section 1 or section 11. The test applied with respect to corporations in section 6662(d)(1)(B) (substituting $10,000 for $5,000 as the threshold level for an understatement to be deemed substantial) would be used to determine whether the partnership would be subject to the penalty.[165]

4. Substantial Valuation Overstatement

The accuracy-related penalty includes an addition to tax for underpayments of tax attributable to valuation overstatements.[166] A valuation overstatement is deemed to occur if the value of any property or its adjusted basis claimed on any return is 200 percent or more of the amount determined to be the correct amount.[167] The valuation overstatement penalty does not apply unless the underpayment of tax attributable to the valuation overstatement exceeds $5,000 ($10,000 in the case of a

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[164]Alternatively, under the partner collection method, the penalty could continue to be payable by partners, although the applicability of the penalty would be determined at the partnership level.

[165]Because the penalty would be imposed at the partnership level, income and deductions from a widely held partnership would not be taken into account in determining a partner's separate liability for the penalty based on other investments.

[166]Like other portions of the accuracy-related penalty, the addition to tax for substantial valuation overstatements equals 20 percent of the underpayment.

[167]Under section 6662(h), the rate of the general accuracy penalty is doubled (to 40 percent) in the case of gross valuation misstatements. As relevant to widely held partnerships, a gross valuation misstatement is a valuation overstatement claimed on a return that is 400 percent or more of the amount determined to be the correct amount.

corporation other than an S corporation or a personal holding company).[168] A valuation overstatement by a partnership flows through to the returns of the individual partners. Thus, an underpayment of tax on an individual partner's return resulting from a valuation overstatement by a partnership is treated as an underpayment of tax attributable to a valuation overstatement. As is generally the case with respect to the accuracy-related penalty, no penalty will be imposed if it is shown that there was a reasonable cause for the underpayment attributable to the valuation or adjusted basis claimed on the return and that such claim was made in good faith.[169]

The applicability of the accuracy-related penalty with respect to valuation overstatements should be determined at the partnership level with respect to widely held partnerships and the penalty imposed on the partnership. Individual partners are unlikely to have had any involvement in valuing partnership property. Therefore, the valuation penalty should be a partnership item. Under this approach, for purposes of applying the penalty to a widely held partnership, the term "underpayment" would be defined to include the net adjustment to partnership income and deduction attributable to a substantial valuation overstatement by the partnership multiplied by the maximum tax rate (either the individual or corporate rate). The underpayment of tax attributable to substantial valuation overstatements would be subject to the $10,000 threshold generally applicable to corporations under section 6662(e)(2). The partnership would be treated as the taxpayer for purposes of determining whether the reasonable cause exception of section 6664(c) should apply.

C. Fraud Penalty

Under section 6663, if any portion of an underpayment is due to fraud, a penalty is imposed equal to 75 percent of such portion. The accuracy-related penalty is not to apply to any portion of an underpayment on which the fraud penalty is imposed. Like the accuracy-related penalty, the fraud penalty should be assessed at the partnership level and collected from the partnership.

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[168] I.R.C. § 6662(e).

[169] I.R.C. § 6664(c).

SECTION VII. SCOPE OF THE PROPOSALS--DEFINITION OF A WIDELY HELD PARTNERSHIP

The definition of a widely held partnership should satisfy three criteria. First, it should cover partnerships with numerous partners, because it is these partnerships that present the most serious administrative difficulties under current law. Second, it should provide a bright line, so that partnerships and the Service will be able to determine with certainty whether any given partnership is subject to the simplified reporting and current assessment system. Third, the definition of a widely held partnership should exclude service partnerships such as accounting or law firms. In a service partnership, each partner is likely to be an active member of the business, making full entity treatment less appropriate.[170]

The following definition should satisfy these criteria. A widely held partnership is any partnership (i) with 250 or more partners during a taxable year[171], and (ii) in which interests are required to be registered under federal or state laws regulating securities or have been sold under an exemption from registration requiring the filing of a notice with a federal or state agency regulating the offering or sale of securities.[172]

In determining the number of its partners during a taxable year, a partnership will be entitled to rely on the number of partners properly reported to the partnership by nominees under

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[170]Although all publicly traded partnerships will presumably be treated as widely held partnerships, the uncertainty inherent in the definition of a publicly traded partnership under section 7704 makes it unsuitable as a threshold test for application of the proposals made herein. Moreover, there is a sizable population of partnerships that have numerous partners but are not publicly traded partnerships under section 7704.

[171]Pursuant to section 6011(e) of the Code, the Service may not require the filing of information returns by electronic or magnetic media unless the filer is required to file at least 250 of the particular information return. Therefore, this appears to be an appropriate bench mark for required participation in the simplified reporting system.

[172]This definition is similar to that under the House Proposal, except that it is restricted to relatively large partnerships. We believe the scope of the definition under the House proposal was considerably broader than necessary.

section 6031(c).[173] Any partnership that actually has 250 or more partners in a taxable year will be subject to audit under the current assessment procedure, as well as any partnership that reports under the simplified system.[174]

Partnerships with less than 250 partners may wish to enter the simplified system. This would be acceptable as long as the system is restricted to partnerships that have a relatively large number of partners. The fewer the number of partners, the easier it would be to take advantage of any variations in the calculation of taxable income resulting from the simplified system. Therefore, partnerships with at least 100 partners should be allowed to elect into the system.

A partnership that becomes subject to the simplified system, either because it is a widely held partnership or because it elects in, will be required to remain in the system unless it receives permission of the Commissioner to be removed. It is expected that such permission would be granted only in rare cases, such as where a partnership suffered a severe diminution in size. It may also be necessary to consider aggregation rules for situations where series of partnerships are structured to avoid the 250 partner limitation.

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[173] A nominee holding a partnership interest on behalf of another person during a partnership's taxable year is required to furnish the partnership with the name, address, and taxpayer identification number of the owner within one month of the close of the taxable year. Temp. Treas. Reg. § 1.6031(c)-1T.

[174] A partnership might be subject to the widely held partnership audit system and not the simplified reporting system for a given year. This would occur if, for example, at the time a partnership mailed Form 1099-Ks to its partners, it did not have information indicating that it had at least 250 partners due to lapses in nominee reporting. If it is subsequently determined that the partnership had 250 or more partners in that year, the partnership would be subject to the widely held partnership audit system, but would not be required to file an amended return and transmit Form 1099-Ks to its partners. It might be necessary to provide a rule for situations in which the Service inadvertently applies the wrong audit and assessment procedure under these circumstances. Consideration should be given to whether any other problems would result from a partnership being subject in a single taxable year to the widely held partnership audit system and not to the simplified reporting system.

SECTION VIII. EFFECTIVE DATE CONSIDERATIONS

Effective date considerations differ somewhat for the current assessment system and the simplified reporting system. The simplified reporting system should probably apply to all widely held partnerships as soon as practicable after the passage of implementing legislation, taking into account the time necessary for partnerships to develop new accounting and reporting procedures.

There are a number of possible approaches to implementing the proposed audit and assessment system for widely held partnerships. First, the new rules could be made effective only for partnerships formed after a certain date. This would permit partnerships to take the new rules into account in structuring their partnership agreements. However, it would delay the true effective date of the provision for many years. Such a delay may be unacceptable in view of the Service's current difficulties in administering widely held partnerships. Alternatively, the audit and assessment system could be made applicable to audits commenced after a given date. While this would make the rules quickly applicable, it would place significant pressure on determining the exact date an audit is commenced. It also might be viewed as unfair to impose a new system on partnerships that have not had any time to prepare for it. Therefore, the best approach would be to make the proposal effective for taxable years ending after a given date.[175] The date selected should allow partnerships enough lead time to amend their partnership agreements should they choose to do so.

The simplified reporting system and the revised audit procedures could be effective in differing taxable years, as the implementation of either is not dependent on the other. However, if the necessary lead time for the simplified reporting system is comparable to that needed under the audit and assessment system, both should be made applicable in the same taxable year.

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[175]The reference to taxable years ending after rather than before a given date is preferred due to occasional uncertainty concerning the date a partnership's taxable year commences.

APPENDIX I

Proposals for Amendments to TEFRA Rules

The unified audit and litigation provisions that were enacted with respect to partnerships as part of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and extended to S corporations by the Subchapter S Revision Act of 1982, represented a radical change in the way that audits and litigation relating to these entities and their investors were conducted. As can be expected with respect to any change of this magnitude, the transition has been difficult and the procedures have not always worked in practice the way that they were envisioned. However, we are in favor of retaining these provisions, at least with respect to partnerships that would not be subject to the new procedures recommended by this study. On the other hand, based upon our experience in administering these provisions, we recommend that certain changes be made. A summary of the TEFRA rules is provided in Appendix II.

1. <u>Boundary Issues</u>

A substantial problem area exists with respect to whether the TEFRA partnership procedures or the regular deficiency procedures apply to a particular taxable year, a particular taxpayer, or a particular adjustment. This determination can be very technical and difficult to make, and the consequences of an incorrect choice can be severe because if the Service applies the wrong procedure, the statute of limitations applicable to the correct procedure may have expired by the time that the problem is discovered. The situations giving rise to this problem are generally described as presenting "boundary issues."

One example of a boundary issue arises in the context of the small partnership exception contained in section 6231(a)(1)(B). Pursuant to that section, the partnership audit provisions do not apply to a partnership that has 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and each partner's share of each partnership item is the same as that partner's share of every other partnership item. Several pitfalls exist in applying this provision. Specifically, if an incorrect determination is made regarding whether there were ever more than 10 partners in the partnership at any one time during the year, or whether a person is a nonresident alien, or whether any special allocations were made during the year, the Service may inadvertently apply the wrong procedures.

Similarly, boundary issues may be encountered as a result of the operation of the special enforcement provisions of section 6231(c). For example, Temp. Treas. Reg. §§ 301.6231(a)(7)-1T(l)(4) and 301.6231(c)-7T(a) provide that upon the filing of a petition naming a partner as a debtor in a bankruptcy proceeding, that partner's partnership items are converted to nonpartnership items, and if the debtor was the tax matters partner (TMP), such status terminates. These rules are necessary because of the automatic stay provision contained in 11 U.S.C. § 362. However, problems arise because the Service is not automatically notified of every bankruptcy filing. When the Service is unaware that a partner is in bankruptcy, the Service may mistakenly treat the debtor as a party to a partnership proceeding and allow the statute of limitations with respect to the partner's nonpartnership items to expire. In such a case, a statutory notice of deficiency adjusting the converted partnership items will be barred, even though the Service could have timely issued such a notice if the Service had been aware of the bankruptcy filing. Likewise, if unbeknownst to the Service the TMP goes into bankruptcy, the Service may issue a notice of final partnership administrative adjustment (FPAA) to the bankrupt TMP, which may be determined to be invalid because the debtor's status as TMP was automatically terminated by the filing of the bankruptcy petition.

Another boundary issue arises in the context of tiered partnerships. In particular, if the source (operating) partnership is non-TEFRA and the tier (investor) partnership is TEFRA, or vice versa, it is unclear whether the TEFRA procedures or the deficiency procedures should be applied. The Service has taken the position that it is the source partnership's status that controls with respect to any adjustments relating to items flowing from the source partnership. However, to the extent that the tier partnership generates income or expense items attributable to its own activities, any adjustment to those items must be made at the tier level. When dealing with multiple tier situations, such determinations are very difficult and mistakes are bound to be made. As a result, many of these adjustments may be in jeopardy if it is subsequently determined that the wrong procedures were applied. To alleviate this problem, the interplay between the TEFRA and deficiency procedures in the context of tiered partnerships should be clarified.

As the above discussion illustrates, boundary issues present hidden traps and create substantial administrative difficulties for the Service, which must frequently decide at its peril whether to apply the TEFRA procedures or the deficiency procedures and run the risk that if it chooses incorrectly, the adjustments may be barred. Since the revenue loss may be substantial, we recommend that legislation be enacted which would mitigate the effect of boundary issues. One approach would be to resolve each boundary issue separately. If that is not feasible, another approach would be to provide that if the Service erroneously makes a determination regarding the proper procedure to apply and timely issues the appropriate notice in accordance with that determination, i.e., a statutory notice or a notice of FPAA, then the statute of limitations for assessment will not expire before 1 year after a court determines that the wrong procedure was followed and that determination becomes final. A legislative proposal along these lines is attached. One potential benefit to this latter approach is that it will cover all boundary issues, even those that have not yet been identified. As a result, this approach should eliminate the need to seek additional legislation concerning boundary issues in the future, if new boundary issues are identified.

Additionally, we have two proposals concerning the small partnership exception that should reduce the number of partnerships that are subject to the unified, entity-level procedures and eliminate some of the boundary issues discussed above:

A. The "natural person (other than a nonresident alien) or an estate" requirement should be eliminated from section 6231(a)(1)(B)(i)(I) and replaced with a "no pass-thru entity" requirement. Under this proposal, a partnership with 10 or fewer partners that has a subchapter C corporation as a partner would still qualify for the small partnership exception, but a partnership having an S corporation, a trust, another partnership (tier), or a nominee as a partner would not be eligible for the exception.

B. The same share requirement contained in section 6231(a)(1)(B)(i)(II) should be eliminated. When dealing with a partnership that has 10 or fewer partners, we do not believe that the mere existence of a special allocation causes sufficient problems to warrant subjecting the entire partnership to the TEFRA procedures. It should be recognized, however, that if this proposal is adopted, a potential for inconsistent treatment of partners may be created if a reallocation of items becomes necessary.

2. Treatment of Partnership Items in Deficiency Proceedings

In Munro v. Commissioner, 92 T.C. 71 (1989), the Tax Court upheld the validity of a statutory notice that disallowed net losses from TEFRA partnerships before computing the deficiency amount, but ruled that it was impermissible for the Service to disallow the partnership losses in the statutory notice even if this was done solely for computational purposes and was not intended to be a substitute for issuing a notice of final partnership administrative adjustment (FPAA) as required by section 6225. The court held that the partnership items (whether income, loss, deduction or credits) included on a taxpayer's return should be completely ignored in determining whether a deficiency exists that is attributable to nonpartnership items. Hence, under Munro, the Service may not assume the correctness of its proposed adjustments to partnership items for computational purposes in determining a deficiency, and taxpayers may not offset net partnership losses against their taxable income for purposes of deficiency proceedings.

Prior to the Munro case, it was the Service's practice to treat all partnership items as if they were correctly reported for purposes of the deficiency proceeding; under Munro, the partnership items are eliminated from the taxpayer's return. However, in Munro situations, where the taxpayer is oversheltered, i.e., losses entirely offset the taxpayer's income, this procedure would not have permitted any adjustment to the nonpartnership items. It was these unusual facts that led to the Munro opinion.

In most of the cases that are either currently in litigation or under audit, net losses from TEFRA entities are claimed and used to only partially offset income from non-TEFRA sources. Since under normal circumstances the TEFRA proceeding progresses more slowly than the deficiency proceeding, computing the deficiency under Munro will result in a greater deficiency being asserted in the deficiency proceeding than would have been asserted under the Service's practice prior to the Munro opinion. Consequently, under Munro, the taxpayer will not get the benefit of the partnership losses until the losses are determined to be allowable in a TEFRA proceeding, even though the factual scenario that gave rise to the Munro opinion is relatively unusual.

While we believe that the Tax Court's opinion is technically correct in that the deficiency procedures and the TEFRA procedures were intended to be totally separate, the solution proposed by the Tax Court is unworkable as a practical matter. In the typical case, computing the tax liability without reference to partnership items will have the same effect as though those partnership items were disallowed. If the partnership items were losses, the effect will be a greatly increased deficiency for the nonpartnership items. If, when the partnership proceeding is completed, the partner is ultimately allowed any part of the losses, the partner will receive part of the increased deficiency back in the form of an overpayment. However, in the interim, the partner will have been subject to assessment and collection of a deficiency inflated by items still in dispute in the partnership proceeding. In essence, implementation of Munro in the typical case means loss of a prepayment forum for TEFRA partnership adjustments. As a policy matter, we view this result as an inappropriate and unintended consequence of implementing Munro.

In light of the above, and other problems which have been identified with respect to the implementation of Munro, we strongly endorse the legislative proposal that has been worked out with the staffs of the Joint Committee and House Legislative Counsel. In essence, this proposal would enable the Service to continue using its prior practice for most cases but provides a special rule covering oversheltered situations such as existed in Munro. With respect to the oversheltered cases, the proposal provides that partnership items shall be disregarded in determining whether a deficiency exists for purposes of the deficiency proceeding and any adjustment in that proceeding shall be taken into account in determining the amount of any computational adjustment following the completion of the partnership proceeding. A copy of this proposal is attached.

3. Relationship Between the Limitations Periods Provided By Sections 6229 and 6501

Section 6501 provides a limitations period with respect to any tax imposed by title 26. This period is determined with reference to the filing of the taxpayer's return. Section 6229 provides a limitations period with respect to any tax imposed by subtitle A that is attributable to any partnership item or affected item. This period is determined with reference to the filing of the partnership's return. Under the existing statutory scheme, it is unclear whether these two sections create separate statutes of limitations, i.e., section 6501 applies with respect to nonpartnership items and section 6229 applies with respect to partnership and affected items, or whether section 6229 simply extends the limitations period with respect to partnership and affected items in situations where the section 6501 period has otherwise expired. Since both of these interpretations are supportable under current law but each approach presents conceptual difficulties, legislation clarifying this area should be enacted. In addition, the issue of whether an extension of the statute of limitations that is obtained pursuant to section 6501(c)(4) and does not make specific reference to partnership items applies to partnership items that subsequently convert to nonpartnership items, should also be addressed.

4. Suspension of the Statute of Limitations During the Pendency of Bankruptcy Proceedings

As discussed with respect to the boundary issues, a partner's partnership items convert to nonpartnership items upon the filing of a petition naming the partner as a debtor in a bankruptcy proceeding. Section 6229(f) provides that the period for assessing tax with respect to items that convert to nonpartnership items shall not expire before the date which is 1 year after the date that the items become nonpartnership items. Section 6503(i) provides for the suspension of the limitations period during the pendency of a bankruptcy proceeding. However, this provision only applies to the limitations periods provided in sections 6501 and 6502. Since the limitations period pertaining to converted items is governed by section 6229(f) rather than section 6501, the suspension of the limitations period provided by section 6503(i) will not apply with respect to partnership items that convert to nonpartnership items by reason of the filing of a petition naming the partner as a debtor in a bankruptcy proceeding. As a result, the limitations period will continue to run during the pendency of the bankruptcy proceeding, notwithstanding that the Service is prohibited from making an assessment against the debtor because of the automatic stay imposed by section 362(a) of the Bankruptcy Code. Moreover, under certain circumstances it is possible for the normal 3 year limitations period to be shortened to 1 year or for the limitations period to arguably expire prior to the filing of the return for a given year. Consequently, either a provision similar to section 6503(i) should be enacted to cover the limitations period provided in section 6229(f) or section 6503(i) should be amended to extend the suspension provision to the section 6229(f) period. The suspension provision should also be extended to the limitations period provided in sections 6229(a) and 6229(d) relating to the time for making a computational adjustment following default or judicial review of a notice of final partnership administrative adjustment (FPAA).

5. Exclusion of Partial Settlements From the 1 Year Assessment Period

Section 6231(b)(1)(C) provides that the partnership items of a partner for a partnership taxable year shall become nonpartnership items as of the date the Service enters into a settlement agreement with the partner with respect to such items. As discussed previously, under section 6229(f), the limitations period for assessing any tax attributable to converted items shall not expire before the date which is 1 year after the date on which the items become nonpartnership items. This rule creates a problem in situations where a settlement agreement is entered into with respect to some but not all of the issues in the case. The reason for this is that a 1 year assessment period will apply with respect to the settled items whereas the remaining items will be governed by the normal assessment period under section 6229(a). If issues are settled at several different stages of the proceeding, the problem can become severe.

The fractured statute problem can be illustrated by the following example:

Assume that five issues are raised in connection with the examination of the 1984 return for the ABC Partnership. While the case is still being handled by the Examination function, the Service and all partners enter into a specific matters closing agreement whereby all parties agree that a deduction was erroneously claimed. The case then goes to Appeals where the Service concedes the second issue. After the case is docketed but before the trial, the parties settle the third adjustment. Pursuant to a court order, the parties file a Stipulation of Settled Issues with the court evidencing their agreement with respect to the third adjustment. The remaining two issues are tried but the partnership concedes the fourth issue on brief. The last issue is decided by the court.

Under the above scenario, the partners in the ABC Partnership will be subject to five different limitations periods for assessment with respect to their investment in the ABC partnership for the 1984 taxable year. Making five separate computations with respect to each partner for a single taxable year is extremely burdensome and creates a drain on the Service's limited resources. Moreover, the fractured statute poses a significant tracking problem for the Service, which may result in many, if not most, of the assessments not being made within the relevant time period. On the other hand, if the assessments are timely made, the partners in the ABC Partnership may become angered or confused when they receive multiple notices of assessment with respect to the same taxable year.

In light of the above, it is recommended that even though partnership items covered by a settlement agreement will convert to nonpartnership items, if the agreement constitutes only a partial settlement, it should not trigger a 1 year assessment period. Instead, legislation should be enacted to provide that the 1 year assessment period will not begin to run until all issues in the case are disposed of. As applied to the above example, this would not occur until the decision of the court became final. One possible way to accomplish this may be to provide that for purposes of the statute of limitations on assessment, a settlement must be comprehensive, i.e., if a settlement is limited to selected items, it will not be treated as a settlement, and hence, it will not commence a 1 year assessment period with respect to those settled items. On the contrary, the assessment period with respect to the settled items will be governed by section 6229(a). Thus, the assessment period with respect to the settled items will be the same as the assessment period for the items that have not been settled.

6. Forum For Contesting the Applicability of the Increased <u>Rate of Interest Under Section 6621(c)</u>

Section 6621(c) provides for an increased rate of interest with respect to any substantial underpayment attributable to tax motivated transactions. Jurisdiction to determine the applicability of section 6621(c) was granted to the Tax Court in section 6621(c)(4), but said jurisdiction is limited to those proceedings in which the Tax Court also has jurisdiction over the deficiency to which the increased rate of interest relates. When the issue arises in connection with an investment in a TEFRA partnership, the applicability of section 6621(c) is treated as an affected item that requires partner-level determinations. As a result, under section 6230(a)(2), the application of section 6621(c) must be determined in separate proceedings at the partner level following the completion of the partnership-level proceeding. Unfortunately, since in an affected item proceeding the Tax Court does not have jurisdiction over the underlying deficiency, the Tax Court similarly lacks jurisdiction to determine the applicability of section 6621(c) in such a proceeding. Likewise, a partner cannot contest the applicability of section 6621(c) in a section 6230(c) refund suit because such actions are essentially limited to computational disputes. Consequently, it is recommended that a judicial forum be provided for partners to challenge the imposition of the increased rate of interest under section 6621(c) relating to deficiencies attributable to their investment in a TEFRA partnership. It is noted, however, that if proposal 13 regarding the determination of penalties and the increased rate of interest at the partnership level is adopted, no further action with respect to this proposal will be necessary since a forum under section 6230(c) will be provided.

7. Forum For Raising Innocent Spouse Defense

Under section 6013(e), an innocent spouse may be relieved of liability for tax, penalties and interest if certain conditions are met. However, existing law does not provide the spouse of a partner in a TEFRA partnership with a judicial forum to raise the innocent spouse defense with respect to any tax or interest that relates to an investment in a TEFRA partnership. Since the innocent spouse defense requires substantive determinations, a refund suit under section 6230(c) would not be permissible. Similarly, since innocent spouse is an affirmative defense that will only be raised by a taxpayer, the taxpayer will only be able to assert the defense in the Tax Court if the Service issues an affected items statutory notice to the taxpayer. If such a notice is not issued to the taxpayer, there does not appear to be a judicial forum available in which to raise the innocent spouse defense. Accordingly, it is recommended that a judicial forum be provided for a spouse of a partner in a TEFRA partnership to raise the innocent spouse defense insofar as it relates to a liability that is attributable to an investment in the TEFRA partnership.

8. Suspension of the Statute of Limitations Upon the Filing of an Untimely Petition

In a deficiency case, section 6503(a) provides in pertinent part that if a proceeding in respect of the deficiency is placed on the docket of the Tax Court, the period of limitations on assessment and collection shall be suspended until the decision of the Tax Court becomes final, and for 60 days thereafter. The counterpart to this provision with respect to TEFRA cases is contained in section 6229(d). That section provides in pertinent part that the period of limitations shall be suspended for the period during which an action may be brought under section 6226 and, if an action is brought during such period, until the decision of the court becomes final, and for 1 year thereafter. As a result of this difference in language, the running of the statute of limitations in a TEFRA case will only be tolled by the filing of a timely petition whereas in a deficiency case, the statute of limitations is tolled by the filing of any petition, regardless of whether the petition is timely. Consequently, if an untimely petition is filed in a TEFRA case, the statute of limitations can expire while the case is still pending before the court. To prevent this from occurring, the Service must make assessments against all of the investors during the pendency of the action and if the action is in the Tax Court, presumably abate such assessments if the court ultimately determines that the petition was timely. Hence, the statute creates a trap for the unwary and necessitates an inefficient use of resources on the part of the Service. Accordingly, section 6229(d) should be amended to make the suspension provision concerning the filing of petitions in TEFRA cases consistent with the rule under section 6503(a) pertaining to deficiency cases.

9. Administrative Adjustment Requests (RAA)

A. Refund Suits Under Section 6228

Section 6230(a)(2)(A)(ii) provides that deficiency procedures apply to items which have become nonpartnership items. An exception to this rule is provided with respect to items that convert by reason of a settlement agreement. Pursuant to section 6231(b)(1)(B), a partner's partnership items become nonpartnership items upon the filing of a suit under section 6228(b). Since items that convert pursuant to section 6231(b)(1)(B) will already be the subject of a judicial proceeding, the deficiency procedures should not apply. Accordingly, this situation should be excluded from the rule under section 6230(a)(2)(A)(ii).

B. Extension of Time Within Which to File an RAA

Section 6227(a) provides that a partner may file a request for an administrative adjustment of partnership items within 3 years after the later of the date of the filing of the partnership return or the last day for filing the partnership return (determined without regard to extensions), but before the Service mails a notice of FPAA to the TMP. Section 6511(c) provides that if an agreement is entered into under section 6501(c)(4) to extend the period for assessment, the period for filing a claim for credit or refund or for making a credit or refund if no claim is filed, shall not expire prior to 6 months after the expiration of the period within which an assessment may be made pursuant to the agreement under section 6501(c)(4). It is recommended that a provision similar to section 6511(c) be enacted with respect to the filing of an RAA where an agreement extending the statute of limitations relating to partnership and affected items is entered into under section 6229(b).

C. Allowance of Credits or Refunds After the Expiration of the Time For Filing an RAA

The rules pertaining to credits or refunds attributable to partnership items and affected items are set forth in sections 6227, 6230(c) and 6230(d). These rules are fairly complex. As a result, there is confusion regarding the allowance of credits or refunds where no RAA has been filed and the time for doing so has expired, but the statute of limitations under section 6229 is still open or the time for filing a claim or suit under section 6230(c) has not yet expired. This situation frequently occurs when the TMP extends the statute of limitations under section 6229 and after the time for filing an RAA has expired, a partner makes an advance payment of tax to stop the running of interest. Under these circumstances, it appears as if a partner should be able to obtain a credit or refund, but it is unclear from the statute whether the making of such a credit or refund would be permissible. Consequently, it is recommended that this point be clarified.

D. RAAs Filed By the Tax Matters Partner in Overpayment Situations

Section 6227(b)(1) provides that if the TMP files an RAA on behalf of the partnership and requests substituted return treatment, the Service may treat the changes shown on the request as corrections of mathematical or clerical errors appearing on the partnership return. If an RAA filed by the TMP on behalf of the partnership is not treated as a substituted return, under section 6227(b)(2) the Service may, without conducting any proceeding, allow or make to all partners the credits or refunds arising from the requested adjustments; conduct a partnership proceeding; or take no action on the request. In light of the above, it appears as if substituted return treatment is only available where additional tax is due; if the requested adjustments would give rise to a credit or refund for the partners, the RAA must be handled under section 6227(b)(2). It is unclear, however, whether in an overpayment situation the partners' right to a credit or refund is protected by the filing of an RAA by the TMP, or whether the partners must file separate RAAs in order to preserve their respective rights to file a refund suit under section 6228. Section 6228(a)(4) seems to indicate that the partners are protected if the request is not allowed and the TMP files suit, since the partners will be treated as parties to the action and they are entitled to participate. On the other hand, it appears as if the partners will not be protected if the TMP fails to timely file a suit since only the TMP is permitted to file a petition with respect to an RAA filed under section 6227(b). Accordingly, it is recommended that the partners be provided with an additional period of time within which to file a petition regarding the RAA, in the event that the TMP fails to file such a petition. This would be similar to the provisions under section 6226 concerning the filing of a petition with respect to a notice of FPAA. Such a rule would be beneficial both to the partners and the Service because it would eliminate the need for the partners to file separate RAAs and the Service would not have to expend its limited resources processing those requests.

10. Application of Section 6223(e) in the Context of a Tiered Partnership

If the Service fails to provide a notice of the beginning of an administrative proceeding (NBAP) or a notice of final partnership administrative adjustment (FPAA) to a partner who is entitled to such notice, section 6223(e) permits the partner to make certain elections. In a tiered partnership, the pass-thru partner (tier) will normally be a notice partner. Under current law, it is unclear whether the section 6223(e) election may be made by the pass-thru partner and would be binding on the indirect partners (the investors in the tier) or whether the indirect partners are entitled to make separate elections. Additionally, if both the tier and an indirect partner make elections, it is unclear which election should be given effect. Thus, legislation clarifying these points would be helpful. In this regard, it is noted that sections 6224(c)(1) and 6224(c)(3) provide rules concerning the effect of settlement agreements entered into by a pass-thru partner or the tax matters partner (TMP) on indirect partners and nonnotice partners, respectively. Similar rules pertaining to section 6223(e) elections may be appropriate.

11. Application of the TEFRA Partnership Provisions to a Partner Who is a Member of a Consolidated Group

When a partner in a TEFRA partnership is a member of a consolidated group, several problems arise if the partner is not the common parent of the members of the consolidated group. The primary reason for this is that Treas. Reg. § 1.1502-77 provides that the common parent is the sole agent for each subsidiary in the group with respect to all matters relating to the tax liability for the consolidated return year, and that no subsidiary shall have the authority to act for or to represent itself in any such matter. On the other hand, the TEFRA partnership provisions grant many rights to the tax matters partner (TMP), such as the authority to extend the statute of limitations on behalf of all partners and to enter into a settlement agreement that may bind certain other partners. In this regard, it is noted that the other members of the consolidated group are treated as partners under section 6231(a)(2)(B) because their income tax liability will be determined in part by taking into account indirectly partnership items of the TEFRA partnership. Hence, in light of these conflicting provisions, it is unclear whether the actions taken by the TMP will be binding on the consolidated group. Some guidance concerning the proper application of the TEFRA partnership provisions in this context would be helpful.

12. Dismissal of Premature Petitions

Section 6226 sets forth the rules concerning judicial review of notices of final partnership administrative adjustment (FPAA). Pursuant to section 6226(a), the tax matters partner (TMP) is given the exclusive right to file a petition for a readjustment of partnership items within the 90-day period after the issuance of the notice of FPAA. Pursuant to section 6226(b)(1), if the TMP does not file a petition within the 90-day period, notice partners are permitted to file a petition within the 60-day period after the close of the 90-day period. If more than one petition is filed under section 6226(b), that section sets forth ordering rules for determining which action goes forward and provides in paragraph (4) for the dismissal of all other actions. Section 6226(h) provides that if an action is dismissed other than under subsection (b)(4), the dismissal shall be treated as a determination that the notice of FPAA is correct. This provision creates a problem in cases where a petition is filed within the 90-day period by a person who is not the TMP. Since such a petition is filed under section 6226(a) rather than under section 6226(b), the dismissal is technically not pursuant to section 6226(b)(4). Hence, pursuant to section 6226(h), the dismissal of the premature petition would have the effect of upholding the notice of FPAA. Such a result is inappropriate. Consequently, it is recommended that legislation be enacted to correct this inequity, which clearly was not intended.

13. Determination of Penalties at the Partnership Level

Section 6231(a)(3) limits the definition of partnership items to those items required to be taken into account **under any provision of subtitle A**. Since penalties are contained in subtitle F, they cannot be partnership items. Instead, penalties are treated as affected items that require partner-level determinations. As a result, under section 6230(a)(2), penalties may only be asserted against a partner through the application of the deficiency procedures following the completion of the partnership-level proceeding. These penalty only cases create an undue burden for the Service and have the potential of significantly increasing the Tax Court's inventory. Moreover, the requirement of conducting a separate proceeding with each partner greatly increases the likelihood of disparate treatment. Hence, the major goals of the TEFRA partnership provisions, namely administrative and judicial economy and consistent treatment of partners, are not being accomplished with respect to penalties that are attributable to an investment in a TEFRA partnership. Accordingly, it is recommended that penalties be determined at the partnership level and imposed against the partners as a computational adjustment. However, it is also recommended that section 6230(c) be amended to provide the partners with a refund forum to raise any partner-level defenses that they may have with respect to the imposition of the penalty. This proposal should also be made applicable to the increased rate of interest under section 6621(c).

14. <u>Repeal of the Unified Procedures For S Corporations</u>

The Subchapter S Revision Act of 1982 added sections 6241-6245 to the Code. These provisions generally made the unified audit and litigation procedures for partnerships applicable to S corporations. Notwithstanding the repeal of General Utilities as part of the Tax Reform Act of 1986, which has made the use of S corporations more popular, the Service is in favor of repealing the unified procedures for S corporations. Historically, S corporations have not generally been used as a vehicle to market abusive tax shelters and the Service did not experience any significant difficulties in auditing S corporations or litigating at the shareholder level. Furthermore, for S corporation taxable years the return for which is due on or after January 30, 1987 (determined without regard to extensions), Temp. Treas. Reg. § 301.6241-1T(c)(2) provides for a small S corporation exception for S corporations with five or fewer shareholders, and it is our understanding that the vast majority of both existing and newly formed S corporations qualify for that exception. Hence, it appears as if the repeal of the unified procedures for S corporations is justified.

Section 6229 **PERIOD OF LIMITATIONS FOR MAKING ASSESSMENTS.**

* * *

(h) **Special Rule When Secretary Erroneously Applies Deficiency Procedures.**- If the Secretary erroneously determines that subchapter C of this chapter does not apply to a partnership taxable year and consistent with that determination timely mails a notice of deficiency to a partner pursuant to sections 6212 and 6501, which includes adjustments to partnership items (or affected items) of the partnership, the period of limitations provided in this section shall not expire before the date which is 1 year after the date that the determination of a court that the incorrect procedure was followed becomes final.

Section 6501 **LIMITATIONS ON ASSESSMENT AND COLLECTION.**

* * *

Redesignate existing subsection (o) as (p) and insert the following:

(o) **Special Rule When Secretary Erroneously Makes Administrative Adjustment.**- If the Secretary erroneously determines that subchapter C of chapter 63 applies to a partnership taxable year and consistent with that determination timely mails a notice of final partnership administrative adjustment to the tax matters partner with respect to that taxable year pursuant to sections 6223 and 6229, the period of limitations for assessing any tax which is attributable to the partnership items (or affected items) of the partnership shall not expire before the date which is 1 year after the date that the determination of a court that the incorrect procedure was followed becomes final.

Section 6230 **ADDITIONAL ADMINISTRATIVE PROVISIONS.**

(a) **Coordination With Deficiency Proceedings.-**

* * *

(3) **TREATMENT OF PARTNERSHIP ITEMS IN DEFICIENCY PROCEEDINGS.--**

(A) **IN GENERAL.**--In determining whether there is a deficiency for purposes of subchapter B, except as provided in paragraph (2)(A), adjustments to partnership items may be made only as provided in this subchapter.

(B) **SPECIAL RULES.--**

(i) **IN GENERAL.**--In any case in which the taxpayer's return shows a loss or no taxable income and shows a net loss from partnership items, solely for purposes of proceedings conducted under subchapter B, partnership items shall be disregarded in determining whether there is a deficiency. Any adjustment in such proceedings shall be taken into account in determining the amount of any computational adjustment.

(ii) **EXCEPTION FOR CERTAIN ITEMS.**--Clause (i) shall not apply to any partnership item the treatment of which has been finally determined under this subchapter.

EFFECTIVE DATE--This amendment shall take effect as if such amendment had been included in the amendments made by section 402 of the Tax Equity and Fiscal Responsibility Act of 1982.

APPENDIX II

Description of TEFRA Rules

Prior to the enactment of unified partnership audit rules by the Tax Equity and Fiscal Responsibility Act of 1982, adjustments to items of income, gain, loss, deduction and credits relating to a partnership had to be made in separate proceedings with the respective partners. Similarly, settlements and judicial determinations were only binding on those partners that were parties to the agreement or judicial proceeding. This system was not an efficient means of auditing tax shelters and other large partnerships, because each partner was entitled to separate administrative and judicial review of partnership items that were common to all partners.[1] The TEFRA partnership audit rules consolidate the administrative and judicial review of all partnership items at the partnership level. Congress, noting the potential conflict between investors and tax shelter promoters, balanced the consolidated audit provisions with considerable protections for individual partners.

The TEFRA partnership audit rules apply to all partnerships, except for partnerships with ten or fewer partners where each partners' share of any partnership item is the same as his share of every other item (*i.e.*, there are no special allocations) and each partner is a natural person (other than a nonresident alien) or an estate.[2] The tax treatment of all partnership items is determined at the partnership level.[3] Generally, all partners must treat items on their individual returns consistently with the treatment of those items on the partnership return unless they notify the Service of an

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[1] *See* General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, at 267-68 (hereinafter referred to as "TEFRA General Explanation").

[2] I.R.C. § 6231(a)(1)(B). All partners of a partnership for the partnership taxable year under audit generally are subject to the TEFRA partnership audit rules. However, under certain circumstances, the inclusion of a partner in a unified proceeding would interfere with efficient enforcement of the tax law. I.R.C. § 6231(c). When special enforcement considerations exist with respect to a partner, that partner's partnership items will be treated as nonpartnership items and the partner is removed from the partnership proceeding. Examples of special enforcement situations include the filing of a bankruptcy petition naming a partner as the debtor or the criminal investigation of a partner. *Id.*; Temp. Treas. Reg. §§ 301.6231(c)-4T through 8T.

[3] I.R.C. § 6221.

inconsistent treatment.[4] If a partner takes an inconsistent position on his or her return and does not provide notice of the inconsistency, the Service may immediately assess any deficiency necessary to make the partner's treatment consistent with the partnership return. Such an assessment would normally also include a negligence penalty.[5]

The central figure in a TEFRA partnership proceeding is the tax matters partner ("TMP"). The TMP is a representative of the partnership who serves as a liaison between the partnership, the Service and the court, with respect to the unified audit and litigation proceedings regarding the tax treatment of partnership items attributable to the partnership. As such, the TMP serves as the focal point for service of all notices, documents and orders on the partnership, and concomitantly has many rights and duties both at the administrative stage of the proceeding and in the course of litigation. The TMP is the general partner designated by the partnership to serve as the TMP or, if there is no such designation, the general partner having the largest profits interest as of the close of the taxable year involved.[6] If the Service determines that is impracticable to apply the largest profits interest rule, the Service may select any partner to serve as the TMP.[7]

Each partner is entitled to participate in all aspects of the administrative proceedings.[8] If the Service decides to initiate a partnership audit, it must furnish both a notice of the Beginning of an Administrative Proceeding and a notice of Final Partnership Administrative Adjustment to all partners entitled to notice.[9] In partnerships with more than 100 partners, only identified partners with a one percent or greater interest in partnership profits, and designated members of

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[4]I.R.C. § 6222(a) and (b).

[5]I.R.C. § 6222(c) and (d). <u>See</u> I.R.C. § 6662(b)(1).

[6]I.R.C. § 6231(a)(7); Temp. Treas. Reg. § 301.6231(a)(7)-1T.

[7]<u>Id.</u>; <u>See</u> Rev. Proc. 88-16, 1988-1 C.B. 691.

[8]I.R.C. § 6224(a).

[9]I.R.C. § 6223(a). Those partners entitled to receive notice from the Service are generally referred to as "notice partners." The partners who are not entitled to receive notice from the Service are referred to as "non-notice partners."

"notice groups,"[10] are entitled to notice from the Service.[11] All other partners are to be kept informed of the partnership proceedings by the TMP.[12]

The TEFRA partnership audit rules provide the TMP with the power to make certain decisions on behalf of the partnership. The period for assessing any tax with respect to any partner that is attributable to any partnership item (or any item affected by a partnership item) does not expire before the date that is three years after the later of the due date determined without extension or actual filing date of the partnership return.[13] The TMP has the authority to extend that period with respect to all partners.[14] The TMP also has the authority to enter into a settlement agreement that binds all non-notice partners, although any partner may, by notifying the Service, refuse to be bound by any agreement entered into by the TMP.[15] The TMP may file an administrative adjustment request (the functional equivalent of an amended return or claim for refund) on behalf of the partnership.[16] The TMP may also select the forum for litigation by filing a petition, during the first 90 days following the mailing of the notice of Final Partnership Administrative Adjustment, with either the Tax Court, the Claims Court, or the United States district court for the district in which the partnership has its principal place of business.[17]

Partners other than the TMP are provided with significant protections under the TEFRA partnership audit rules. Notice partners have the authority to petition for judicial review from a notice of Final Partnership Administrative Adjustment during the 60 days following the 90-day period after the mailing of a Notice of Final Partnership Administrative Adjustment to the TMP (assuming the TMP fails to file a petition during the 90-day

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[10] A "notice group" is a group of partners having in the aggregate a five percent or more interest in partnership profits who designate one member to receive notice on behalf of the group. I.R.C. § 6223(b)(2).

[11] I.R.C. § 6223(b).

[12] I.R.C. § 6223(g); Temp. Treas. Reg. § 301.6223(g)-1T.

[13] I.R.C. § 6229(a).

[14] I.R.C. § 6229(b)(1)(B).

[15] I.R.C. § 6224(c)(3)(B).

[16] I.R.C. § 6227(b).

[17] I.R.C. § 6226(a).

period).[18] If any partner files a petition in the Tax Court, a district court or the Claims Court, any partner in the partnership may file an election to participate in the action.[19] If the TMP fails to execute a consent to extend the statute of limitations, the Service must obtain a consent individually from each partner or issue a notice of Final Partnership Administrative Adjustment to the TMP in order to suspend the running of the statute of limitations.[20] An administrative adjustment request may be filed individually by a partner other than the TMP.[21] In addition, any partner may reach a settlement of his or her own case individually with the Service, and may file a request not to be bound by any agreement entered into by the TMP.[22] Partners may individually waive their rights under the TEFRA partnership audit rules or any restrictions placed on the Service by those rules.[23]

Any settlement agreement entered into between the Service and one or more partners, is binding on the parties to the agreement in the absence of fraud, malfeasance or misrepresentation of fact.[24] The TMP cannot bind notice partners. As noted above, an agreement entered into by the TMP is binding on non-notice partners (i.e., those partners with less than a one percent profits interest in partnerships with over 100 partners) only if the TMP expressly states in the agreement that it binds the other partners, and the agreement between the Service and the TMP will not bind any partner who has filed a statement with the Service restricting the TMP's authority to settle on his or her behalf.[25] If the Service enters into a settlement agreement with

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[18] I.R.C. § 6226(b).

[19] I.R.C. §§ 6224(a); 6226(c)(2); Tax Court Rule 245(b).

[20] I.R.C. § 6229(b)(1)(A) and (d).

[21] I.R.C. § 6227(c).

[22] I.R.C. § 6224(c)(1) and (c)(3)(B).

[23] I.R.C. § 6224(b).

[24] A partner holding an interest through one or more pass-through partners is bound by a settlement agreement entered into by a pass-through partner, unless the indirect partner has been identified to the Service. I.R.C. § 6224(c)(1).

[25] But see Tax Court Rule 248. Under that rule, if the case is docketed in the Tax Court and certain conditions are met, the court may enter a decision consistent with a settlement entered into with some of the partners, that would be binding on all parties to the action, notwithstanding that there may be notice

respect to partnership items for a particular taxable year, the Service generally is obligated to offer consistent terms to any other partner who so requests.[26] The partner's right to request consistent treatment is subject to certain time limitations.[27]

In general, a change in tax liability of a partner to properly reflect the treatment of a partnership item[28] is made through a "computational adjustment." After a final determination has been reached with respect to a partnership proceeding, the Service allocates the final adjustment among the partners and computes their revised tax liability based on return information in its possession. A computational adjustment may include a change in tax liability that reflects a change in an affected item if that change is necessary to properly reflect the treatment of a partnership item.[29] However, changes in a partner's tax liability with respect to affected items which require partner-level determinations are not included in a computational

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partners, or non-notice partners who filed statements prohibiting the TMP from entering into settlements on their behalf, who did not enter into a settlement agreement with the Service.

[26]I.R.C. § 6224(c)(2). The Service's obligation to offer consistent terms only applies if the items subject to the original agreement were partnership items with respect to the settling partner at the time of the original agreement. Temp. Treas. Reg. § 301.6224(c)-3T(b)(1). Furthermore, the items must be partnership items of the requesting partner at the time of the request. Thus, for example, the requesting partner must not have previously settled these items with the Service or had the items converted to nonpartnership items by reason of a special enforcement situation such as the partner's bankruptcy). Temp. Treas. Reg. § 301.6224(c)-3T(b)(2).

[27]I.R.C. § 6224(c)(2). <u>See</u> Temp. Treas. Reg. § 301.6224(c)-3T(c)(3).

[28]The term "partnership item" means any item required to be taken into account with respect to a partnership taxable year under subtitle A of the Code to the extent that regulations provide it is more appropriately determined at the partnership level than at the partner level. I.R.C. § 6231(a)(3). <u>See</u> Treas. Reg. § 301.6231(a)(3)-1. Partnership income, loss, deduction, or credit are common examples of partnership items.

[29]The term "affected item" means any item to the extent it is affected by a partnership item. I.R.C. § 6231(a)(5). A change in a partner's allowable medical expense deduction due to the effect of a partnership item on the adjusted gross income threshold is an example of an affected item.

adjustment, but rather require the issuance of a statutory notice of deficiency prior to assessment of the tax liability.[30]

Any partner, or the TMP acting on behalf of the partnership, may file an "Administrative Adjustment Request."[31] In general, an Administrative Adjustment Request has the same effect under the TEFRA partnership audit rules as either an amended partnership or partner return or a claim for refund with respect to the partnership or the partner. An Administrative Adjustment Request may be filed with respect to partnership items for a partnership taxable year (1) within the three year period after the later of the filing date of the partnership return for that year or the last day for filing such return (determined without regard to extensions), but must be filed before (2) the mailing to the TMP of a notice of Final Partnership Administrative Adjustment for such taxable year.[32]

The TMP may file an Administrative Adjustment Request with respect to the treatment of partnership items on the original partnership return. If the TMP asks that the treatment shown on the request be substituted for the treatment of partnership items on the original partnership return, the Service may treat the changes shown on the request as corrections of mathematical or clerical errors on the partnership return.[33] If the TMP files an Administrative Adjustment Request on behalf of the partnership which is not treated as a substituted return, the Service may, with respect to all or part of the requested adjustments: (1) compute the appropriate tax as to partners and issue refunds; (2)

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[30] I.R.C. § 6230(a)(2)(A)(i). A partner-level penalty based on an erroneous partnership deduction is an example of an affected item that is asserted through a statutory notice of deficiency.

[31] I.R.C. § 6227.

[32] I.R.C. § 6227(a).

[33] I.R.C. § 6227(b)(1). If the Service treats the Administrative Adjustment Request as a correction of mathematical or clerical errors appearing on the partnership return, the Service may proceed to assessment of the tax against partners without carrying on a unified proceeding. <u>See</u> I.R.C. §§ 6230(b)(1) and 6225. However, if any partner timely objects, the correction cannot be made with respect to that partner without conducting a partnership-level proceeding. I.R.C. § 6230(b)(2).

conduct a unified partnership proceeding; or (3) not act on the request.[34]

If any partner individually files an Administrative Adjustment Request, the Service may: (1) process the request in the same manner as a claim for refund with respect to items that are not partnership items; (2) assess any additional tax resulting from the request; (3) mail to the partner a notice that all partnership items of the partner for the partnership taxable year to which such request relates shall be treated as

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[34]If the Service fails to act on an Administrative Adjustment Request made on behalf of the partnership, the TMP may file a petition for judicial review of the request. I.R.C. § 6228(a)(1). Such a petition can be filed only after the expiration of six months from the date of the filing of the Administrative Adjustment Request and before two years have elapsed from the filing date. I.R.C. § 6228(a)(2)(A). However, no petition may be filed after the Service has issued a notice of the Beginning of an Administrative Proceeding (unless after issuance of such notice the Service fails to issue notice of a Final Partnership Administrative Adjustment, in which case the partner may file a petition within the six-month period following the expiration of the applicable statute of limitations). I.R.C. § 6228(a)(2)(B) and (C). These limitation periods may be extended by agreement of the parties. I.R.C. 6228(a)(2)(D). Generally, a court in which a petition is filed will only have jurisdiction over items covered by the Administrative Adjustment Request that were not allowed by the Service and over items raised by the Service as offsets to the requested adjustments. I.R.C. § 6228(a)(5).

nonpartnership items;[35] or (4) conduct a unified partnership proceeding with respect to the items covered in the request.[36]

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[35]If the partner is mailed a notice that all of his or her partnership items for the partnership taxable year to which an administrative adjustment request relates will be treated as nonpartnership items, the Administrative Adjustment Request is treated as a claim for credit or refund of an overpayment attributable to nonpartnership items and the partner may bring a refund action under section 7422 with respect to such claim within two years of the mailing of such notice. I.R.C. § 6228(b)(1). If the Service fails to grant the request in whole or in part and does not issue a notice converting the partner's partnership items to nonpartnership items, the partner may initiate a refund action within the period starting six months following the filing of the request and ending two years after such filing. I.R.C. § 6228(b)(2)(B). Upon the commencement of such an action, the partner's partnership items are treated as nonpartnership items. I.R.C. § 6231(b)(1)(B). No refund actions may be brought in a federal district court or the Claims Court with regard to partnership items except as provided above or as provided in section 6230(c) (relating to computational adjustment disputes). I.R.C. § 7422(h).

[36]I.R.C. § 6227(c).

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
April 3, 1990

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STATUS OF NEGOTIATIONS OF INCOME TAX TREATIES AND TAX INFORMATION EXCHANGE AGREEMENTS

The Treasury Department announced today the countries with which it is currently engaged in income tax treaty and tax information exchange agreement (TIEA) negotiations and invited comments from interested persons. Comments should be submitted in writing to Philip D. Morrison, International Tax Counsel, Room 3064, Treasury Department, Washington, D.C. 20220.

I. INCOME TAX TREATIES

A. Hearings before Senate Foreign Relations Committee anticipated in late April on:

Finland
Germany
India
Indonesia
Spain
Tunisia
Multilateral Convention on Mutual Administrative Assistance in Tax Matters

B. Active Negotiations; Meetings Scheduled

Mexico--first round held March 12-16; second round tentatively scheduled for August 13-17
the Netherlands--negotiation of a new treaty continued March 19-23; next round tentatively scheduled for early summer
the USSR--first round of negotiation of a new treaty held March 26-30
Israel--negotiation of a protocol to existing treaty (not in effect) to continue April 23-27
Canada--negotiation of a protocol to existing treaty to continue May 14-18
Switzerland--negotiation of a new treaty to continue October 22-26

NB-749

C. Other Active Negotiations; No Meetings Scheduled

Bangladesh--correspondence on open issues
Belgium--correspondence on open issues
Bulgaria--first negotiations expected to begin in May or June
Denmark--correspondence on a protocol to cover 1986 Tax Reform Act and other changes
France--meeting expected in 1990 to discuss a technical protocol
Ireland--meeting to resolve open issues likely September 24-28
Italy--negotiation of a protocol to existing treaty
Kuwait--reviewing open issues
Sweden--text of new treaty undergoing final review
Sri Lanka--correspondence on open issues
Thailand--correspondence on open issues; further negotiations likely this year
Turkey--correspondence on open issues
Zambia--correspondence on open issues

D. Negotiations Initiated; No Meetings Scheduled

Austria
Barbados
Malaysia
Portugal
Singapore
Trinidad & Tobago
Yugoslavia

II. TAX INFORMATION EXCHANGE AGREEMENTS

A. In Effect

Barbados (effective November 1984)
Bermuda (effective December 1988)
Dominica (effective May 1988)
Dominican Republic (effective October 1989)
Grenada (effective July 1987)
Jamaica (effective December 1986)
Mexico (effective January 1990)
Trinidad and Tobago (effective February 1990)

B. Signed, But Not Yet In Effect

Costa Rica
Peru
St. Lucia

C. Active Negotiations

Bolivia
Colombia
Guyana
Panama

TREASURY NEWS

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TEXT AS PREPARED
FOR RELEASE UPON DELIVERY
EXPECTED AT 10:00 A.M.
APRIL 3, 1990

STATEMENT OF FRANK VUKMANIC
DIRECTOR OF THE OFFICE OF
MULTILATERAL DEVELOPMENT BANKS
DEPARTMENT OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON FOREIGN OPERATIONS
COMMITTEE ON APPROPRIATIONS
U.S. HOUSE OF REPRESENTATIVES

Introduction:

Mr. Chairman: I am pleased to participate in this panel on global environmental issues and international economic assistance programs. My statement today will report on several initiatives that Treasury has taken within the Multilateral Development Banks over the past year and how we have sought to shape the policies of those institutions in this increasingly important area.

We have received an extensive mandate from Congress directing us to seek more than thirty specific environmental reforms in the Multilateral Development Banks. These reforms have included: restructuring and strengthening of environmental line units; hiring of environmentally-qualified staff; greater emphasis on staff training on environmental implications of development; increased coordination with local community groups and non-governmental organizations; and the preparation of additional projects that will have a positive and beneficial effect on the environment. We have made a concerted and conscientious effort to carry out this mandate and I believe we have some substantial successes to report.

Administration Initiatives:

At last year's Economic Summit meeting in Paris in July, President Bush asked other heads of state and government to join him in encouraging the World Bank and the regional development banks to integrate environmental considerations into all aspects of their activities. At the Annual Meetings of the World Bank and International Monetary Fund last September, the President encouraged other countries to weigh environmental considerations more heavily in economic decision-making, and said that we need to work more cooperatively together to develop constructive responses to global warming, specifically emphasizing measures to promote energy efficiency and conservation and greater protection of tropical forests.

Treasury has pursued the full range of environmental reform issues in numerous international meetings: meetings of the Development Committee of the World Bank and IMF in April 1989 and in September 1989, the Annual Meetings of the World Bank and IMF last September, and the ministerial meeting of the Organization for Economic Cooperation and Development last May. In addition, we have emphasized the importance of environmental reforms in the annual meetings of the three regional banks. Such reform issues have been an important part of U.S. negotiations to replenish the resources of these institutions, particularly those of the Inter-American Development Bank (IDB) and the ninth replenishment of the International Development Association (IDA-9). We have also raised environmental issues in the negotiations now going forward for establishment of the European Bank for Reconstruction and Development (EBRD).

<u>IDA Replenishment</u>:

One of our most significant accomplishments in the IDA-9 negotiations was the inclusion of more stringent environmental provisions in the replenishment agreement. That agreement provides for:

-- Implementation of environmental impact assessment (EIA) procedures, thereby helping to assure that environmental costs and benefits are weighed carefully early in the project appraisal process.

  - Projects which are expected to have significant environmental consequences will receive rigorous technical reviews at sufficiently early stages of project preparation to ensure that their environmental impacts are fully factored into decisions on site selection and project design.

  - As part of this process, environmental impact assessments will be made available to the Executive Board at least 180 days in advance of Board action;

-- Increasing public access to environmental information, including environmental impact assessments or summaries of them, thereby promoting participation by local community groups and non-governmental organizations;

-- Closer collaboration and cooperation with non-governmental organizations in borrowing countries;

-- Greater emphasis on energy efficiency and conservation, including end-use efficiencies, renewable energy technologies, and least-cost planning in borrowing countries;

-- More support for debt for nature swaps; and

-- More rapid progress on environmental action plans. Environmental action plans will be completed on all IDA borrowers as soon as feasible.

Progress within the Banks:

A great deal has already been accomplished on a number of environmental reforms within the Multilateral Development Banks. Let me cite some specific examples that will illustrate the progress that has been made over the past year. At last count, the World Bank had approximately 100 individuals working on various aspects of environmental issues. This is up from approximately 65 individuals a year ago. Last September, the Bank adopted an operational directive for assuring that environmental impact assessments are completed for projects that will have a significant effect on the environment.

In January, the Inter-American Development Bank established an environmental line unit and assigned fifteen professionals to carry out the functions of the unit. In February, the Bank adopted environmental classification and impact assessment procedures. It has also continued its work with non-governmental organizations and local community groups, sponsoring a conference on environmental issues in the hemisphere last year and inviting many organizations and groups from borrowing member countries to participate.

The Asian Development Bank has continued its efforts to integrate environmental considerations more effectively into the project appraisal process -- setting up a comprehensive review system that produces environment reports on specific projects at six stages of the appraisal progress. The Bank has also sought to involve non-governmental organizations from developing countries in identification and preparation of specific project proposals. Projects that have benefited from this NGO involvement include two from the Philippines, one from Nepal and one from Bangladesh. In June, 1989, the ADB also sponsored a consultative meeting with non-governmental organizations from the region. It is pursuing other work on NGO institutions and capabilities and a study on the possibilities for debt for nature swaps.

The African Development Bank has been working closely with three U.S. non-governmental organizations -- the Sierra Club, the Natural Resources Defense Council, and the American

Farm Trust -- to increase its cooperation and coordination with non-governmental organizations in Africa. An initial meeting -- involving a number of African organizations -- was held last September in Abidjan. We have encouraged this process and hope that the U.S. organizations will be able to continue their activities in this area. The African Development Bank has also developed an environmental policy paper to guide its lending activities as they affect the environment. The paper is currently under review by a committee of the board of executive directors of the Bank.

All of the Multilateral Development Banks are reporting continuing increases in the number of environmentally beneficial projects and of projects with environmentally beneficial components. There has also been a rapid rise in technical assistance programs for preparation of environmentally beneficial projects and strengthening of environmental institutions in borrowing countries.

We are pleased with the progress achieved thus far. At the same time, we recognize there is much more that remains to be done. We will encourage the Asian Development Bank and the African Development Bank to increase the number of environmentally-qualified staff. We will continue the emphasis we have already placed on energy efficiency and conservation measures and programs to protect tropical forests. We will increase our efforts to assure that the agreements we have reached are implemented effectively.

In the World Bank, implementation of environmental impact assessment procedures over the next two years will be a difficult and time-consuming task. We are consulting with Department of State, USAID, the Environmental Protection Agency, and the Council on Environmental Quality about the possibility of detailing U.S. experts to assist in this process. We are also asking other countries to consider seconding experts for this purpose as well. In the regional development banks, this task will be even more daunting, and will almost certainly require additional efforts by us and other developed countries.

Protection of Tropical Forests:

In legislation that was passed last year, this subcommittee emphasized the importance of programs for protecting tropical forest resources. This is an area which we have watched closely and one where we have had serious concerns for several years. Members may recall that the Treasury Department in 1988 adopted standards for U.S. evaluation of Multilateral Development Bank projects that may adversely affect tropical moist forests. At our urging, the World Bank announced plans to adopt its own standards for such projects. We expect those standards to be put in place later this year. We hope that they will provide a suitable framework for the Bank's projected increase in lending for tropical forestry projects.

The Administration has also supported the work of the Tropical Forestry Action Plan (TFAP). This Plan, led by the World Bank, the Food and Agriculture Organization and the United Nations Development Program, seeks to provide an overall framework -- institutional, policy and loan strategy-- for preserving and replenishing tropical forest resources in developing countries. It undertakes forestry sector reviews in individual countries and identifies specific projects that may be funded by both bilateral and multilateral donors.

We believe that the conceptual approach being taken by TFAP is correct. However, we have encountered some problems with the development of specific loans under the TFAP program. In particular, we are concerned that there be a better balance between timber programs and the preservation and protection elements of individual loans. In many cases, the TFAP process has also been too much of a closed process, excluding the participation of forest dwellers and NGOs. Accordingly, we have encouraged reforming and strengthening of TFAP programs, urging greater emphasis on building up institutional capacities for park management and forestry preservation in borrowing countries and involving non-governmental organizations in all stages of planning and implementation.

We are working closely with non-governmental organizations such as World Wildlife Fund in this area. We are also working closely with these organizations on evaluating specific MDB loan proposals that may present problems. In June of 1989, we were successful in making changes in a forestry loan to Sri Lanka from the World Bank. In December, we undertook a particularly close review of a $8 million forestry project in Guinea, urging the World Bank to put more weight on protection and preservation elements in the loan. We are now conducting an even more searching review of an $80 million loan to Ivory Coast because of similar concerns.

Debt for Nature Swaps:

In 1988, Treasury encouraged the World Bank Group to play a more active role in promoting debt for nature swaps. Unfortunately, progress in this area has not been as rapid as we had first hoped. One recent encouraging sign has been a proposal to preserve an important tract of Atlantic rain forest in Paraguay. The tract extends over 69,000 hectares and is a virgin, humid, semitropical rainforest of particularly rich biodiversity. It is the last large privately-owned tract of this unique vegetation type in Latin America.

The International Finance Corporation, which acquired the tract a number of years ago through foreclosure, is working with USAID and Nature Conservancy to transfer title to an appropriate Paraguayan institution and establish a nature reserve in the area. The parties are also seeking to finance the recurrent costs associated with reserve management. Our understanding is that USAID is willing to provide $500,000 for the proposal and that other funding would come from Nature Conservancy and other private organizations. Although an agreement is not assured at this time, we are hopeful that the project will go forward under World Bank auspices and that it will be a model for future debt for nature transactions.

Energy Efficiency and Conservation:

Energy efficiency and conservation measures are another important area in which we have received a significant legislative mandate from this sub-committee. During the past year, Treasury formed an informal working group comprised of experts from USAID, the Environmental Protection Agency, the Departments of State and Energy, and several NGOs to exchange views on how we might encourage greater emphasis on energy efficiency and conservation in the Multilateral Development Banks. Much of the specificity that we were able to achieve in the IDA-9 Agreement grew out of the work of this group.

Treasury has also been an active member of the Committee on Renewable Energy, Commerce, and Trade (CORECT), which seeks to encourage greater reliance on renewable energy technologies in developing countries. We have helped to draft a financing paper for the committee emphasizing the role of the World Bank in encouraging this process. The World Bank, itself, is now working with the Department of Energy to identify and help implement innovative mechanisms for financing renewable energy and conservation services for small energy consumers in developing countries. This project, Financing of Energy Services for Small-scale Energy Users, also known as FINESSE, is being targeted initially at four southeast Asian countries --Indonesia, Malaysia, Philippines and Thailand. A workshop is scheduled to be held in Kala Lumpur in the spring of 1991. This week, the World Bank and USAID are sponsoring a seminar on use of wind energy for large scale electric power production.

We have also encouraged the World Bank to work more closely with USAID in developing least-cost energy plans in borrowing countries and in coordinating their overall programs in energy efficiency and conservation. The Energy Section Management Assistance Program (ESMAP) is expected to put more emphasis on integrating the results of their studies and assessments into the capital lending programs of the Bank. A high level review of ESMAP is also underway and more specific recommendations are expected in the near future. In the regional development banks, we are also asking for greater emphasis on renewable energy technologies, end-use efficiencies and least-cost planning.

Conclusion:

Mr. Chairman, I believe we are making good progress on the full range of environmental reforms in all of the Multilateral Development Banks. We have been particularly encouraged by the adoption of procedures for environmental impact assessment in both the World Bank and the Inter-American Development Bank. We look forward to adoption of similar procedures in the other banks. Effective implementation of these procedures will be difficult and time-consuming and require technical support from us and other member countries.

Energy efficiencies and conservation and protection of tropical forests are two other key areas which clearly need additional attention from us. We are making a good start in both of these areas -- in reviewing the Energy Sector Management Assistance Program (ESMAP) in the World Bank and in working to reform and strengthen the mandate of the Tropical Forestry Action Plan (TFAP). We have had important support in these areas from other agencies in the U.S. Government and from non-governmental organizations that are interested in these issues. I am convinced that we will continue to make important progress in the year ahead.

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.

April 3, 1990

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $16,400 million, to be issued April 12, 1990. This offering will provide about $1,150 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $15,255 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, April 9, 1990. The two series offered are as follows:

91-day bills (to maturity date) for approximately $8,200 million, representing an additional amount of bills dated January 11, 1990, and to mature July 12, 1990 (CUSIP No. 912794 UU 6), currently outstanding in the amount of $ 7,825 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $8,200 million, to be dated April 12, 1990, and to mature October 11, 1990 (CUSIP No. 912794 VE 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 April 12, 1990. In addition to the maturing 13-week and 26-week bills, there are $9,075 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 $ 784 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $1,014 million as agents for foreign and international monetary authorities, and $5,745 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

FOR RELEASE AT 4:00 P.M.
April 4, 1990

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION $7,500 MILLION OF 7-YEAR NOTES

The Department of the Treasury will auction $7,500 million of 7-year notes to refund $4,831 million of 7-year notes maturing April 15, 1990, and to raise about $2,675 million new cash. The public holds $4,831 million of the maturing 7-year notes, including $761 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $7,500 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 price of accepted competitive tenders.

In addition to the public holdings, Federal Reserve Banks for their own accounts hold $223 million of the maturing securities that may be refunded by issuing additional amounts of the new notes at the average price of accepted competitive tenders.

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

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Attachment

NB-752

HIGHLIGHTS OF TREASURY
OFFERING TO THE PUBLIC
OF 7-YEAR NOTES
TO BE ISSUED APRIL 16, 1990

April 4, 1990

Amount Offered:

To the public	$7,500 million

Description of Security:

Term and type of security	7-year notes
Series and CUSIP designation	E-1997 (CUSIP No. 912827 YT 3)
Maturity date	April 15, 1997
Interest rate	To be determined based on the average of accepted bids
Investment yield	To be determined at auction
Premium or discount	To be determined after auction
Interest payment dates	October 15 and April 15
Minimum denomination available ..	$1,000

Terms of Sale:

Method of sale	Yield auction
Competitive tenders	Must be expressed as an annual yield, with two decimals, e.g., 7.10%
Noncompetitive tenders	Accepted in full at the average price up to $1,000,000
Accrued interest payable by investor	None

Payment Terms:

Payment by non-institutional investors	Full payment to be submitted with tender
Deposit guarantee by designated institutions	Acceptable

Key Dates:

Receipt of tenders	Wednesday, April 11, 1990, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):	
a) funds immediately available to the Treasury ..	Monday, April 16, 1990
b) readily-collectible check ..	Thursday, April 12, 1990

TREASURY NEWS

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

TEXT AS PREPARED
NOT FOR RELEASE UNTIL DELIVERY
Expected at 10:00 a.m.
Thursday, April 5, 1990

TESTIMONY OF DAVID C. MULFORD
UNDER SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS
BEFORE
THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
OF THE
UNITED STATES SENATE
APRIL 5, 1990

INTRODUCTION

I am pleased to be here today to discuss the Government's efforts to achieve national treatment for U.S. financial firms abroad. In your invitation, you expressed concern that American firms may be losing their competitive edge in international finance, and questioned the "equity of regulatory practices" in the United States and major foreign financial centers. The competitiveness issue of U.S. financial firms is of great interest to this Administration and particularly to the Treasury Department.

You have aptly pointed out that this issue has many dimensions of which worldwide regulatory equity is only one. Secretary Brady, as you may be aware, has asked the Treasury to examine related aspects of competitiveness in a comprehensive study on the cost of capital. I will focus my remarks today, as you requested, on the extent to which our national treatment policy has been successful, especially in Japan and the European Community. I will also comment on increased foreign penetration of U.S. financial markets, the diminished role of U.S. financial firms abroad, and the tendency of other major financial countries to adopt reciprocity or retaliatory powers.

NATIONAL TREATMENT POLICY

First, I would like to emphasize that the principle of national treatment, as embodied in the International Banking Act of 1978 and the OECD National Treatment Instrument and Codes of Liberalization, remains the cornerstone of Treasury's belief that everyone benefits from open financial markets which are accessed easily by domestic and foreign participants. We firmly believe that it is not sufficient simply to remove blatant discriminatory barriers. Foreign firms should effectively enjoy the same competitive opportunities as domestic firms. Despite moments of frustration and mounting pressure we have not strayed from this principle.

National Treatment Studies

Our efforts to implement national treatment have included national treatment studies and financial market talks. We continually monitor foreign financial markets and have intensified our scrutiny in the course of preparing the national treatment reports to the Congress in 1979, 1984 and 1986. We are currently preparing the most extensive study thus far, which the 1988 Trade Act requires the Treasury Secretary to submit to the Congress later this year.

This study will be broader in scope and depth than previous studies. It will report on the treatment accorded U.S. banks and securities firms in foreign markets and describe our efforts to reduce discriminatory treatment. We will prepare detailed country chapters and also report on the activities of foreign financial institutions in the U.S. In fact, this study will attempt to provide more complete answers to many of the questions you have raised. In my remarks today, I do not want to prejudge its conclusions.

Financial Market Talks

The success of open U.S. financial markets prompted the Treasury to urge other countries to adopt national treatment. We have engaged in a series of financial market talks aimed at opening foreign markets and creating a level playing field for U.S. firms. For example, we have met with our counterparts from Japan, Canada, the European Community, Taiwan and Korea to discuss a wide range of financial market issues. We have also raised financial market issues with Latin American officials. Since you have expressed particular interest in Japan and the EC, let me turn briefly to our efforts in these markets.

Japan

Perhaps the most notable progress has been in Treasury's financial discussions with the Japanese. The so-called Yen/Dollar group, now known as the U.S.-Japan Working Group on Financial Markets, has met thirteen times since early 1984. These talks, which I lead on the U.S. side, have contributed to substantially greater access for U.S. firms to Japanese financial markets -- to their stock exchanges, government securities markets, the Euroyen market and, to a lesser degree, Japanese domestic money markets.

This is not to say our work is complete. We are continuing to press for more rapid interest rate deregulation and the development of a short-term money market as well as further progress across a range of issues. These include examining Japanese laws which frustrate foreign financial firms in offering innovative products and services to Japanese investors. Progress has been steady, but slow. The Japanese have recently indicated their intention to expand use of the auction process in the government securities market, increase the number of seats on the Tokyo Stock Exchange and accept applications for investment trust management licenses. We intend to continue these discussions in Tokyo next month.

European Community

We have also worked with our colleagues in the European Community as they have drafted legislation to establish an integrated market in banking and securities by the end of 1992. We expressed particular concern about a potential mirror-image reciprocity provision which was initially included in the Second Banking Directive and a similar provision in the directive on investment services. These directives are part of the major liberalization and regulatory framework for the 1992 market. The EC subsequently revised the Second Banking Directive to provide for reciprocal national treatment and effective market access, although it still provides for sanctions when third countries do not provide national treatment. We will continue to monitor developments in this area to avoid potential discrimination against firms from non-EC countries.

General Outcome

Overall, our efforts have been successful, if in varying degrees. Our talks with the Canadians produced a landmark financial services agreement, as part of the 1989 U.S.-Canada Free Trade Agreement, which removed many discriminatory practices. We are moving forward slowly but steadily with Taiwan and Korea. During our financial policy talks in February, the Koreans agreed to several measures which should enhance foreign banks' access to local currency funding in the Korean money market. The Koreans also agreed to abide by the scheduled opening of the securities sector to foreign firms. We now are waiting for evidence to support Korea's intentions.

In Latin America we have made the least progress. Nevertheless, we will continue to urge financial market reforms and more liberal investment policies in Latin American countries, especially in conjunction with development bank lending. Some of these countries, such as Venezuela and Mexico, have adopted a new openness in trade which I hope will spread to their financial sectors. It is difficult to justify that major debtor countries receiving support from a variety of sources under the strengthened debt strategy should maintain financial systems that remain substantially closed to the world financial community. We intend to have follow-up discussions with these and other markets as we pursue our efforts. The 1990 National Treatment Study, currently underway, will help identify problem areas.

The Uruguay Round

Finally, let me comment on financial services in the Uruguay Round. This facet of the Uruguay Round is a relatively new effort to improve opportunities for U.S. financial institutions in foreign markets. At Treasury's initiative, finance officials have begun to craft an agreement which would contain legally binding obligations calling for both market access and national treatment for financial institutions. The OECD countries have already made considerable progress in this area. The Uruguay Round provides an opportunity to pursue liberalization in a wider range of countries, including the newly industrializing economies of Asia and Latin America.

COMPETITIVENESS OF U.S. BANKS

You expressed concern that the position of U.S. banks has steadily declined while other foreign banks, particularly Japanese banks, have rapidly gained strength and market share.

I agree that U.S. banks have lost their position of world dominance. Not only has their position declined worldwide, it has also declined in the United States. Meanwhile, Japanese banks have increased their market share around the world and their penetration in the United States. This has occured while U.S. banks have acquired only a negligible share of the Japanese market and have not enjoyed the same ease of access the Japanese banks have enjoyed in the United States.

There are a number of factors which account for U.S. banks drawing back from foreign markets. Some result from international developments, including exchange rate changes, while others stem from U.S. domestic considerations. One difficulty facing U.S. banks has been the political and legislative uncertainties surrounding the future landscape of the U.S. financial system. The ability of U.S. banks to compete on all fronts with foreign banks abroad has, in part, been hampered by U.S. restrictions on their activities. Limitations in the United States have also curtailed U.S. banks' activities domestically including inter-state banking. Nevertheless, without going into statistical detail (1988 is the last full year for which complete internationally comparative data are available), I agree, that for a variety of reasons, U.S. banks have lost a major competitive position.

NATIONAL TREATMENT VERSUS RECIPROCITY

To return to our original discussion, I believe the United States has been well served by our policy of national treatment. At home, the U.S. domestic market has benefited and abroad we have made some significant strides in opening markets, although usually as a result of arduous negotiations. National treatment has its limitations, but they may be less dangerous than those associated with other alternatives.

Since at the Federal level we offer national treatment in U.S. markets, we do not have a test to determine whether a foreign financial firm should be allowed to enter or increase the scope of its activities in the United States based on the openness of its home country. In this regard, we are increasingly in a minority in the international community.

OECD Countries

For example, in 1984, the OECD found that 11 of the 24 OECD members had some form of reciprocity powers available. Since then, other countries have added reciprocity powers. With the adoption of reciprocal national treatment that will become operative on January 1, 1993 under the EC's Second Banking Directive, at least 18 out of 24 OECD members will have reciprocity powers. We have pressed our concerns about the consistency of these new reciprocity measures with OECD members.

On the other hand, we have also seen substantial progress towards national treatment in OECD countries since 1984. This is true in the Scandinavian countries, in Australia, Canada, Japan, Switzerland, many other European countries, and even under the EC Second Banking Directive, provided that it operates in a non-discriminatory manner.

You inquired specifically about Japan and the European Community.

Japan

Broadly speaking, we understand that Japan does not, in practice, require reciprocity beyond a general assurance that its firms have a right of establishment in foreign countries. However, Japan's banking law does contain language which requires the Minister of Finance, in reviewing a foreign institution's banking license application, to examine whether Japanese banks are entitled to equivalent status in the foreign country. In effect, this is a provision for reciprocity. However, Japan's Ministry of Finance appears to apply this standard flexibly, focusing only on markets which specifically prohibit the presence of Japanese banks. On the securities side, there are no statutory or regulatory reciprocity provisions.

The European Community

EC officials maintain that on January 1, 1993, the EC will move to a unified banking market which places less restraint on what financial institutions can do than exists in the United States or Japan. Given the EC's repeated desire to maintain open markets, it seems unlikely that the EC's reciprocity powers under the Second Banking Directive would be used in the present environment against U.S. financial institutions. We will continue to monitor the implementation of this and other directives.

Nevertheless, in a listing of significant worldwide practices where the EC sees room for improvement, EC officials question the appropriateness of 1933 Glass-Steagall restrictions on universal banking in the global financial markets of the 1990s. They also note that the McFadden Act restricts geographical expansion and that certain states deny national treatment and discriminate against banks from other states whose parent banks are not U.S.-owned. They cite Federal Reserve limits on daylight overdrafts which they claim place foreign banks at a competitive disadvantage in U.S. markets. EC officials maintain that those who oppose reciprocity and urge national treatment abroad should be careful to ensure that their own domestic practices are beyond criticism.

United States

I must admit that in the United States we often fail to realize how our own highly regulated and fragmented markets are viewed overseas. Even though at the federal level we pursue a policy of national treatment, at the state level there are denials of national treatment. When foreign firms or foreign Governments bring specific complaints to the Treasury's attention, we act on them, writing to the states in question, requesting that national treatment be given, but we cannot force it.

Moreover, we should not forget that in addition to Federal requirements, the 50 states each have securities and banking laws that must be observed. This is not a denial of national treatment, but while normal to us, it might appear daunting to a foreigner.

CONCLUSION

To conclude, I would like to emphasize my support for this Committee's concern about the absolute need for open markets and equal access to competitive opportunities in our rapidly integrating financial world. As I have stated, the Treasury has been actively pursuing national treatment for U.S. financial firms in foreign markets through discussions with other countries. In different fora, we have engaged in financial market talks with Japan, the European Community, Korea, Taiwan, and Canada. We have also raised our concerns with Latin American officials. We have worked with the OECD to strengthen the Codes of Liberalization with respect to the financial services sector and to upgrade the National Treatment Instrument. In addition, we are rapidly moving forward in our preparations for the 1990 National Treatment Study -- a comprehensive study which will thoroughly analyze the treatment of U.S. financial institutions abroad.

In this context, we have studied with interest the "Fair Trade in Financial Services Act of 1990" (S.2028). We certainly appreciate its objective of promoting progress in opening foreign markets for U.S. financial firms. However, the Administration must oppose this bill for the same reasons that it has opposed and expressed concern about reciprocity in the European Communities' financial services directives.

The U.S. objection to even limited reciprocity is the risk that reciprocity would be used and retaliation would follow. The impact could be devastating to confidence in world financial markets and established patterns of monetary and capital flows. The President has clearly stated his opposition to measures that might restrict the flow of capital or increase protectionism -- the market place should be free to allocate resources. The Department of Justice has constitutional concerns about certain provisions of this bill which it will address in a separate letter. Thus, in seeking progress, the Administration prefers to encourage other countries to open and liberalize their markets, to our mutual advantage, rather than threaten to deny foreign firms access to our own.

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

FOR IMMEDIATE RELEASE
April 4, 1990

CONTACT: Art Siddon
(202) 566-5252

TREASURY UPDATES ESTIMATE OF FINANCING REQUIREMENTS

The Treasury Department announced that market borrowing requirements estimated for the April-June quarter have been revised upward. Treasury estimates that market borrowing will be in a range of $10 billion to $15 billion during the April-June 1990 quarter, with a cash balance of $30 billion on June 30.

The revised borrowing estimate compares with a paydown of $5 billion to $10 billion, leaving a $35 billion cash balance, announced in Treasury's financing press conference of Jan. 31, 1990. The increase in Treasury's borrowing need is largely attributable financing the working capital needs of the Resolution Trust Corporation.

The Treasury will announce the terms of the regular May quarterly refunding on May 2, 1990, when it will update Treasury's market borrowing requirement estimate for the April-June quarter. A preliminary range of estimates for the July-September quarter will be announced at that time.

NB-754

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
April 4, 1990

CONTACT: Desiree Tucker-Sorini
(202) 566-8773

Statement by
Nicholas F. Brady
Secretary of the Treasury

I am pleased the Senate has confirmed Tim Ryan for Director of the Office of Thrift Supervision. I also appreciate the Senate's expeditious consideration and thorough review of this nomination.

NB-755

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE

April 5, 1990

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $9,766 million of 52-week bills to be issued April 12, 1990, and to mature April 11, 1991, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	7.70%	8.30%	92.214
High -	7.73%	8.33%	92.184
Average -	7.72%	8.32%	92.194

Tenders at the high discount rate were allotted 63%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 34,810	$ 34,810
New York	22,040,650	8,621,870
Philadelphia	21,455	21,455
Cleveland	42,735	42,735
Richmond	48,110	46,260
Atlanta	30,760	30,760
Chicago	1,598,045	175,695
St. Louis	22,815	20,445
Minneapolis	21,540	11,540
Kansas City	66,660	66,660
Dallas	26,025	16,025
San Francisco	818,865	266,165
Treasury	412,050	412,050
TOTALS	$25,184,520	$9,766,470
Type		
Competitive	$21,714,250	$6,296,200
Noncompetitive	1,110,270	1,110,270
Subtotal, Public	$22,824,520	$7,406,470
Federal Reserve	2,200,000	2,200,000
Foreign Official Institutions	160,000	160,000
TOTALS	$25,184,520	$9,766,470

NB-756

PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR RELEASE AT 3:OO PM
April 5, 1990

Contact: Peter Hollenbach
(202) 376-4302

TREASURY ANNOUNCES ACTIVITY FOR SECURITIES IN THE STRIPS PROGRAM FOR MARCH 1990

The Department of the Treasury announced activity figures for the month of March 1990, of securities within the Separate Trading of Registered Interest and Principal of Securities program, (STRIPS).

	Dollar Amounts in Thousands
Principal Outstanding (Eligible Securities)	$408,865,583
Held in Unstripped Form	$312,650,853
Held in Stripped Form	$96,214,730
Reconstituted in March	$2,948,560

The accompanying table gives a breakdown of STRIPS activity by individual loan description. The balances in this table are subject to audit and subsequent revision. 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, MARCH 31, 1990
(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	$5,373,754	$1,284,800	$24,000
11-1/4% Note A-1995	2/15/95	6,933,861	6,401,381	532,480	-0-
11-1/4% Note B-1995	5/15/95	7,127,086	5,771,406	1,355,680	-0-
10-1/2% Note C-1995	8/15/95	7,955,901	7,311,101	644,800	16,000
9-1/2% Note D-1995	11/15/95	7,318,550	6,471,350	847,200	-0-
8-7/8% Note A-1996	2/15/96	8,575,199	8,322,399	252,800	-0-
7-3/8% Note C-1996	5/15/96	20,085,643	19,864,843	220,800	-0-
7-1/4% Note D-1996	11/15/96	20,258,810	19,958,810	300,000	-0-
8-1/2% Note A-1997	5/15/97	9,921,237	9,852,037	69,200	-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	9,792,329	16,000	-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	11,214,646	128,000	-0-
8-7/8% Note D-1998	11/15/98	9,902,875	9,896,475	6,400	-0-
8-7/8% Note A-1999	2/15/99	9,719,628	9,716,428	3,200	-0-
9-1/8% Note B-1999	5/15/99	10,047,103	9,197,503	849,600	-0-
8% Note C-1999	8/15/99	10,163,644	10,081,644	82,000	-0-
7-7/8% Note D-1999	11/15/99	10,773,960	10,769,160	4,800	-0-
8-1/2% Note A-2000	2/15/00	10,673,033	10,673,033	-0-	-0-
11-5/8% Bond 2004	11/15/04	8,301,806	3,778,606	4,523,200	73,600
12% Bond 2005	5/15/05	4,260,758	1,907,708	2,353,050	-0-
10-3/4% Bond 2005	8/15/05	9,269,713	8,295,313	974,400	38,000
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	2,660,784	3,344,800	88,400
11-1/4% Bond 2015	2/15/15	12,667,799	2,345,399	10,322,400	35,200
10-5/8% Bond 2015	8/15/15	7,149,916	1,863,516	5,286,400	97,920
9-7/8% Bond 2015	11/15/15	6,899,859	2,328,659	4,571,200	48,000
9-1/4% Bond 2016	2/15/16	7,266,854	6,202,854	1,064,000	649,600
7-1/4% Bond 2016	5/15/16	18,823,551	16,732,351	2,091,200	119,200
7-1/2% Bond 2016	11/15/16	18,864,448	10,662,208	8,202,240	226,480
8-3/4% Bond 2017	5/15/17	18,194,169	7,294,969	10,899,200	108,640
8-7/8% Bond 2017	8/15/17	14,016,858	9,493,658	4,523,200	212,800
9-1/8% Bond 2018	5/15/18	8,708,639	3,982,239	4,726,400	-0-
9% Bond 2018	11/15/18	9,032,870	2,050,870	6,982,000	56,800
8-7/8% Bond 2019	2/15/19	19,250,793	7,533,993	11,716,800	361,600
8-1/8% Bond 2019	8/15/19	20,213,832	14,101,192	6,112,640	816,320
8-1/2% Bond 2020	2/15/20	10,228,868	8,335,668	1,893,200	-0-
Total		408,865,583	312,650,853	96,214,730	2,948,560

[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

FOR IMMEDIATE RELEASE
April 5, 1990

CONTACT: Cheryl Crispen
566-8773

Statement by
Nicholas F. Brady
Secretary of the Treasury

We are pleased with the positive movement that has taken place to date in the Structural Impediments Initiative talks. The Interim Report reflects substantial progress. We welcome the commitment by the Government of Japan to tackle the structural impediments in their economy and we have committed to address our own.

We must continue our efforts to eliminate structural impediments in both our economies and we look forward to more progress in the coming months as we work toward the final report.

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NB-757

April 5, 1990

STRUCTURAL IMPEDIMENTS INITIATIVE (SII)

Key Elements of SII Interim Report

In accordance with the agreement reached between President Bush and then Japanese Prime Minister Uno when they launched the Structural Impediments Initiative (SII) in July 1989, agreement was reached during talks on April 2-5 on an SII Interim Report.

For the purpose of this interim assessment, substantial progress was made on the structural impediments identified in the Japanese economy and in the US economy.

Many of the measures in the interim report should contribute to the goals of opening markets, reducing trade and current account imbalances, and promoting consumer interests. However, additional progress is needed in subsequent SII talks to develop the plans and actions more fully in some areas. The effectiveness of the measures and commitments will depend upon achieving greater specificity in the commitments and, ultimately, on the actual implementation of measures to reduce or eliminate the structural impediments.

Attached is a summary list of the policy commitments made by the Japanese and US Governments, as contained in the Interim Report.

Key Elements of SII Report - Japanese Commitments

During the Structural Impediments Initiative Talks, the Japanese Government committed itself to:

I. Saving and Investment Patterns

-- Increase substantially investment in infrastructure in order to reduce the shortage of investment relative to GNP and help to reduce Japan's current account surplus;

-- Start immediately on the formulation of a new 10-year comprehensive plan of public investment to achieve this increase;

-- Specify the aggregate expenditures in this new comprehensive investment plan in the final report;

-- Prepare on a fast track basis eight new larger, long-term sectoral plans in key infrastructure areas, such as housing, airports and port facilities, parks, and sewers and provide positive and specific targets for these plans in the final report.

II. Land Use

-- Conduct a comprehensive review of land taxation on the basis of such principles as equity, neutrality, and simplicity, and submit reform legislation to the Diet by end-FY1990. This will include review of taxation of certain agricultural land, with a view to addressing the exemption (deferment) system for the property and inheritance taxes;

-- Rationalize assessments for the inheritance tax, bringing assessments closer to market value;

-- Launch a new larger, long-term plan for investment in housing;

-- Review zoning designations and expand special Urban Promotion Areas (UPA's) to accommodate growing housing demands.

-- Deregulate various land use policies, including zoning limits on building heights and housing density.

III. Distribution

-- Adopt a goal of "24 hour" customs clearance;

-- Improve infrastructure for imports, including airports, harbors and roads;

-- Ease restrictions in the distribution area, e.g., liquor licensing, trucking, premium offers and general pharmaceutical goods;

-- Substantially liberalize the Large Scale Retail Store Law, including shortening the approval period to 18 months, falling to 12 months within one year, and increasing the transparency of the approval process, with emphasis on consumers rather than competitors;

-- Strengthen antitrust enforcement against anticompetitive practices in the distribution sector.

IV. Exclusionary Business Practice

-- Make enforcement of the Antimonopoly Act more vigorous, including amending the Act to make penalties effective and making penalties public so that violators do not escape public notice;

-- Make private remedies for violations of the Act more effective;

-- Make "administrative guidance" pro-competitive and more public and consumer-oriented;

-- Issue guidelines to ensure that business practices in the distribution area and among keiretsu firms do not hinder fair competition;

-- Reduce the average time required for the examination of patents to international levels within five years;

-- Review all industry "fair competition codes" to remove anticompetitive effects of restrictions on the use of premiums with a priority on those that affect foreign trade or investment;

-- Encourage transparent, non-discriminatory procurement by private Japanese companies with respect to foreign companies and goods.

V. Keiretsu Relationships

-- Make keiretsu more open and transparent;

-- Restrict cross-shareholding or require divestiture of shares where cross-shareholding among keiretsu firms is found to lead to anticompetitive practices;

-- Strengthen enforcement of the Antimonopoly Act and Fair Trade Commission monitoring of transactions within keiretsu groups;

-- Examine enhancement of financial disclosure requirements with a specific plan to enhance disclosure of related party transactions and report specific conclusions due by final report;

-- Conduct regular Japan Fair Trade Commission analyses of various aspects of keiretsu groups, with a special emphasis on the role of trading companies.

-- Liberalize Japan's policies on foreign direct investment, including amending the Foreign Exchange and Foreign Trade Control Law to:

  o relax or abolish the prior notification requirement for foreign direct investment and importation of technology into Japan; and

  o limit the broad authority of the Government of Japan to block foreign direct investment and the importation of technology on broad economic grounds.

VI. Pricing Mechanism

-- Establish a Government-LDP Joint Headquarters for Adjustment of Price Differentials which is implementing a six-point program, with 52 specific measures to redress unwarranted price differences. Information will be provided to Japanese consumers on price differences. Examples of actions to be taken relevant to unreasonable price differentials are:

  o Deregulation of the distribution system, including addressing the problems of the Large Scale Retail Store Law, and strengthening of antimonopoly enforcement;

- o Increased infrastructure spending relative to the size of the Japanese economy, emphasizing distribution and import systems;

- o Fostering greater availability of land, particularly in metropolitan areas;

- o Encouragement of open procurement policies in the public and private sectors.

Instruct government agencies to obtain information on price differentials through price surveys, and promote comprehensive policy measures -- including the full range of deregulation and pro-competitive measures covered by the other five SII areas -- in order to reduce unreasonable price differentials and enhance consumer welfare through unfettered competition.

Key Elements of SII Report-U.S. Commitments

Below is a list of the principal commitments made by the U.S. Government during the Structural Impediments Initiative (SII) talks.

I. Savings and Investment Patterns

A. Federal Budget Deficit

- The Administration's top priority is to eliminate the Federal budget deficit by 1993 and to reduce government indebtedness. The deficit is being reduced within the context of the GRH process and the Social Security Integrity and Debt Reduction Fund.

- Deficit reduction will be achieved through spending restraint and economic growth.

- The Administration has made several proposals which would facilitate deficit reduction, including: a second sequester; the requirement of a supermajority vote to cancel savings from sequestration; and support for enhanced rescission authority.

B. Low Private Saving Rates

The Administration has proposed several initiatives to stimulate private saving and investment, including:

- Introduction of Family Savings Accounts
- Enhancement of Existing IRAs
- Lower the Tax Rate on Capital Gains to Promote Long-term Investment.

II. Corporation Investment Activities and Supply Capacity: Improvement of U.S. Competitiveness

A. Anti-Trust Reform

The Administration supports legislation that would reduce uncertainty about antitrust law for production joint-ventures that enhance competition, while retaining appropriate safeguards for consumers.

B. Product Liability Reform

The President has approved the Council of Competitiveness' recommendations to support strongly legislation which would contribute to uniformity of product liability laws among the States and limit damage awards.

C. **Policy Toward Foreign Direct Investment**
The Administration reaffirms its open foreign investment policy and its commitment to resist attempts to hinder the free international flows of investment capital.

III. Corporate Behavior

- The Administration supports policies such as reduction of the tax on capital gains, savings incentives, and budget deficit reduction that would lower the cost of capital for U.S. corporations and, thus, encourage greater investment.

- The Department of Treasury is studying how the relationship between managers and institutional investors affects long-term competitiveness.

IV. Government Regulation

A. **Export Deregulation**
The U.S. and its allies on the Coordinating Committee for Multilateral Export Controls (COCOM) have agreed to streamline export controls. The U.S. is reviewing and will consider changing its export control scheme to allow exports of strategic products and technology by countries such as Japan which impose strict export control on those items without U.S. re-export license, irrespective of their destination.

B. **Energy Exports**
The U.S. has made significant progress in eliminating many energy trade barriers, including controls on exports of refined products, Cook Inlet crude oil, and certain Alaskan natural gas products.

C. **Import Liberalization**
The U.S. is gradually phasing out voluntary restraint agreements (VRA) on steel. VRAs on machine tools are due to expire on December 31, 1990.

V. Research and Development

- The Administration in its FY 1991 budget proposed a number of initiatives to advance U.S. research and development by both the public and private sectors, including the proposal to make permanent the R&E tax credit.

- A new position of Undersecretary for Technology has been established in the Department of Commerce.

- The Department of Commerce has issued an updated "Metric Conversion Policy for Federal Agencies" which should further encourage private sector use of the metric system.

VI. Export Promotion

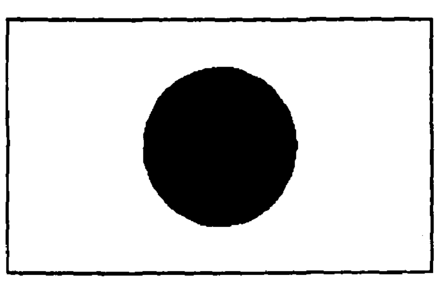
- The Department of Commerce has developed a special export program aimed specifically at increasing U.S. exports to Japan. Commerce is also expanding export promotion activities to other countries.

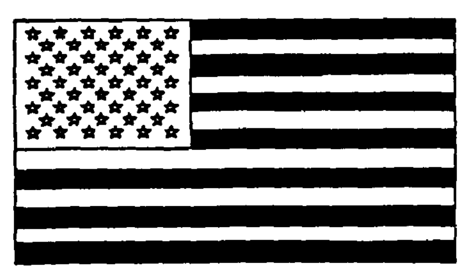
VII. Workforce Education and Training

- The President and the Nation's Governors recently agreed on national educational goals that stress excellence in education and scholastic achievement.
- The Labor Department has initiated a seven-point action plan to improve the quality of the workforce.

JOINT PRESS RELEASE

INTERIM REPORT AND ASSESSMENT
of the
U.S. - JAPAN WORKING GROUP
on the
STRUCTURAL IMPEDIMENTS INITIATIVE





April 5, 1990

Joint Press Release

The U.S.-Japan Working Group on the Structural Impediments Initiative (SII) reaffirms its continuing commitment to identify and solve structural problems in both countries which stand as impediments to trade and to balance of payments adjustment. In that regard, the Working Group provides the attached interim report on the Structural Impediments Initiative.

Since the U.S. and Japanese Heads of State agreed to launch the Structural Impediments Initiative in July, 1989, the SII Working Group has studied and identified structural problems in both countries that impede trade and balance of payments adjustment. The structural problems which were identified by the Government of Japan in the U.S. economy were in the following areas: U.S. Savings and Investment Patterns, Corporate Investment Activities and Supply Capacity, Corporate Behavior, Government Regulations, Research and Development, Export Promotion and Workforce Training and Education. The structural problems identified by the U.S. Government in the Japanese economy were in the following areas: Japanese Savings and Investment Patterns, Land Use, Distribution System, Exclusionary Business Practices, Keiretsu Relationships and Pricing Mechanisms.

Plenary meetings of the SII Working Group were held in September and November, 1989, and February 1990. In September and November, the SII Working Group identified and discussed specific structural impediments. In February, the SII Working Group exchanged productive ideas for possible policy changes which would accelerate the adjustment process and contribute to the reduction of trade and current account imbalances, open markets, and improvement of competitiveness. Both the U.S. and Japanese Governments have already taken steps, some of which are identified below, as an indication of their commitment to the SII process and to solving the problems that have been identified. Both governments believe that the interim report represents substantial progress to date and is a product of determined, earnest efforts to achieve structural improvement in both countries. Both governments agreed that further progress will be required in order to address structural problems before the final report. Matters concerning implementation and the follow-up phase of the report will also be dealt with by the time of the final report.

U.S. - JAPAN STRUCTURAL IMPEDIMENTS INITIATIVE

INTERIM REPORT BY THE U.S. DELEGATION

APRIL 5, 1990

Structural Impediments in the U.S. Economy

The Government of Japan has identified several conditions in the U.S. economy which may impede balance of payments adjustment and long-term competitiveness and has offered helpful suggestions to remedy these conditions. Below is a review of U.S. initiatives that address the issues raised by the Government of Japan.

I. Saving and Investment Patterns

Raising U.S. saving rates would help to reduce the nation's current account imbalance. Increasing the pool of domestic saving would contribute to lower U.S. interest rates, thereby facilitating domestic capital formation, productivity and economic growth. The Administration is taking action to promote saving by both the public and private sectors.

Public Sector: Deficit Reduction and Government Saving

The top priority is to eliminate the Federal budget deficit by 1993 and to reduce government debt. The deficit is being reduced within the context of the Gramm-Rudman-Hollings (GRH) process.

Federal Budget Deficit

- o Substantial progress has already been made on the Federal budget deficit.
  - -- It has been reduced from 6.3% of GNP in FY 1983 to 2.9% in FY 1989.
  - -- In the budget plans submitted by the President, the deficit is expected to fall from 2.3% of GNP in FY 1990 to 1.1% in FY 1991.
- o Deficit reduction will be achieved through spending restraint and continued growth.

- Following the procedures in the GRH law, the President ordered a sequester in FY 1990 and demonstrated his fiscal resolve by announcing his willingness to operate with the sequester for the entire fiscal year, if necessary and by not canceling the budget savings achieved through the sequester. This reversed past practice and set a strong precedent for future fiscal discipline.

The Budget Process

- The President's FY 1991 budget calls for a stronger Gramm-Rudman-Hollings (GRH) law, one which would close loop-holes and strengthen the process of deficit reduction. For example:

  - the President's budget proposes an automatic second sequester that would be imposed if targets are not met later in the budget period;

  - the technical feasibility of using revised economic assumptions for the purpose of calculating the budget proposals for the second sequester is being studied;

  - a requirement for a super-majority vote to cancel the savings from sequestration once achieved; and

  - automatic off-set rules for supplemental funding requests.

- The President strongly supports a form of enhanced rescission authority called legislative line-item veto proposed in late 1989 by a group of Senators. In the absence of a line-item veto amendment to the Constitution, enhanced rescission would give the President a realistic opportunity to seek to eliminate from appropriations bills special interest items that he deems unworthy, while offering Congress full protection through a vote on each rescission.

Social Security Surpluses

- o The Administration has proposed in the FY 1991 budget a Social Security Integrity and Debt Reduction Fund (SSIDRF) to ensure that anticipated surpluses in the Social Security program are not spent for other purposes. Instead, they would be applied to reduce the Federal government's outstanding debt.

- o By retiring government debt and, in effect, balancing the non-Social Security budget, anticipated surpluses would be injected into the Nation's capital markets. Thus, the Federal government would become a net saver -- a source of funds for enhanced growth.

  - -- Once the SSIDRF is fully phased in, the Federal government would pay from the general operating budget into the SSIDRF each year an amount equal to the projected surplus on the Social Security trust funds during that year. The payments into the fund could be used only to reduce outstanding Federal debt held by the public. These payments would be counted as a standard outlay in the budget.

  - -- To preclude Federal borrowing as a method to finance these contributions, the current GRH law would be amended to require a balanced budget in 1994 and thereafter. Payments into the SSIDRF would be exempt from the sequester in the GRH law.

  - -- In the near term, saving allocated to the SSIDRF would rise quickly, from 0.3% of GNP in 1993 to 1.5% of GNP in 1995.

  - -- The Director of the Office of Management and Budget, testified before the Senate Finance Committee on February 8, 1990 to explain the Administration's SSIDRF proposal.

Revenue Developments

- o Federal revenues have grown steadily during the current, 8-year economic expansion. In each year since the expansion began, Federal revenues have exceeded the average of 18% of GNP experienced during the 1950-1979 period. Revenues are projected to increase by 9% in FY 1991 and to total 19.9% of GNP.

- o The projected increase in revenues in FY 1991, comes largely from a projected increase in incomes, but additional steps are being proposed which would affect revenues. For example, the President's budget for FY 1991 proposes:

  - -- Extending social security retirement coverage to those state and local employees not currently participating in public employee retirement programs. This measure would provide coverage for approximately 4 million state and local employees. This extension of coverage is expected to yield revenues of $2.1 billion in FY 1991, and more in future years.

  - -- Providing coverage for all state and local government employees under the Medicare Hospital Insurance program. This proposed extension, to take effect on October 1, 1990, would yield an anticipated $1.7 billion in FY 1991.

  - -- Reducing tax rate on capital gains will increase Federal revenues (see Lower Capital Gains Tax Rates, below).

  - -- Raising a variety of aviation user fees. The air passenger tax would be increased to 10%, the air freight tax to 6.25%, the non-commercial aviation gasoline tax to 15 cents per gallon, and the non-commercial jet fuel tax to 17.5 cents per gallon. It is anticipated that these proposals would raise $500 million for the Airport and Airway Trust Fund in FY 1991, and more in future years.

  - -- Making permanent the 3% communications excise tax. If enacted, this extension would yield an estimated $1.6 billion in FY 1991, and more in future years.

- In addition to these revenue measures, the IRS has identified several management reforms and opportunities for increased enforcement that are expected to yield more revenue. Some of these are listed below.

  -- Resources will be reallocated to accelerate the examination process for tax shelter cases, making it possible to close such cases more quickly. Significant cases will be prioritized and given expeditious handling. It is estimated that this reallocation of resources will yield an additional $349 million in FY 1991.

  -- Settlement authority for appeals will be delegated to the examiners of the Coordinated Examination Program on the basis of historical appeals settlement precedents. The result will be an acceleration of the receipt of taxes, penalties, and interest. The effect on FY 1991 revenues is estimated to be $547 million.

  -- Resources will be shifted to conduct actuarial examinations of small retirement plans, increasing the number of examinations in this area from the previously planned 700 to 18,000. The revenue effect begins in FY 1990, with additional collections of $64 million. An additional $602 million is anticipated for FY 1991.

  -- Resources will be reallocated from examinations staff to appeals staff in order to help close targeted large cases in the appeals process. The IRS plans to target between 30 and 50 cases in FY 1991, yielding collections of approximately $1 billion in that year.

Private Sector: Incentives to Save and Invest

Though still below historical levels, the personal saving rate in the U.S. seems to be improving. It reached 5.4% in 1989, up from a trough of 3.2% in 1987, and it now appears to be moving higher. The Administration's Working Group on Savings and the Cost of Capital considered numerous options to stimulate personal savings. As a result of this review and analysis, the Administration has proposed to Congress several initiatives designed to stimulate private saving and investment further.

Family Savings Accounts

- The Administration has proposed the introduction of Family Savings Accounts (FSAs). FSAs would stimulate private saving by allowing tax-free earnings on contributions to these accounts.

  - Individuals would be able to make non-deductible contributions of up to $2500 per year and couples up to $5000 per year, provided the taxpayer's adjusted gross income is less than $60,000 per year (less than $100,000 for heads of households, and less than $120,000 for married couples filing joint returns).

  - Contributions to FSAs would be allowed in addition to contributions to qualified pension plans, IRAs, 401(k) plans, and other tax-favored forms of saving.

  - Earnings on contributions retained in the FSA for at least seven years would be eligible for full tax exemption upon withdrawal. Withdrawals of earnings allocable to contributions retained in the FSA for less than three years would be subject to both a 10% excise tax penalty and to income tax. Withdrawals of earnings allocable to contributions retained in the FSA for three to seven years would be subject only to income tax.

- On March 27, 1990, the Assistant Secretaries of the Treasury for Tax Policy and Economic Policy testified before the Senate Finance Committee to explain the Administration's proposal to establish Family Savings Accounts.

Individual Retirement Accounts

- o The Administration has proposed improving existing Individual Retirement Accounts (IRAs) by making them more attractive to savers.

  - -- Withdrawals of up to $10,000 per taxpayer would be allowed for eligible home purchases.

  - -- The 10 percent excise tax on early withdrawals would be waived for eligible taxpayers.

  - -- Eligibility for penalty-free withdrawals would be limited to individuals who did not own a home in the last three years and are purchasing or constructing a principal residence that costs no more than 110% of the median home price in the area where the residence is located.

Lower Capital Gains Tax Rates

- o The Administration has proposed lowering the effective tax rates on capital gains. The proposal would induce more saving and investment by raising after-tax rates of return, especially for long-term investment.

  - -- When fully effective in 1992, the exclusion on capital gains would be 30% for assets held 3 years or more, 20% for assets held at least 2 years (but less than 3 years), and 10% for assets held at least one year (but less than 2 years).

  - -- The holding period requirements are phased in. For dispositions of assets in 1990, the 30 percent exclusion applies to all assets held at least 1 year. For dispositions in 1991, assets held 2 years receive the 30 percent exclusion, and assets held 1 year receive a 20 percent exclusion.

  - -- The proposal would apply to all individual capital assets except collectibles (eg., works of art, antiques, gems, etc.).

  - -- Excluded capital gains are included in the alternative minimum tax.

  - -- As a result of these exclusions, the effective tax rates applicable to capital gains on qualified assets by a taxpayer in the 28 percent tax bracket would be, respectively, 19.6 percent, 22.4 percent, and 25.2 percent.

- On March 28, 1990, the Chairman of the President's Council of Economic Advisers and the Assistant Secretary of the Treasury for Tax Policy testified before the Senate Finance Committee to explain the Administration's proposal to reduce tax rates on capital gains.

Other Incentives to Save and Invest

- In addition to the saving initiatives described above, eligible U.S. workers can still participate in 401(k) savings plans. These plans, which are similar to the Japanese "ZAIKEI", involve the deduction of a predefined proportion of an employee's pay. These funds are deposited into a savings or investment account. The employee is not taxed on these funds until they are withdrawn. A penalty is assessed for withdrawals prior to retirement.

- The Secretary of the Treasury has testified against the double taxation of dividends. The Department of the Treasury is currently studying this issue. Best efforts will be made to complete this study by the time of the final SII report. No legislation is expected in 1990.

II. Corporation Investment Activities and Supply Capacity: Improvement of U.S. Competitiveness

Investment in U.S.-based production capacity would enhance the competitiveness of exports from the United States. Changes in certain U.S. laws and regulations, as well as the continued openness of the United States to foreign investment, will facilitate productive investment in the United States.

Anti-trust Reform

- The Administration supports legislation which would reduce uncertainty about the treatment of production joint-ventures under the anti-trust laws. The legislation would promote production joint-ventures that enhance competition, while retaining appropriate safeguards for consumers.

- When an anti-trust lawsuit is filed against a production joint-venture, the courts would be required to take into account the competitive benefits of the venture as well as its costs.

- For production joint-ventures that are notified to the government, anti-trust liability would be limited to actual damages rather than the current treble damage liability.

- All stages -- from the beginning stage of joint R&D activities to the final stage of joint production -- would be covered by either the proposed legislation or the 1984 National Cooperative Research Act. U.S. Government guidelines, either those in effect or those to be issued, will clarify the treatment of joint research and production activities under the Antitrust Laws.

Product Liability Reform

- o The Council on Competitiveness, chaired by the Vice President, has endorsed legislation that would reform product liability laws. This legislation would contribute to uniformity in all 50 states and limit damage awards.

  - -- It is designed to restore basic principles of fairness: adequate compensation for accident victims; fault-based liability; and dispute resolution.

  - -- The result would be to cut down on excessive litigation and the cost of doing business in the U.S. It would also lessen disincentives to develop new products and other innovations.

- o The President has approved the Council of Competitiveness' recommendation to make product liability reform a top priority.

- o The Administration is also working with groups from all sectors of the U.S. economy to reform U.S. product liability laws. The Administration recognizes that reform is necessary to remove burdens on innovation and to improve U.S. competitiveness, while still ensuring protection for injured parties.

Policy Toward Foreign Direct Investment

- o United States policy toward foreign direct investment has long recognized that a free flow of investment capital across borders benefits both host and investor countries. The United States generally provides foreign investors non-discriminatory treatment under U.S. laws and regulations. It is in the interests of U.S. consumers, workers, and investors to maintain this open policy.

- o In his Economic Report transmitted to the Congress in February 1990, President Bush stated:

  > To serve the interests of all Americans, we must open markets here and abroad, not close them. I will strongly resist any attempts to hinder the free international flows of investment capital, which have benefitted workers and consumers here and abroad.

- o Consideration is being given by the Administration to the issuance of a more detailed policy statement reaffirming the Administration's strong commitment to an open direct investment policy.

- o For over 200 years, the United States has welcomed foreign investment and, at the same time, protected vital national security concerns. The U.S. restricts foreign investment only to protect the national security. The Exon-Florio provision of the Omnibus Trade Act, which authorizes the President to prohibit foreign acquisitions that threaten to impair the national security, is consistent with this long-standing policy.

- o The President delegated his authority to review foreign acquisitions that might impair the national security to the Committee on Foreign Investment in the United States (CFIUS). As of April 1990, CFIUS reviewed over 300 transactions, formally investigated seven, and referred four to the President for a decision. In only one case has the President prohibited a transaction pursuant to Exon-Florio.

- o In line with the Administration's open investment policy and the provision of the law, the Exon-Florio authority will be used only when no other measures are adequate or appropriate to protect the national security.

- o The Government of Japan has raised a question regarding the U.S. position on H.R. 5 (the Bryant Bill). This bill would require registration and disclosure of foreign direct investment in the United States. The Administration strongly opposes this bill.

Tax Treatment of Foreign Investors

- o The U.S. and Japan have entered into a tax treaty that provides for non-discriminatory treatment of business enterprises of the two countries.

Other Measures to Build Supply Capacity

- o In order to reduce U.S. reliance on oil imports, the President's FY 1991 budget includes proposals for tax credits to encourage the discovery of new oil and gas fields and the reclamation of old ones.

- o Capital investment in productive capacity will also be encouraged by the Administration's proposals that would lower the cost of capital.

III. Corporate Behavior

The productivity of U.S. workers and the competitiveness of U.S. corporations are affected by the decisions of corporate managers. These managers, in turn, are influenced by the behavior of company shareholders. The Administration is pursuing policies which will encourage managers to take decisions that will benefit their companies in the long-term.

- Long-term investment (as well as short-term) might be discouraged by the high cost of capital in the United States, and by a tax system which penalizes certain forms of saving and investment.

- The Bush Administration is pursuing policies to lower the cost of capital. Such policies include lowering the tax rate on capital gains, promoting private saving, and eliminating Federal dis-saving. These policies are intended to lower the cost of capital for American companies, thereby encouraging long-term investment and long-term planning by management.

- The Administration's Working Group on Savings and the Cost of Capital continues to review proposals that could result in a lower cost of capital for U.S. companies.

- In addition to efforts to reduce the cost of capital, the Administration continues to seek ways to foster a long-term investment horizon on the part of corporate managers.

    - The Treasury is conducting a study of how the relationship between managers and institutional investors of U.S. corporations affects long-term competitiveness. The study is expected to be completed by early summer.

    - The Secretary of the Treasury also supports efforts to address regulatory fragmentation in the securities and futures markets. This is intended to promote innovation and increase investor confidence by more effective enforcement and steps to improve the operation of markets (including, among others: harmonization of margins; coordinated circuit-breakers; and improved clearance and settlement procedures).

- As part of its review of factors that affect corporate competitiveness, the Treasury is examining how compensation packages influence the time horizons of executives and of other employees.

IV. Government Regulation

Certain government regulations discourage international trade and competition. Progress is being made to deregulate controls on both exports and imports.

Export Deregulation

- In view of the changing strategic situation, the U.S. and its allies on the Coordinating Committee for Multilateral Export Controls (COCOM) have agreed to streamline export controls. COCOM is discussing the streamlining of licensing systems for machine tools, telecommunications and computers as a first step to reduce the number of controlled goods.

- COCOM has also agreed to guidelines for member countries to eliminate most licensing requirements for trade among COCOM member countries. The United States plans to implement its new system in the near future.

- In July 1989, the U.S. removed all controls on the re-export of dual use goods and technologies (except supercomputers and electronic listening devices) into and among COCOM member countries (and Finland and Switzerland), as provided in Section 774.2(k) of the Export Administration Regulations.

- New export administration regulations issued in October 1989 eliminated the requirement for U.S. re-export authorization for exported U.S. goods that are incorporated as parts and components and comprise less than up to 25 percent of the end product. This liberalization eliminated re-export controls on large numbers of telecommunications, electronics and instrumentation equipment imported into European nations and Japan from the U.S.

- The U.S. Government is reviewing and will consider changing its export control scheme to allow exports of strategic products and technology by those countries such as Japan which impose strict export control on those items without U.S. re-export license irrespective of their destination.

- o The U.S. has significantly reduced trade impediments resulting from short supply export controls. The Administration has revised U.S. short supply policy with regard to agricultural commodities. The Administration has proposed in the Uruguay Round that GATT-contracting parties should be prohibited from restricting exports of agricultural food products for reasons of short supply. The United States is working with its major trading partners, including Japan, to gain support for elimination of GATT Article XI 2.(a).

Energy Exports

- o The U.S. has made significant progress in eliminating many energy trade barriers.

  - -- In 1985, controls on exports of refined petroleum products were eliminated as part of the renewal of the Export Administration Act of 1979.

  - -- Exports of crude oil produced in the state waters of Alaska's Cook Inlet were allowed in 1986, pursuant to the Energy Policy and Conservation Act (EPCA) of 1976.

  - -- Exports of crude oil to Canada were substantially decontrolled in 1985, as authorized by both the EPCA and the Mineral Leasing Act.

  - -- From 1988 to 1990, the Administration removed legal and regulatory barriers to the development of a project to export Alaskan LNG to Pacific rim energy markets, as authorized by the Natural Gas Policy Act.

  - -- The Commerce Department recently completed a study for Congress (as required by Section 2424 of the Omnibus Trade and Competitiveness Act of 1988) on the benefits and costs of exporting California heavy crude oil and recommended a partial relaxation of the ban on exports. This matter is pending; the Commerce Department will offer testimony before the House Foreign Affairs Committee on Thursday, April 5, 1990 with respect to this issue.

Import Liberalization

- On July 25, 1989, President Bush announced the Steel Trade Liberalization Program to phase out the voluntary restraint agreements (VRA) after two and a half years and to negotiate the elimination of subsidies and other trade distorting practices affecting steel. This program reflects his commitment to a meaningful international consensus and to freer and fairer trade in steel on a global basis.

  -- As part of this extension and in keeping with overall Administration policy regarding adjustment measures, major U.S. steel companies must make substantial commitments to reinvestment in modernization for enforcement authority to continue. In addition, each of the major steel companies is required to commit at least one percent of net cash flow for worker retraining.

  -- Since the inception of VRAs on steel in 1984, the major U.S. steel producers have spent $8.0 billion on steel-related expenditures, including plant and equipment, research and development, worker retraining, and other efforts to adjust and modernize. These companies have modernized their production facilities, eliminated excess capacity, and drastically reduced their production costs.

- VRAs on machine tools, which began on January 1, 1987, are due to expire on December 31, 1991.

  -- As with steel, and reflecting Administration policy on adjustment, there is a domestic action plan in place which is intended to facilitate the revitalization of the U.S. machine tool industry.

  -- Despite thin profits, the machine tool industry has increased expenditures on research and development and product engineering and design.

  -- Combined spending on research and new product development totalled $143 million in 1988 (the most recent data available), or 4.2% of gross sales. By comparison, profits were only 2.1% of sales in 1988.

  -- During the last two years, many machine tool companies have introduced major new models of machining centers, milling machines, lathes and punching machines.

V. Research and Development

A steady stream of innovative ideas and technological development will enable the United States to remain a formidable competitor in international markets. To maintain this technological flow, the United States must strengthen its research and development efforts. The Administration has proposed several initiatives to advance U.S. research and development by both the public and private sectors.

Federally-supported Research and Development

- The President's FY 1991 budget calls for a $4.5 billion increase in Federal funding for research and development, to a record high of $71 billion. Support for civilian R&D will increase by 12% and defense-related R&D will increase by 4%.

- A 22% proposed increase for Federal civil space activities includes a 72% increase for the development of the commercial potential of space, a 47% increase for manned exploration, a 36% increase for space station development, and a 22% increase for scientific exploration.

- Part of the $4.5 billion expansion in Federal R&D spending is devoted to a 14% funding increase for the National Science Foundation. The Administration remains committed to doubling the NSF budget by 1993.

- The President demonstrated his commitment to promoting technological development in the United States by establishing the position of Undersecretary for Technology at the Commerce Department. The President's nominee for this position testified before the Senate Commerce, Science and Transportation Committee on March 26, 1990, and is now awaiting confirmation by the Senate.

Private Research and Development

- o The Omnibus Budget Reconciliation Act of 1989 modified the Research and Experimentation (R&E) credit and extended it for the first nine months of 1990. The R&E credit is 20% of qualified research expenses that exceed a company's base amount (the product of the company's average gross receipts during the previous four years and the ratio of the company's 1984-88 R&E to its 1984-88 gross sales).

- o The President's FY 1991 budget would make permanent the R&E credit, and would revise R&E expense allocation rules. These changes would encourage firms to establish and expand research facilities by assuring them that tax incentives will still be available when research is carried out.

- o Private research and development would also be bolstered by lowering the cost of capital and reducing regulatory and legal barriers to investment (see policy initiatives described above).

Adoption of the Metric System

- o The Commerce Department has revised and issued for public comment an updated "Metric Conversion Policy for Federal Agencies" under the Code of Federal Regulations. The update, to be issued in final form by June 1990, includes stronger guidance for agency metric implementation, suggestions for agency metric organization and requirements for agencies to report metric progress to Congress.

- o Commerce officials continue to meet with standards groups, trade associations and business advisory groups to encourage use of the metric system in the private sector.

- o The Secretary of Commerce wrote to each state governor in December 1988 alerting them to the 1988 Trade Act requirements for Federal agencies to convert to metric in grants, procurement, publications and other business-related activities by the end of FY 1992. He urged them to plan similar initiatives at the state level and to name a senior official to the National Council on State Metrication. Response from the states was encouraging.

- The General Services Administration (the principal buyer for the U.S. Government) obtained public comment on their planning for metric conversion and will publish their plan in the Federal Register this week. The plan calls for Federal procurement to be conducted in a manner that will stimulate U.S. industry to rapidly develop greater metric capability.

- The House Committee on Science, Space and Technology, Subcommittee on Science Research and Technology, will hold hearings on Federal agency compliance with the metric provisions of the 1988 Trade Act on April 24, 1990. These hearings, in reaction to a recently completed GAO study on the matter, demonstrate the urgency with which metrication is viewed by the Congress. Senior officials of the Departments of Commerce, Defense, Energy, and Education, the General Services Administration and NASA are scheduled to testify.

- At Federal agency urging, most U.S. technical standards organizations are revising their policy on metric use to develop more aggressively the metric standards needed by U.S. business and industry in their transition to metric.

- The Department of Commerce continues to study ways for the private sector to significantly expand and increase the use of the metric system.

VI. Export Promotion

The President has clearly stated that trade and the competitiveness of U.S. business are high priorities of his Administration. To this end, the Administration has been working hard to make U.S. export promotion efforts more effective.

- The FY 1991 budget proposed $159 million for the Commerce Department's export promotion efforts, an increase of $10 million over 1990.

- The Department of Commerce has developed a special export program aimed specifically at increasing U.S. exports to Japan.

  - This program focuses on long-term commitments by U.S. firms to the Japanese market and capturing a larger share of Japan's public infrastructure and overseas development projects.

  - It also provides services tailored to the needs of small and medium-sized U.S. exporters seeking to enter the Japanese market.

  - Successful implementation and operation of this program will provide a model for the development of trade promotion plans for other countries and regions.

- The Department of Commerce is expanding its export promotion activities in several geographical areas:

  - Commerce has developed a 3-tiered program to help U.S. companies respond to the opportunities presented by the integration of the European Community (EC) into a unified market in 1992.

  - For Eastern Europe, the Commerce Department has been active in promoting U.S. business opportunities through a number of trade missions and, most recently, by establishing the Eastern Europe Business Information Center.

  - The Commerce Department developed an education program to inform the U.S. business community, particularly small businesses, about the new trade and investment opportunities created by the U.S.-Canada Free Trade Agreement.

VII. Workforce Education and Training

Improving the education and training of the U.S. workforce would heighten America's competitiveness. The Administration has set ambitious goals to improve the quality of education and training in the United States.

Workforce Education

- o The President and the Nation's governors recently agreed on a package of six national educational goals for achieving scholastic excellence and providing U.S. students with skills to compete in a rapidly changing world.

- o These goals, to be reached by the year 2000, include: a high school graduation rate of 90% or more; preeminence in the world in math and science scholastic achievement; full adult literacy; ensuring that all schools are free of drugs and violence; and (in grades four, eight and twelve) achieving competency in key subject areas such as English and mathematics.

- o The President's FY 1991 budget includes a $500 million increase (36%) for programs which prepare children to learn, provide remedial assistance to the disadvantaged, and stress math and science education.

- o The Educational Excellence Act of 1989 contains programs to reinvigorate the U.S. educational system. The Administration's bill was approved by the Senate on February 7, 1990. The President's FY 1991 budget provides $401 million to support programs proposed in the Act.

- o The Administration has proposed, as part of the Educational Excellence Act of 1989, an alternative teacher certification process. Under the Administration's plan, gifted professionals would be certified to teach elementary and secondary school, even if they had not followed the traditional course for teacher certification.

Workforce Training

- The programs provided for under the Job Training Partnership Act (JTPA) are considered highly effective, and the President's FY 1991 budget proposes spending approximately $4 billion to fund them.

- The Administration proposed amendments to the JTPA in 1989 which are intended to revise eligibility criteria to ensure that the program targets the most disadvantaged; provide more intensive and comprehensive services to participants; and improve coordination among Federal, State and local human resource programs. Hearings have been held in both the House and Senate on these amendments. House "mark-up" is scheduled for after Easter. The Administration expects legislative action this Congressional session.

- In addition to the growing commitment of the private sector to workforce education, the Labor Department has initiated a seven-point action plan to improve the quality of the workforce. A series of pilot programs will be launched this spring to expand work-based training.

- The Labor Department has awarded a grant for demonstration projects to the Human Resources Development Institute, the research arm of the AFL-CIO, to upgrade training for current employees in several industries. The unions and the Department of Labor will use the experience gained in these projects in expanding this approach to other industries.

- Another demonstration project is developing methods to support structured work-based training in small firms. Such firms typically lack the necessary expertise and resources for training on their own. The demonstrations will experiment with effective methods for overcoming barriers to training.

- The Secretary of Labor has recently published a booklet, "Work-based Learning: Training America's Workers", as part of the Administration's effort to build a positive perception of, and thereby encourage, work-based training. This booklet proposes a national work-based training board and improvements in the national apprenticeship system. The National Advisory Board on work-based training will provide guidance on expansion of structured work-based training and on development of a voluntary system for accelerating such training.

- The Labor Department is in the process of testing alternative uses of unemployment insurance (UI) funds to accelerate jobless workers' return to work. Three experimental projects are studying the effectiveness of offering UI claimants a cash incentive to obtain a job early in their jobless stage. Two others are designed to help UI recipients set up their own business and provide entrepreneurial training, counselling, and a self-employment allowance.

- Towards the objective of increasing U.S. private investment in human resource development, the Department of Labor will examine options to increase investment in skills training by conducting research and demonstration projects which:

  - study the effectiveness of existing incentives for both employer and employee-financed training;

  - examine incentive policies in other countries, including Japan; and

  - form partnerships with industry groups to promote and implement structured workplace training programs.

- In 1990, the U.S., in cooperation with Japan, will exchange visits of experts and host a symposium on comprehensive human resource development.

JAPAN - U.S. STRUCTURAL IMPEDIMENTS INITIATIVE

INTERIM REPORT BY THE JAPANESE DELEGATION

APRIL 5, 1990

Saving and Investment Patterns

I. Basic Recognition

1. Reduction in the Current Account Surplus

As a result of appropriate policies pursued to sustain solid economic growth led by a strong domestic demand, Japan's current account surplus has been reduced remarkably from 4.5 percent of GNP in FY 1986 to an estimated 2.2 percent in FY 1989, which is less than half the level of FY 1986. This ratio in FY 1990 is projected to be less than 2 percent.

Impressive growth of imports, along with increases in overseas travel expenditures by the Japanese people, reflecting in part an increased emphasis on leisure, has contributed to this positive trend. U.S. exports to Japan have increased faster than U.S. exports to the rest of the world.

To make further progress on the basis of this positive trend, the Government of Japan will continue to undertake economic policies aimed at promoting sustained non-inflationary growth led by domestic demand.

The Government of Japan recognizes the need to continue to reduce its current account surplus and reaffirms its commitment to work actively toward that end. The Government of Japan also recognizes that a reduction of the imbalance between domestic savings and investment is important to that process. This will help further a reduction in the current account surplus.

2. Recognition of the Need for and Importance of Social Overhead Capital Improvement

The Government of Japan recognizes that there remain areas where Japan is still behind other major industrialized countries in terms of the levels of social overhead capital accumulation, though the pace of improvement has been rapid -- partly as Japan was historically a slow starter in this field -- with annual public investment (Ig) four times as large as that of the U.S. measured against the GNP.

Under these circumstances, the Government of Japan will continue to pursue its policies to increase and promote steady accumulation of social overhead capital, based on the keen recognition of the need for and importance of social overhead capital improvement.

This would, through sustained non-inflationary growth of domestic demand, facilitate further reduction in the current account surplus.

II. Measures to be Taken

1. Positive Measures in the FY 1990 Budget

(1) The Government of Japan declared in the "Economic Outlook and Basic Policy Stance of Economic Management for FY 1990," manifest of guiding principles for the budget, that much emphasis should be placed, in compiling the FY 1990 Budget, on the improvement of the social overhead capital, especially those directly related to the quality of life, in order to further substantiate the foundation for a better life of the people.

(2) Based on that principle, the expenditures for public works, at 7,444.7 billion yen, surpasses the historic high level of the previous fiscal year, despite the revenue constraint caused by unsuccessful sales of NTT stocks in the previous fiscal year, and notwithstanding the vigorous expansion of the economy expected in FY 1990 which does not warrant additional stimulus.

Furthermore, the public works expenditure by local governments financed entirely by themselves (in the Local Public Finance Program) as well as the expenditures of the public work executing agencies financed through the FILP (Fiscal Investment and Loan Program) are expected to rise 7 percent, respectively, in FY 1990.

In sum, the investment by the public sector on GNP basis (Ig) would add up to 26.3 trillion yen.

(3) While there are currently fifteen long-term plans for specific categories of social overhead capital designed to improve them in a systematic manner, it is expected that total cumulative expenditures in seven out of eight such plans, which are to expire at the end of FY 1990, will exceed the projected target expenditures as a result of further emphasis placed on social overhead capital in the FY 1990 Budget.

2. Toward Further Improvement

(1) The Government of Japan intends to increase and promote steady accumulation of social overhead capital, from a medium to long term perspective, as the nation heads for an aging society toward the twenty-first century.

For that purpose:

(i) The ministries concerned will expedite preparations, at this early juncture, for formulating new long-term plans on eight categories of social overhead capital -- including housing, sewers, parks, airports and port facilities -- whose current plans are to expire at the end of FY 1990 (i.e., March 1991), in order to indicate positive and specific targets for larger long-term plans for the major areas by the final SII report.

It is envisaged that the current long-term plans for certain other key areas will also be augmented on a scale similar to that for these plans.

(ii) The Government of Japan will start formulating immediately a new comprehensive plan of public investment for the coming ten years. In this plan, real aggregate investment in infrastructure will be increased substantially above current levels for the ten years to boost domestic investment, improve social overhead capital and reduce the shortage of investment relative to savings and to the size of the Japanese economy. This should, along with other measures, facilitate further reduction in the current account surplus.

Toward these ends, the Government of Japan will specify the aggregate amount of expenditures of the plan in the final SII report.

Through these efforts, the accumulation of social overhead capital in Japan will be considerably enhanced and advanced.

(iii) The yearly expenditure for social overhead capital should be decided flexibly considering the prevailing economic and fiscal conditions, paying due attention to avoiding inflation and overheat of the economy as well, given the significant role that the public investment plays as a counter-cyclical measure in Japan.

(2) In allocating the expenditure among various types of social overhead capital, utmost consideration should be given, as much as possible, to those closely linked to the improvement of the quality of life.

(3) The Government of Japan will make effective use of the legislative form of the budget that authorizes contracts incurring treasury liabilities over the succeeding fiscal years, in order to secure maximum efficiency in

executing public investments within the constitutional framework of the single year budget system.

(4) The Government of Japan will make more effective use of the FILP (Fiscal Investment and Loan Program) funds to improve social overhead capital. Such effective use would include financing urban redevelopment projects through the Japan Development Bank. In allocating the FILP funds, utmost consideration should be given, as much as possible, to housing and other projects contributing to enhancement of the quality of life of the people.

(5) The Government of Japan will see to it that overall efficiency be increased in promoting the complex multi-jurisdictional development projects like the Kansai International Airport and the Tokyo Bay Area Development, by ameliorating systems for securing better communication and closer cooperation among the related ministries.

(6) Land Use, Deregulation, etc.

(i) The Government of Japan will give due consideration to effective utilization of publicly held lands in metropolitan areas for urban facilities, urban redevelopment, and public housing projects to ensure smooth implementation of public works. The Government of Japan sees to it that the discharged track yard site in Shiodome should be highly utilized as multi-functional urban space responding to the needs arising from internationalization, and as a regional transportation hub. Related urban infrastructures including subways and roads should be furnished as well.

(ii) The Prime Minister's Office will be central in vigorously promoting utilization of super-subterranean space (about 50 meters below surface or deeper in metropolitan areas) for social overhead capital including urban infrastructures in metropolitan areas and thus securing more effective use of land. Wide-ranging issues--legal, safety, and environmental--need to be addressed carefully in the process.

(iii) More active use of various resources in the private sector, such as financial resources, technologies and know-hows, is important for the improvement of social overhead capital, as seen in such cases as the Kansai

International Airport and the Trans Tokyo Bay Road Project. The Government of Japan will continue to promote further deregulation and to provide various incentives as needed in order to make the best use of these private sector resources in the social overhead capital improvement.

(iv) The Government of Japan will effectively activate the special act which aims at promoting organized development of housing sites and railways in greater metropolitan areas, thereby improving the quality of life of the residents and promoting orderly development of the region.

For example, discussions are being held on the formation of the basic plan, including the appropriate form of managing entities, for a new railway line called the "Joban New Line."

(7) The Government of Japan will sincerely implement the U.S.-Japan Major Projects Arrangements aiming at facilitating the U.S. firms to gain expertise in the Japanese construction market.

3. Encouraging Consumption in the Private Sector

(1) As to curtailing work hours, the Government of Japan will launch a trial, starting this April, of 40 hour weeks for those government employees on shift work schedules, to pave a road to complete 5 day weeks for all government employees, and will encourage curtailing work hours in the private sector.

(2) As to improvement of consumer credit convenience, study on the credit sales industry in the future, including the issue of allowing revolving credit function to the credit cards issued by bank affiliated companies, is now in progress by the Council on Credit Sales, paying due attention to consumer protection, equal footing for competition and maintenance of an orderly credit system. Efforts will be made to reach a conclusion of the Council by the final SII report.

(3) The Government of Japan will welcome business decisions of the financial institutions to lengthen operating hours of their teller machines when they so decide based on their own commercial considerations, while there are no restrictions on the operating hours at present.

Land Policy

I. Basic Recognition

The land problem is one of the most serious domestic problems facing the Government of Japan. The Government of Japan has, as a first step, already enacted the Basic Land Act (*) last December. Recognizing the need such as for the increase of supply of housing and residential land, the Government of Japan will implement a wide range of specific measures as set forth in guidelines such as the Priority List of Land Policies, also announced last December, and as set forth below.

Due to these measures, it is expected that housing and other demand will be boosted, leading to greater import opportunities.

1. Promotion of further supply of housing and residential land in metropolitan areas.
2. Comprehensive review of the land taxation system.
3. Greater utilization of land owned by the central or local governments or other public land.
4. Improvement of infrastructure necessary to facilitate increase in the supply of housing and residential land.
5. Review of the Land Lease Law and the House Lease Law.
6. Review of divisions between Urbanization Promotion Areas and Urbanization Control Areas and promotion of specific deregulation measures.
7. Rationalization of the official assessment of land value.

(*) The Basic Land Act stipulates:

(a) basic principles regarding land such as giving priority to public welfare;

(b) responsibilities of the central and local governments, private enterprises and individuals; and

(c) basic elements concerning land policies.

II. Measures to be Taken

1. The Government of Japan will take the following measures and submit necessary legislation to the Diet by the end of FY 1990.

(1) Improvement of the existing system to enable the formulation of master plans regarding the supply of housing and residential land across two or more prefectures,
(2) Establishment of a new system for identifying and promoting the utilization of, idle land such as unused plant sites.
(3) Improvement of current city planning and other systems in order to facilitate the conversion of agricultural land within urbanization promotion areas to residential land.

Through these measures, substantial increase of the supply of housing and residential land in metropolitan areas would be expected.

2. (1) The Government of Japan will conduct a comprehensive review on the land taxation system on the basis of such basic principles of taxation as equity, neutrality and simplicity, and in accordance with the principles expressed by the Basic Land Act and with other land policies. A study will be initiated by a sub-commission to be established this spring under the Government Tax Commission. Taking into consideration the results of this study, the Government of Japan will submit the necessary legislation to the Diet by the end of FY 1990.
(2) With respect to the taxation system on agricultural land within urbanization promotion areas of the major metropolitan areas, the Government of Japan, together with necessary adjustments and improvements in the related policies, will conduct a review with a view to addressing the deferment system of payment of the inheritance tax and the fixed assets tax, in accordance with the Comprehensive Land Policy Plan, so that the results will be smoothly implemented from FY 1992.
(3) In addition to the establishment of the new system for idle land mentioned in 1. (2), a review will be made with regard to the possible strengthening of the special land holding tax on idle land.

3. The Government of Japan will examine, by the end of FY 1990, the utilization of State-owned land in the major metropolitan areas and try to enable the land to be utilized for, through sales and other arrangements, appropriate private projects of urban district development, urban facilities, urban redevelopment and public housing projects, except those cases where preservation of land for public use is necessary. The Government of Japan will urge local governments to take similar measures with regard to local government-owned land.

Effective utilization of the extensive land owned by the Japanese National Railways Settlement Corporation in metropolitan areas will also be ensured.

4. In order to increase the supply of housing and residential land, installation of the required infrastructure will be steadily pursued. In this context, the Government of Japan is committed as specified in Section II. 2. (1) (i) of "Saving and Investment Patterns" chapter to indicate a positive and specific target for a larger long-term plan for housing (as well as other major areas whose plans are to expire at the end of FY 1990) by the final SII report. The "eminent domain system" will also be utilized. Studies will be conducted on the system concerning public use of the deep underground in order to encourage its utilization.

5. In order to meet the changed circumstances and to improve the legal relationship between lessors and lessees, a review of the Land Lease Law and the House Lease Law has been conducted, and an outline of the draft amendment of these laws may be ready by as early as the end of FY 1990. The Government of Japan will then submit the necessary legislation to the Diet without delay. These measures are expected to induce a more appropriate use of land and an increase in the supply of good quality houses for lease.

6. In order to encourage effective utilization of land, the Government of Japan will conduct timely and appropriate review of divisions between Urbanization Promotion Areas and Urbanization Control Areas, and zoning. It is expected that Urbanization Promotion Areas will be expanded to provide for the growing housing demands. Specific deregulation measures, including the relaxation of limits on building heights, total floor area ratio, and coverage ratio will be pursued for quality projects contributing to the increase of housing supply and the formation of a better urban environment.

7. In order to rationalize the official assessment of land value, the Government of Japan will:
(1) rationalize the land value assessment for inheritance tax calculation as soon as possible, taking into account the nature of the tax with a view to making the assessment reasonably closer to the market value; and

(2) give guidance to local governments to rationalize their land value assessment for fixed assets tax calculation at the time of the reassessment of the land valued in FY 1991; and advise them to make public the land values of the standard points.

Distribution System

I. Basic Recognition

Concerning the distribution system in Japan, the Government of Japan attaches great importance to the enrichment of consumer life in Japan through further improving efficiency, ensuring market access, and building physical infrastructures. Based upon such recognition, the Government of Japan will promote the implementation of a broad spectrum of measures:

1. The distribution of import freight will be accelerated and its cost will be reduced by the improvement of airports, harbors, and other import infrastructures.

2. Customs clearance procedures and other import procedures will be further expedited to correspond to the increasing trade volume, while maintaining such functions as realizing a proper and fair sharing of the tax burden, and ensuring the health and safety of the people.

3. Deregulation of the distribution system will be further promoted with regard to a variety of laws and regulations, such as the Large-Scale Retail Store Law, with a view to enriching consumer life in Japan.

4. As to trade practices concerning distribution, an improved environment will be sought from the standpoint of promoting competition and securing market openness.

5. Wide-ranging measures with lasting, structural impact will be implemented in order to expand imports, thereby improving the efficiency of Japan's market structure including the distribution system.

II. Measures to be Taken

1. Improvement of Import-related Infrastructures

(1) Airport Improvement

(a) Based on the Fifth Five-Year Plan for Airport Improvement (FY 1986-90), the improvement of the New Tokyo International Airport, the off-shore expansion of the Tokyo International Airport and the improvement of the Kansai International Airport are being vigorously promoted as the three most important projects. In particular, completion of the second phase construction of the New Tokyo International Airport and the first phase construction of the Kansai International Airport will double the cargo handling capacity as the cargo handling area will expand from about 20 hectares at the New Tokyo International Airport alone to about 50 hectares at the two airports combined. This expansion of capacity, together with the improvement and the expansion of the regional airport and airport-related cargo handling facilities, is a significant step toward the goal of ensuring airport capacity sufficient to meet the demand for international air services for some time to come. The airport-related cargo handling facilities at the New Tokyo International Airport and at the Baraki Terminal are being improved and expanded responding to the increasing demand for international air cargo handling. Considerable efforts are also being invested in the improvement of local airport facilities: For instance, the construction of the New Hiroshima Airport is now vigorously under way with December, 1993 as the target inauguration date.

(b) Regarding the Sixth Five-Year Plan for Airport Improvement, the Minister of Transport referred the matter to the Aviation Council on March 15. The Ministry of Transport will request formulation of a new five-year plan after receiving an interim report of the Council in August. A major goal of the review is to ensure that Japan's airport facilities can meet the medium-to-long term growth of demand in international air transportation. To this end, a number of airport improvements, including the expansion plan of the Kansai International Airport (its overall concept) and increased use for international service of regional airports, will be discussed in the process.

(c) Improvement of roads related to import is being promoted in line with the Tenth Five-Year Plan for Road Improvement (FY 1988-92).

(2) Harbor Improvement

Harbors are being improved in line with the Seventh Five-Year Plan for Harbor Improvement (FY 1986-90). In order to be able to respond to increasing imports, the improvement of container terminals for overseas trade and large scale multi-purpose terminals for overseas trade will be given high priority in the Eighth Five-Year Plan now being prepared. Concerning warehouse facilities, the Government of Japan is promoting private investment in facilities through such means as low-interest loans by the Japan Development Bank (JDB) and favorable tax measures. Since FY 1989, special emphasis is being placed on promoting the improvement of warehouse facilities dealing primarily with imported goods through a special low-interest loan facility. Thanks to these measures, warehouse companies in the Tokyo and Osaka metropolitan areas plan to expand their facilities by 16% by the end of FY 1991.

2. Expeditious and Proper Import Procedures

In order to ensure rapid entry of normal cargo imports into the Japanese distribution system, the Government of Japan goal is 24 hours clearance (from presentation of import declaration to import permit) through entry procedures for imports by 1991. The Government of Japan will ensure adequate budget resources and make regulatory changes necessary to accomplish this goal.

(1) Customs Clearance Procedures

Automated Processing System will be introduced for customs clearance of sea cargoes from 1991 to 1992. In addition, the Japanese Customs will further improve and rationalize the customs clearance procedures, in accordance with the report by the Japan-U.S. Customs Experts Group. This will include efforts for achieving, within a few years, the implementation of upgrading of NACCS (Nippon Air Cargo Clearance System), expansion of the scope of the Provisional Examination System and its procedural simplification, and introduction of the Automated Risk Judgement System supported by the Customs Data Base.

(2) Import Procedures other than Customs Clearance Procedures

A Japan-U.S. Experts Group, consisting of officials of the agencies concerned, will be set up in order to make import procedures more expeditious and proper. This Group will submit a report including recommendations for improvement by the time of the final report of the SII.

3. Deregulation

(1) Large-Scale Retail Store Law

As dynamic changes are called for in the distribution industry, deregulation measures will be taken in order to meet new needs of consumers, to enhance the vitality of the distribution industry and to ensure smooth procedures for opening new stores. Deregulation measures will be put into place by both the central Government and local public authorities.

The following deregulation measures will be implemented by the Government of Japan.

(a) Deregulation measures that will be immediately taken (such measures as those for an appropriate implementation of the law)

(i) In order to ensure smooth coordination procedures and to facilitate the opening of new stores and expansion of existing stores, the following deregulation measures for an appropriate implementation of the law will be in effect by the end of May this year, subsequent to the deliberation by the relevant council. These are the maximum measures which are legally possible under the current Large-Scale Retail Store Law (LSRSL).

(aa) Shortening of coordination processing period for opening stores:
The coordination processing period will be less than one and a half years.

(bb) Exceptional measures concerning floor space for import sales:
Regarding floor space for import sales, coordination procedures will be exempted for an increase up to a specific scale (approximately $100m^2$ of the floor space).

(cc) Exemption of coordination procedures for the increase of a certain increase in floor space: Coordination procedures will be exempted for certain cases such as a floor space increase up to a specific scale (whichever is the smaller, 10% of the existing floor space or 50m^2).

(dd) Relaxation of the scope of regulation on closing time and the number of business holidays:
Closing time under regulation will be relaxed from "after six o'clock p.m." to "after seven o'clock p.m." The number of business holidays will be relaxed from "less than four days a month" to "less than 44 days a year".

(ee) Enhancement of transparency in the coordination procedures:
Transparency of the coordination procedures will be improved through such measures as further disclosure of the outcome of the deliberation in the Council for Coordinating Commercial Activities, regular publication of the status of coordination activities and receipt and processing of the inquiries by the interested parties including those wishing to open stores.

It is confirmed that, as has been the case in the past, the ongoing coordination procedures will not prevent other procedures required by other laws and regulations (such as Building Standards Law and City Planning Law) from being pursued in parallel nor will they prevent those wishing to open stores from advertising for potential tenants. It is also confirmed that in case of acquisition of existing retail outlets through corporate acquisition (including those by foreign firms), the coordination procedures are not required.

(ii) Regarding separate regulation by local public authorities, the central Government, together with the above measures, will make its utmost efforts by, for example, directing local public authorities to take necessary corrective measures in the light of objectives of the law.

(iii) In order to ensure an appropriate implementation of the law and of separate regulation by local public authorities, the Government of Japan will take necessary follow-up steps including the checking of the status of implementation of the above measures. The institutional system will be put into place to achieve the above-mentioned objective by establishing the headquarters for follow-up both in the Ministry of International Trade and Industry (MITI) Headquarters and in regional Bureaus and Department.

(iv) In order to ensure an appropriate implementation of the above measures thus to expedite the processing of the coordination procedures, the fiscal 1990 budget will establish a new division called the Distribution Industries Division in the MITI and will increase by ten the number of officials concerned. Further efforts will be made to expand and strengthen the institutional set-up.

(v) In order to accelerate changes in the distribution industry and to expand manufactured imports, together with the above measures, steps will be taken to help promote imports by the distribution industry including small and medium distributors. To achieve this objective, the budget, the fiscal loans and investment plan, and the tax reform proposal of the FY 1990 will establish tax incentive measures to promote manufactured imports, promote grass-root import expansion activities of small and medium distributors, promote international comprehensive distribution centers, expansion of import promotion fairs by local retailers, and others. Further efforts will be exerted to expand and reinforce such measures.

(b) Amendment of the law which is to be submitted to the Japanese Diet during the next regular session

The Government of Japan will immediately start preparation for the amendment of the law aiming at submitting the bill during the next regular session of the Japanese Diet, by initiating the deliberation of the relevant council.

(i) Standpoint of the amendment

(aa) Sufficient consideration upon consumer interest.

(bb) Ensuring expedited processing of the coordination procedures.

(cc) Ensuring the enhanced clarity and transparency of the procedures.

(dd) Consideration upon international request to Japan to increase imports.

(ii) Items considered as the elements of the amendment.

(aa) Introduction of exceptional measures of coordination procedures concerning the floor space for import sales aiming at more import expansion.

(bb) Shortening of coordination processing period for opening stores. (The objective of efforts is to shorten the period to approximately one year.)

(cc) Enhancing clarity and transparency of coordination procedures for opening stores.

(dd) Restraining local public authorities' separate regulations.

(ee) Others.

(c) Review after the above-mentioned amendment of the LSRSL

The LSRSL shall be reviewed further two years after the above-mentioned amendment of the LSRSL. This study will include an analysis of the law's impact on consumers and competition in the retail sector and, based thereon, the need for a basic review of the law and further action.

In order to make the first point clear, the above-mentioned amendment shall include a provision stating that the effectiveness of the implementation of the amendment will be examined and that, based on this result, examination will be made on matters including removal of regulations applied to specific geographical areas.

(2) Regulation concerning premium offers and advertisement

The regulation of premium offers by the Act Against Unjustifiable Premiums and Misleading Representation, including that by Fair

Competition Codes, is designed to ensure fair competition in the market place and to protect consumer interests. Obviously, it is not intended to be an impediment to new entry by foreign or domestic firms.

The Fair Trade Commission (FTC), however, is currently reviewing all existing Fair Competition Codes on premium offers so that they will not work as impediments to new entry by foreign or domestic firms, giving priority to Codes relevant to foreign trade or investment. The FTC will relax, as part of such an undertaking, the regulation of nine Codes as early as possible this year.

Of the nine Codes, the contents of regulation by the Fair Competition Code on Premium Offers in Chocolate Industries will be relaxed for the second time by this June. Newspaper advertisements with coupons will be allowed by this summer.

In reviewing the Codes, the FTC will hear the opinions of foreign firms and foreign businessmen.

Guidance on Fair Trade Conferences by the FTC will be tightened lest they should take any action beyond their proper objectives.

(3) Regulation concerning liquor sales and other businesses

(a) The Guidelines for Liquor Sales Licensing were amended, and their implementation has been improved since last September by such measures as the easing of the licensing criteria for large retail shops and the simplification and clarification of those for average-sized liquor shops. Concretely, liquor sales licenses are planned to be issued to all the large retail shops (with a floor space of more than 10,000m^2) and to about 5,000 average-sized shops by 1994. Moreover, the Government of Japan will seek the possibility of front-loading licensing to large retail shops, which are expected to sell more imported liquors, and will reach a conclusion before the final report of the SII is submitted.

(b) On trucking business, a law was approved by the Diet at the end of last year and the Government of Japan has decided to promote deregulation. The revised law altered the method of entry regulation from the licensing system to a permit system while abolishing the supply-demand adjustment regulation, and changes the permit system for fare regulations to a notification system. (The revised law is due to take effect on December 1 this year.)

(c) With regard to the Pharmaceutical Affairs Law regulation concerning general sales of pharmaceuticals, the Government of Japan plans to decide on deregulation measures by mid-May which will include the reduction of items general pharmacies should be equipped with to about one third of the present number.

(d) In NTT, introduction of discounts for bulk contractors of the "free dial" (toll-free calls) is under consideration with a view to introduction by this June. Reduced postal rates have been made available for direct mails and catalogues sent out in large numbers for business purposes. These have become possible by the introduction of the advertising mail service in October 1987 and the catalogue parcel service in September 1989.

4. Improvement of trade practices

(a) The Fair Trade Commission (FTC) has held meetings of the Advisory Group on Distribution Systems, Business Practices and Competition Policy, consisting of scholars and business experts, in order to formulate a guideline clarifying the criteria regarding the enforcement of the Antimonopoly Act vis-a-vis the marketing policies of manufacturers towards distributors and of distributors towards manufacturers. The Advisory Group is due to issue a recommendation this June. The Fair Trade Commission, after receiving the recommendation, will formulate and publish the guideline. The FTC will strictly enforce the Antimonopoly Act according to this guideline so that business transactions among companies will not hinder fair competition.

The FTC will intensify information gathering on illegal activities under the Antimonopoly Act, and will strictly eliminate such activities. For that purpose, the FTC will endeavor to enhance its investigation system.

(b) The Ministry of International Trade and Industry (MITI) is now examining its policies on such matters as the ways and means of encouraging the industries concerned to take positive measures to improve trade practices. After consulting with the Industry Structure Council, the Ministry will formulate a guideline for improving trade practices aiming at simplification, clarification and increased transparency of trade practices. MITI will start the process of formulating the guideline this spring and will try to reach a conclusion by the time of the final report of the SII. In that process, the Ministry will hear the opinions of foreign business organizations in Japan. MITI will present the guideline to the industries concerned and encourage them to take necessary steps. Contact points for processing complaints from foreign businesses will be established both in MITI and in the industries concerned.

5. Import Promotion

The Japanese Government has introduced a new package of comprehensive import expansion measures in order for Japan to become a world leading importing nation. It includes:

(a) creation of tax incentives to promote manufactured goods imports;

(b) considerable increase in budget allocation for import expansion measures such as the establishment of an information network for the promotion of imports and the dispatch of experts to western countries and other forms of human exchanges in search of products to be exported to Japan;

(c) strengthening and expansion of the low-interest loan facilities for import promotion;

(d) elimination of tariffs on more than 1,000 products.

These measures are to be implemented after Parliamentary approval in this Diet session.

Regarding concrete complaints by foreign firms concerning the standards and certification system, the Office of Trade Ombudsman (OTO) will continue to receive them and promptly respond to those claims. OTO will continue to hold meetings of the members of the OTO Advisory Council as well as the members of the Special Grievances Resolution

Meeting with the members of the foreign Chambers of Commerce in Japan, including the members of the American Chamber of Commerce in Japan (ACCJ) at the latter's request. This will continue to provide opportunities for the latter to express their opinions on the improvement of access to the Japanese market including issues relating to the standards and certification system. Appropriate government agencies concerned will study these opinions with a view to improving the openness of the Japanese market and will report back the results of their consideration.

The Government of Japan will initiate a new review in the area of standards, certification and testing, where it will review existing regulations and practices with regard to standards, certification and testing, including matters connected with industry association standards, to ensure that processes are transparent and that standards and testing are performance based where appropriate. As a first step, this new review will take up standards, certification and testing which are raised by ACCJ, other foreign chambers of commerce and other interested parties through the O.T.O and other appropriate channels.

Exclusionary Business Practices

I. Basic Recognition

Maintenance and promotion of fair and free competition is an extremely important policy objective, which not only serves the interest of the consumers but also increases new market entry opportunities including those of foreign companies. Based upon such recognition, the Government of Japan will implement wide-ranging measures.

1. Enhancement of the Antimonopoly Act and its enforcement.
2. Greater transparency and fairness in administrative guidance and other government practices.
3. Encouragement of transparent and non-discriminatory procurement procedures by private companies.
4. Facilitation of patent examination disposals including a shorter examination period.

II. Measures to be Taken

1. Enhancement of the Antimonopoly Act and its Enforcement

The Government of Japan or the Fair Trade Commission (FTC) will take the following action, including legislative action, which are necessary or appropriate to achieve the goals acknowledged in the Report regarding enhancement of the Antimonopoly Act and its enforcement.

(1) Resorting More to Formal Actions

The Fair Trade Commission (FTC) will strictly exclude illegal activities violating the Antimonopoly Act by resorting more to formal actions under the Act. This will be realized by enhancing the FTC's investigation system and by expanding its capacity to collect evidence of illegal activities.

In addition, an Ombudsman system will be newly established in the FTC to deal promptly with information and complaints from foreign businessmen and foreign firms concerning such cases as violation of the Antimonopoly Act.

(2) Ensuring Greater Transparency

In order to ensure transparency, to enhance deterrent effect and to prevent similar illegal activities from occurring, the contents, including the names of the offenders, the nature of the offense and circumstances surrounding it, of all formal actions such as recommendations and surcharge payment orders will be made public. Warnings will also be made public other than in exceptional cases.

(3) Increase in Budgetary Allocation

In the FY 1990 Budget Proposal, the Government of Japan has decided to substantially increase the number of personnel in the FTC investigation department and create new divisions:

(a) allocate 25 new officials (129 - 154), resulting in a 20% increment in staff,

(b) establish one new office for strengthening violation detection (1 - 2 offices),

(c) establish two new divisions for enhancing investigative functions (6 - 8 offices),

(d) establish one new division in the Osaka Local Office for enhancing investigative functions of local offices (1 - 2 offices).

The Government of Japan will continue with its efforts to steadily improve and strengthen the FTC.

(4) Surcharges

In order to enhance the deterrent effect against violations, the Government of Japan plans to revise, within the FY 1991, the Antimonopoly Act to raise surcharges against cartels so that they are effective. Moreover, group boycotts will also be regulated as cartels if they substantially restrain competition, and will be subject to surcharges if they influence prices.

(5) Resorting to Criminal Penalties

The FTC will resort to more criminal penalties through criminal prosecution triggered by its indictments.

The FTC will more actively indict illegal activities when deemed necessary taking account of the degree of its maliciousness and the importance of its social impacts. For that purpose, the FTC will improve its criminal indictment system through such measures as establishing indictment standards and internal administrative procedures, and will make public the FTC's policy on criminal indictment.

In addition, the Ministry of Justice and other relevant governmental agencies will coordinate in enhancing systems to cope adequately with any cases violating the Antimonopoly Act.

(6) The Damage Remedy System

A study on the effective use of the current damage remedy system provided in the Section 25 of the Antimonopoly Act is currently undertaken by a study group set up in the FTC, in order that any individual party suffering damage from violation of the Antimonopoly Act can resort effectively to damage remedy suits. The FTC plans to receive and make public the results of the deliberations of the study group by June this year. Upon the publication of the study, appropriate measures will be taken so that the current damage remedy system will be effectively utilized.

2. Government Practices

(1) Deregulation will be further promoted on the basis of the recommendations issued by the Provisional Council for the Promotion of Administrative Reform.

(2) Administrative Guidance

In order to ensure transparency and fairness of administrative guidance, the Government of Japan will see to it that administrative guidance is not intended to restrict market access nor to undermine fair competition. The Government of Japan will implement its administrative guidance in writing as far as possible, and unless there are good reasons not to do so, it will make the administrative guidance public when it is implemented.

(3) Advisory Committees and Study Groups

The Government of Japan confirms the following principles:

(a) The results of the deliberations of government sponsored "industry advisory committees and study groups"shall be made public.

(b) Where subjects of discussions are related to consumer interests, the committees and study groups shall invite, as members, those who can effectively represent consumer interests.

(c) The substance discussed in the committees and study groups shall not be anti-competitive.

(d) The "visions" developed by the Government shall not be used to enhance the competitive position of particular companies in the Japanese market.

(e) In the "visions" involving trade matters, the significance of imports shall be emphasized.

(4) The exemptions from the application of the Antimonopoly Act should be at a minimum, and the necessity of existing exemptions will be reconsidered with a view to promoting competition policy. The scope of exemptions will also be reviewed, even in cases where they will be maintained.

No recession cartel based upon the Antimonopoly Act is currently in effect.

3. Procurement Practices of Private Firms

(1) The Government of Japan confirms its view that procurement by private firms should be left to the decisions of the buyers and the efforts of the suppliers under free competition at the market place, and that any action in violation of the Antimonopoly Act hindering market competition must be resolutely eliminated.

(2) The Government of Japan believes that, as a matter of course, procurement by private firms should be non-discriminatory against foreign goods.

(3) The Government of Japan, therefore, will encourage, from an international viewpoint, private firms to make their procurement procedures transparent and non-discriminatory against foreign goods as soon as possible.

4. Effective Patent Examination

Regarding the patent system, consideration on the harmonization of patent systems has been under way in multilateral fora such as WIPO and GATT. The Government of Japan, together with the U.S. Government, will actively participate in, and contribute to, the discussions there.

The Government of Japan has vigorously promoted comprehensive policy measures to expedite patent examination disposals, which include the continual increase in the prescribed number of patent examiners (by 30 persons each in FY 1989 and in FY 1990), as well as the submission of the revision of the Patent Law before this session of the Diet for the commencement of the electronic filing of patent applications. Through such measures, the situation of the patent examination delay has already started to be improved.

Through further intensive accumulation of such measures, the Government of Japan will make the patent examination period of Japan internationally comparable within five years. Apart from the ordinary examination procedure, the accelerated examination system which terminates the examination in a short period, has been introduced and is expected to be utilized.

Keiretsu Relationships

I. Basic Recognition

Certain aspects of economic rationality of Keiretsu relationships notwithstanding, there is a view that certain aspects of Keiretsu relationships also promote preferential group trade, negatively affect foreign direct investment in Japan, and may give rise to anti-competitive business practices. In order to address this concern, the Government of Japan intends to make Keiretsu more open and transparent. The Government of Japan will take measures in its competition policy and enforce the Antimonopoly Act strictly, so that business transactions among companies with the background of Keiretsu relationship would not hinder fair competition.

The Government of Japan will also promote a wide range of policies to facilitate the entry of foreign enterprises into the Japanese market.

II. Measures to be Taken

1. Strengthening the Function of the Fair Trade Commission

(1) The Fair Trade Commission (FTC) will strengthen its monitoring of transactions among Keiretsu firms, including but not limited to, those which have cross shareholding relationships, to determine whether these transactions are being conducted in a way that impedes fair competition. If such monitoring reveals that competition is substantially restrained in any particular field of trade by the cross shareholding, the FTC will take appropriate measures - including restrictions on cross shareholding or transfers of shares held in the cross share- holding - to remedy the illegal situation, and further, if the same monitoring reveals that anti-competitive practices are occurring, the FTC will take appropriate measures to prevent and remedy the anti-competitive practices.

In this connection, the FTC has established the "Advisory Group on Distribution Systems, Business Practices and Competition Policy," consisting of scholars and business experts, in order for the FTC to set up a guideline which will clarify the criteria regarding the enforcement of the Antimonopoly Act with respect to the exclusiveness of transactions among companies in the same Keiretsu group, whether or not cross shareholding is involved. The Advisory Group is scheduled to issue a recommendation this June. On the basis of the recommendation, the FTC will set up and publish a guideline to ensure that the transactions among companies in Keiretsu groups will not hinder fair competition, and thereby contributing to the promotion of fair and more open transactions among them without any discrimination against foreign firms. The FTC will strictly enforce the Antimonopoly Act according to the guideline.

(2) The FTC will conduct regularly, roughly every two years, close analysis of various aspects of Keiretsu groups, including supplier-customer transactions, financing arrangements among group firms, personal ties, and special emphasis on the role of general trading companies in Keiretsu groups. The results of these analyses will be published. The FTC will take steps, including stricter enforcement of the Antimonopoly Act, to address anti-competitive and exclusionary practices uncovered in the FTC analyses.

2. Foreign Direct Investment

The Government of Japan is considering issuance of a policy statement on the openness of Japanese foreign investment policy.

(1) The Government of Japan will reexamine the Foreign Exchange and Foreign Trade Control Law with a view to submitting an amending bill in the next ordinary Diet session.

The current Foreign Exchange and Foreign Trade Control Law enables the Government of Japan to restrict the foreign direct investment and importation of technology into Japan in any industrial sector on the grounds that the investment and the importation of technology might adversely and seriously affect similar domestic business activities or the smooth performance of the Japanese economy.

The Government of Japan will revise these provisions of the law on the recognition that these provisions are neither appropriate nor fit to the present practices of the law, and that such restrictions are not needed on a general basis.

The bill will contain the relaxation or abolition of the provisions relating to prior notification requirements for foreign direct investment and importation of technology into Japan.

(2) The low-interest loan facility offered exclusively to foreign companies and Japanese affiliates of foreign companies by the Japan Development Bank (JDB) and the Okinawa Development Finance Corporation is to be drastically expanded. In addition, a corresponding facility is to be

established in the Hokkaido-Tohoku Development Finance Corporation. Furthermore, advisory offices for the promotion of foreign direct investment in Japan are to be set up in the overseas representative offices of the JDB in order to support foreign companies investing in Japan in cooperation with Embassies, Consulates-General and JETRO offices. Appropriate offices of JETRO or these advisory offices in cooperation with Embassies and Consulates-General provide information useful in arranging beneficial ventures between foreign firms and Japanese companies and arrange seminars and missions for potential investors (JETRO offices only).

3. Revision of the Take-Over Bid System

Regarding the take-over bid (TOB) system, the Government of Japan is planning to submit, at this Diet session, a bill calling for abolition of the prior notification requirement for TOB's and prolongation of the take-over period.

4. Enhancement of the Disclosure Requirements

(1) In order to introduce the so-called 5 percent rule, which requires the disclosure of substantial ownership in shares, the Government of Japan is planning to submit a bill at this Diet session, together with the revision of the TOB system. The new rule would also require continuing reporting as investors above the five percent threshold acquire or dispose of blocks of shares in an amount equal to one percent or more.

(2) With respect to the disclosure requirements related to the Keiretsu problem, the Government of Japan will examine areas in which improvements are needed for their further enhancement, taking into account the disclosure requirements in the U.S. and Europe, and will reach a conclusion before the final SII report is submitted. It is envisaged that improvements in disclosure requirements will include enhanced reporting of related-party transactions as well as consolidated financial information.

5. Reexamination of the Company Law

The Committee on Legislation will reexamine the Company Law with a view to enhancing the disclosure requirements and to simplifying mergers and acquisitions procedures.

Pricing Mechanisms

I. Basic Recognition

Based upon the recognition that it is undesirable, in realizing a high quality of life, for large and unreasonable price differentials between domestic and overseas markets to continue to exist for a long time, the Government of Japan will implement the following policies to adjust the differentials:

1. Obtaining information on price differentials and providing it to consumers and industries;
2. Deregulation and strict enforcement of the Antimonopoly Act;
3. Promotion of imports and improving productivity;
4. Formation of more appropriate land prices;
5. Setting of public utility prices at more appropriate levels.

II. Measures to be Taken

1. Implementation of Measures to Adjust Price Differentials between Domestic and Overseas Markets

The Government and the Liberal Democratic Party (LDP) established on December 4 last year the Government-LDP Joint Headquarters for Adjustment of Price Differentials between Domestic and Overseas Markets to promote comprehensive policy measures for the adjustment of the price differentials from a consumer-oriented standpoint. The membership consists of the Prime Minister as Chairman, with the Minister of State of Economic Planning Agency, the Minister of International Trade and Industry, the Chief Cabinet Secretary and the Chairman of Policy Affairs Research Council of the LDP as Vice Chairmen, and other Cabinet Ministers and LDP leaders concerned. The Headquarters decided on 52 items as concrete measures to be taken for the adjustment of price differentials between domestic and overseas markets in its second meeting held on January 19 this year.

These concrete measures can be grouped into the following six pillars:

(1) The government agencies concerned will endeavor to obtain information on price differentials through such means as surveys of price

differentials of goods and services between domestic and overseas markets, and, where needed, to take necessary measures such as providing the industries concerned with the information on price differentials in order to adjust and narrow the gap.

(2) The government agencies concerned will endeavor to improve the competitive condition in the distribution system by such means as deregulation and strict enforcement of the Antimonopoly Act.

(3) The government agencies concerned will endeavor to further promote import and/or improve productivity of the relevant industries for the purpose of contributing to the adjustment and narrowing of the price differentials between domestic and overseas markets.

(4) Efforts will be made to set prices for public utilities at more appropriate levels by further improving productivity of the industries concerned and by examining from an international perspective their cost compositions and other elements of price formation.

(5) Based upon the deliberations of the Ministerial Conference for Land Policies, efforts will be made to rationalize land prices, especially in metropolitan areas, through close coordination among the government agencies concerned.

(6) The government agencies concerned will promote other policy measures which will contribute to the adjustment of price differentials, such as further deregulation, strict enforcement of the Antimonopoly Act and the dissemination of relevant information to the consumers.

The government agencies concerned will steadily implement the 52 measures included in the above six pillars and publish the state of implementation each time any measure is implemented.

2. Continuous Implementation of Domestic and Overseas Price Surveys and the Dissemination of Information to Consumers and Industries

The Ministry of International Trade and Industry (MITI) has repeatedly carried out price surveys, including the Japan-U.S. joint price survey, to grasp the present conditions of price differentials between domestic and overseas markets.

MITI decided to continuously conduct domestic and overseas price surveys, and requested for necessary resources in the supplementary budget for FY 1989 and the FY 1990 budget. Specifically, price surveys on 130 items, including a wide range of consumer items, are under way since

March this year, based upon the supplementary budget for FY 1989. Two series of price surveys on 60 items will be conducted, based upon the FY 1990 budget. Based upon the results of these surveys, MITI will provide detailed information to consumers and industries. The dissemination of comparative price information will not be done in a manner which discriminates against imports or interferes with individual firm pricing decisions.

MITI also held a discussion meeting, with consumers and industrial representatives on February 6 this year and heard their views on the problem of price differentials between domestic and overseas markets. Similar meetings have been held in eight major cities since then. MITI intends to hold such meetings based upon the results of domestic and overseas price surveys.

3. Promotion of Deregulation

The Provisional Council for the Promotion of Administrative Reform made an extensive study on deregulation, and the Government of Japan has been engaged in the promotion of deregulation based upon the recommendations of the Council.

Specifically, the Cabinet decided, in December 1988, on the General Plan for the Promotion of Deregulation to promote the reform of public regulations, basing its decision on the recommendations made by the Council. In addition, the Government of Japan decided to continue active promotion of deregulation in its Administrative Reform Plan of 1990 (Cabinet Decision, December, 1989), and the agencies concerned have been making the utmost efforts in accordance with this decision.

As the Council is planned to be dissolved on April 19 this year, the Government of Japan will consider the most effective scheme thereafter for the continued promotion of administrative reform, including deregulation.

4. Further Steps Based on the Interim Report of the SII

In addition to the measures listed above, the Government of Japan will take concrete steps with respect to the structural problems identified in this interim report.

Some of them are described below, and it is expected that those steps will allow price mechanisms to work more effectively in the Japanese market.

These measures will be implemented in conjunction with the six policy pillars and 52 measures decided in December 1989 and January 1990 by the Government-LDP Joint Headquarters.

(1) Deregulation of the distribution system, including the Large-Scale Retail Store Law, liquor sales, trucking and other businesses

The government agencies concerned will endeavor to improve conditions for free and fair competition in the distribution system through various measures. These will include the immediate relaxation of implementation and subsequent amendment of the Large-Scale Retail Store Law and the Government of Japan encouragement to private firms to make their procurement transparent and non-discriminatory.

(2) Promotion of fair and free competition in the market through the enhancement of the Antimonopoly Act and its enforcement

The Government of Japan plans to raise surcharges against cartels, so that surcharges will be effective. The FTC will resort to more criminal penalties. Appropriate measures will be taken so that current damage remedy system will be effectively utilized.

(3) Increase of Japanese overhead capital

The Government of Japan notes that these efforts will include the substantial increase in social overhead capital, including that which relates to the entry and distribution of imported products in Japan. In the new ten-year plan, real aggregate investment in infrastructure will be increased substantially above current levels for the ten years to boost domestic investment, improve social overhead capital and reduce the shortage of investment relative to savings and to the size of the Japanese economy.

(4) The Government of Japan will implement a wide range of measures with respect to the land problem. These include measures which encourage increased supply of available land, including the establishment of a new system for identifying and promoting the utilization of idle land (such as unused plant sites), reviewing the land taxation system, and reviewing the Land Lease Law and the House Lease Law in order to improve the legal relationship between lessors and lessees.

(Note) Full and precise contents of the measures above are described in the related part of this interim report.

Japan / U.S. Structural Impediments Initiatives

Comments of the Japanese Delegation
on the
Interim Report by the U.S. Delegation (*)

1. In the Interim Report produced through the Structural Impediments Initiatives (SII) talks, policies to be taken by the U.S. Government on each of the seven areas which are recognised as the U.S. structural problems are specifically identified. These policies are aimed at fundamental changes of the U.S. economy based on the recognition that extreme importance should be attached to the necessity of strengthening the competitiveness of the U.S. economy. The Japanese side appreciates the U.S. Government's position on these policies.

2. Substantial portion of these U.S. measures put into the Interim Report are those proposed in the 1990 State of the Union Message and the 1991 Presidential budget proposal which included many of the Japanese suggestions made in the course of the SII talks. President Bush himself has shown deep interest in structural reforms as well as in the progress of the SII talks themselves aimed at strengthening U.S. competitiveness.

(*) These comments constitute solely the views of the Government of Japan on progress to date and areas for further progress.

3. The Government of Japan expects that, under the continued strong leadership of President Bush, these proposals will be put into effect without delay, thereby strengthening the U.S. economy.

Further, the Government of Japan hopes that further efforts will continue to be made with a view to making yet more progress on structural reforms of the U.S. economy.

Some comments on the U.S. Interim Report from these viewpoints are as follows.

Savings and Investment

1. The United States of America, both politically and economically, is the biggest and most important country in the world. Also, the U.S. dollar is a key currency in the international monetary system.

It is therefore important for the economic stability of the world that the U.S. economy and its competitiveness be strengthened.

2. From this viewpoint, we welcome the U.S. Government's initiative in identifying the savings and investment patterns of its own economy as a structural impediment to trade and external adjustment, and by taking a series of actions to boost savings both by the public and private sectors.

3. Specifically, it is noteworthy that the clear message of the SII talks is that the Administration is placing Federal Budget deficit reduction as a top priority. We expect that the targets of the deficit reduction under the Gramm-Rudman-Hollings procedure will be met in each fiscal year.

We also welcome the series of initiatives by the Administration including the reinforcement of the Gramm-Rudman-Hollings Budget Process. We sincerely hope that these measures will be enacted as early as possible with the understanding and cooperation of the Congress.

4. Secondly, on private sector savings, we highly appreciate the recent decision by the U.S. Administration to propose incentives to save, which we hope will accelerate the recent upward trend of the savings ratio of individuals.

We also hope that these measures will be put into effect as soon as possible.

5. The studies on savings and investment in the corporate sector, being conducted by the Treasury Department, will yield an important foundation for formulating the U.S. policies necessary for enhancement of the long-term competitiveness of U.S. corporations.

We are looking forward to seeing potentially historic results of these very important initiatives.

Improvement of the U.S. Economy's Competitiveness

Tackling with structural distortions both at the public sector level as well as at the private sector level in the U.S. would bring about the further vitalization of industrial sector and improve the international competitiveness of the U.S. itself. The Government of Japan would welcome the forceful implementation of specific measures by the U.S. Government aimed at this objective.

The Government of Japan strongly hopes that the U.S. Government continues to make efforts on each of the following areas identified as structural problems in the U.S. economy; corporate investment activities and supply capacity, corporate behavior, government regulation, R&D, export promotion and workforce education and training.

- In order to enlarge the production capacity of the U.S. manufacturing industry, measures to increase investment should occur and statement welcoming foreign direct investment would encourage such helpful activity. It is requested that the U.S. avoid taking tax enforcement measures aimed unfairly at foreign companies.
- As to the U.S. corporations, further specific measures are expected to be taken by the U.S. Government to encourage corporate managements to take a longer-term perspective.
- Government regulations such as re-export licensing system which prevent the U.S. corporations from becoming more competitive in the foreign markets are expected to be reviewed.

- Efforts should be made with a view to establishing guidelines on implementation of laws pertaining to Anti-Trust Act in order to strengthen the activities of joint R&D and of production joint-venture by the U.S. manufacturing industry. Further, necessary measures are expected to be taken for the thorough implementation, also by the private sector, of international standards of weights and measures, i.e. metric system, so that the exports of U.S. products will be increased.

- Fundamental export promotion policies should be established and implemented to encourage export activities by U.S. industries and increase U.S. exports.

Effective cooperation is welcomed between the Ministry of International Trade and the Industry of Japan and the U.S. Department of Commerce in export promotion.

- It is expected that studies should be conducted to find existence of any impediments for parallel import to Japan in the U.S., and that, if there are any, appropriate measures should be taken.

- In order to improve further the quality of workforce, it is expected that efforts should be made to strengthen the U.S. education systems particularly in mathematics and science as well as vocational education and training programs.

U.S./JAPAN STRUCTURAL IMPEDIMENTS INITIATIVE

COMMENTS OF THE U.S. DELEGATION on the INTERIM REPORT BY THE JAPANESE DELEGATION *

The Government of Japan's interim report reflects substantial progress at this stage of the Structural Impediments Initiative (SII) talks. The United States Government appreciates the hard work and leadership on the part of the Japan SII Working Group and the Government of Japan that produced this report. Many of the measures in the interim report should contribute to the goals of opening markets, reducing trade and current account imbalances, and promoting consumer interests.

The measures and commitments in the interim report are, in many respects, welcome plans for action. Additional progress is needed in subsequent SII talks to develop the plans and actions more fully in some areas. The effectiveness of the measures and commitments will depend upon achieving greater specificity in the commitments, and, ultimately, on the actual implementation of measures to reduce or eliminate the structural impediments.

<u>Saving and Investment Patterns</u>

A principal objective of the SII talks is the reduction of trade imbalances and current account imbalances of Japan and the United States. The U.S. Government welcomes the significant reduction which took place in Japan's current account surplus in 1989 to $57 billion from a peak of $87 billion in 1987, along with the further reduction in the U.S. deficit. Reducing the gap between saving and investment in Japan is essential for the further reduction of the current account imbalance.

The U.S. Government, therefore, welcomes the commitment of the Government of Japan to reduce the shortage of investment relative to savings and thereby to further the reduction of the current account surplus. Of particular importance to the achievement of that goal are the following specific commitments by the Government of Japan in the interim report:

o To increase substantially real aggregate investment in infrastructure above current levels in a new comprehensive plan of public investment which would last 10 years, thus reducing the shortage of investment relative to saving and to the size of the economy.

* These comments constitute solely the views of the U.S. Government on progress to date, and areas for further progress.

- o To start immediately formulating this new comprehensive plan.

- o To specify the aggregate amount of expenditures of this plan in the final report.

- o To prepare on a fast-track basis eight new larger, long-term sectoral plans in key infrastructure areas, including housing, airports and port facilities, parks and sewers whose current plans are to expire at the end of FY 1990. This offers a concrete mechanism for meeting Japan's social overhead capital needs, for improving the quality of life of the Japanese people, and helping reduce Japan's current account surplus.

- o To provide positive and specific targets for these sectoral plans in the final SII report.

- o To welcome the voluntary extension of the operating hours of bank automated teller machines to increase consumer convenience.

These decisions represent substantial progress for the purposes of the interim assessment. However, further action and specification will be needed in order to ensure a substantial increase in investment relative to saving and as a share of GNP. Only when the Government of Japan provides positive and specific targets for the timing and levels of funding for public investment will it be possible to assess the effects on the pattern of Japanese saving and investment, and on the current account surplus.

Land Use

The U.S. Government welcomes the Government of Japan's basic recognition of the seriousness of the land use problem, and its commitment to address this problem through a wide range of policy measures. Of particular importance, the Government of Japan has already taken, or has committed to take, the following actions in the interim report:

- o Passage of the Basic Land Act in December, 1989, outlining principles which will guide the government's efforts to reform land taxation and to improve land use policies.

- o To establish a system for identifying and promoting the utilization of idle land and to conduct a review with regard to the possible strengthening of the special land-holding tax on idle land.

- o To conduct a comprehensive review of land taxation, and to submit reform legislation to the Diet by end-FY 1990, with a view to revising land taxation on the basis of principles such as equity, neutrality and simplicity.

- To review the taxation of agricultural land within Urbanization Promotion Areas (UPAs), with a view to addressing the deferments system of payments of the inheritance and fixed asset (property) taxes.

- To rationalize the land value assessment values for the inheritance tax, taking into account the nature of the tax, with a view to bringing assessments closer to market value.

- To install urban infrastructure, and, in this context, to indicate a positive and specific target for a longer-term plan for housing by the final SII report.

- To review the Land and House Lease Laws and then to submit draft reform legislation to the Diet in order to improve the legal relationship between lessors and lessees.

- To review the UPA zoning designations, and to expand UPAs to accommodate growing housing demand.

- To pursue specific deregulation measures, including the relaxation of limits on building heights and housing density.

The U.S. Government believes that it is essential that the Government of Japan build on these actions and achieve further progress. Studies will need to be completed and positive action taken on the basis of these studies.

Further action will be needed in a number of areas, including: progress toward the elimination of the property and inheritance tax exemptions (deferrals) for agricultural land in urban areas; imposition of penalty taxes on idle land, pending the completion of efforts to make tax policies neutral; reduction in capital gains tax rates; correcting the legal imbalances between lessees and lessors; progress in implementing the Government of Japan's commitments to convert idle land to productive use, to install urban infrastructure and to implement the deregulation measures cited above.

Distribution System

The United States Government shares the Government of Japan's assessment that, in order to increase import opportunities and improve the quality of life for the Japanese consumer, improved infrastructure, deregulation and enhanced anti-monopoly enforcement are all necessary in the distribution sector. The U.S. Government welcomes the Government of Japan's commitment to:

- Improved infrastructure for imports, including airports, harbors, and roads.

- o The goal of "24 hour" import clearance, as a useful step which should contribute to faster clearance procedures.

- o Measures to ease restrictions in the distribution area, including rules on liquor licensing, trucking, premium offers and general pharmaceutical goods, and review of standards, certifications and licenses which are impeding imports.

- o Shortening the approval period for new store openings under the Large Scale Retail Store Law and seeking legislative changes which would further liberalize that law.

- o Measures to improve trade practices in the distribution sector, including stronger enforcement against anticompetitive practices.

- o Implementing a program of incentives, including tax credits, to increase imports, as well as measures to enable small stores to carry more imported goods.

Many of the proposed actions of the Government of Japan are not yet possible to appraise because they are still under study and review. These include future plans for airport expansion, improvements in procedures to expedite import clearance, guidelines for anti-monopoly actions of manufacturers towards distributors, and guidelines for improving trade practices. The U.S. Government looks forward to rapid completion of these reviews, which we hope will lead to a more open Japanese distribution system.

The U.S. Government expects the relaxation of the Large Retail Store Law and its revision in the coming year to result in a substantial increase in the availability of foreign products and a more competitive distribution sector. We believe this objective could be further enhanced by exempting certain geographic areas from the law's application and hope that this measure will be taken in the near future.

Finally, the U.S. Government has been told by the Government of Japan that the measures that have been proposed will significantly open the distribution system of Japan. If this is borne out in the implementation phase, then many of the key problems related to the opening and expansion of stores would have been addressed without complete abolishment of the Large-Scale Retail Store Law itself. Should this, however, not prove to be the case, then the U.S. Government will return to its original view about the need for more drastic legislative solution.

Exclusionary Business Practices

The United States Government shares the view of the Government of Japan that fair and free competition in the Japanese market is essential for the market entry opportunities of foreign companies and the benefit of Japanese consumers. In particular, the Antimonopoly Act should be enhanced and enforcement made more effective; government actions should be transparent and market-oriented; the procurement policies of private companies should be transparent and nondiscriminatory; and the patent system should be improved.

The U.S. Government appreciates the efforts that the Government of Japan has made in most areas; in particular, its commitments to:

- o Strengthen substantially enforcement of the Antimonopoly Act, including increased staff and budget; more formal actions, resulting in more public disclosures of violations and violators; public disclosures of "warnings"; and more criminal prosecutions.
- o Impose more effective penalties, including proposing legislation for higher fines (surcharges).
- o Implement actions to make private remedies more effective.
- o Issue guidelines to ensure that business practices in the distribution area and among keiretsu firms do not hinder fair competition.
- o Minimize exemptions from the Antimonopoly Act.
- o Implement government-wide policies to make "administrative guidance," "visions" and the results of study groups more pro-competitive and consumer-oriented; and, in general, public and in writing.
- o Encourage transparent, nondiscriminatory procurement by private Japanese companies with respect to foreign companies and goods.
- o Reduce, within five years, the average time required for the examination of patents to coincide with international levels.
- o Review all industry "fair competition codes" to remove anticompetitive effects of restrictions on the use of premiums, with a priority on codes that affect foreign trade and investment.

We support and encourage, and will continue to support and encourage, the increased role of the Fair Trade Commission in the Japanese economy and increases in its budget and staffing that are designed to increase enforcement.

The commitments and measures are welcome plans for action. It is important, however, that these plans be substantiated by greater specificity and actual implementation in order to eliminate exclusionary business practices in Japan. The U.S. Government will discuss these commitments and measures, and their implementation, in the course of the SII. We are especially interested in further clarification and specificity regarding: the extent of increases in surcharges and the effectiveness of other enforcement measures; steps to enhance the effective utilization of private remedies; effective deregulation of sectors and restrictions (such as those on premiums) that can affect foreign trade and investment; demonstrable progress in reducing patent examination delays; pro-competitive government actions; and the removal of other exclusionary practices that operate as barriers to trade and investment.

Keiretsu Relationships

The United States Government is of the view that keiretsu relationships can promote preferential group trade, negatively affect foreign direct investment in Japan, and give rise to anticompetitive business practices. The U.S. Government is encouraged, therefore, by the Government of Japan's clear statement of its intention to address this concern. In particular, we welcome the following specific commitments contained in the interim report:

- To make keiretsu more open and transparent;
- To take steps to improve the climate for foreign direct investment in Japan;
- To strengthen monitoring by Japan's Fair Trade Commission of keiretsu transactions and enforcement of the Antimonopoly Act, taking steps to remedy anticompetitive practices;
  - In this connection, the FTC will publish a guideline to ensure that keiretsu transactions do not hinder fair competition, and will strictly enforce the guideline;
- To begin addressing the cross shareholding issue by restricting cross shareholding relationships between keiretsu firms where FTC monitoring reveals that the cross shareholding leads to substantial restraint of competition;
- To conduct regular FTC analysis of various aspects of keiretsu groups, with special emphasis on the role of the general trading company.

- o To examine disclosure areas in which improvements are needed, and to complete, before the final report, a study of further improvements with a view to enhancing disclosure of related-party transactions;

- o To encourage foreign direct investment in Japan by amending the Foreign Exchange and Foreign Trade Control Law to:

  - relax or abolish prior notification requirement for foreign direct investment and the importation of technology into Japan, and

  - revise the provisions enabling the Government of Japan to restrict foreign direct investment and the importation of technology on broad economic grounds, recognizing that such restrictions are not needed on a general basis;

- o To promote foreign direct investment in Japan, including the establishment of overseas advisory offices and the activities of JETRO;

- o To submit legislation abolishing the prior notification requirements for takeover bids; and

- o To issue a policy statement welcoming foreign investment in Japan.

The U.S. Government believes that it is essential for the Government of Japan to build on the commitments enumerated above through additional actions and commitments in a number of areas, including: issuance of a broader policy statement encouraging the loosening of keiretsu ties; further actions to address the cross shareholding issue; measures to encourage opening of keiretsu procurement practices; further steps to relax or abolish the broad authority of the Government of Japan to restrict foreign direct investment and the importation of technology on broad economic grounds; and measures to bolster shareholders' rights in Japan.

Pricing Mechanisms

The U.S. Government believes that action by the Government of Japan is appropriate, given that "large and unreasonable" gaps between foreign and Japanese prices are a structural adjustment problem with significant adverse impact on Japanese consumers. The U.S. Government welcomes:

- o The decision to establish a Government-LDP Joint Headquarters for Adjustment of Price Differentials as an indication of the very high priority attached to the problem.

- o The broad scope of the 52 point program outlined by the group, although several items, designed to enhance Japanese productivity, are not germane to the SII discussions.

  -- In the distribution sector, this list includes amending the regulations and guidelines on the Large-Scale Retail Store Law; relaxation of licensing and the regulations for retail distribution of liquor tobacco, salt, and medical supplies; and specific examination of business practices affecting distribution of processed food products.

  -- The plan includes eight steps to rationalize public utility charges including airfares, domestic/international telephone rates.

  -- It also calls for formulation of land policies, including promoting housing supply, and revising the land tax system to promote more appropriate land prices.

- o The broad scope of this list clearly reflects that past policies and practices in these areas are at the root of the price problem.

The U.S. Government believes that continuing attention to price levels in Japan suggests price changes may be a useful device for monitoring efficacy of SII reforms in other areas.

The U.S. Government notes that many of the actions listed above require further elaboration and specific commitments before an assessment can be made of their effectiveness in reducing Japanese prices. The Japanese program requires further attention to timetables for implementation and to the elimination of regulations which attempt to manage markets by restricting entry. The nexus between the Japanese Government-LDP program and the SII undertakings in this and other sections should lead to more specific solutions to problems of deregulation and market entry with particular implications of eliminating unreasonable price differentials. It is essential that price surveys be designed and presented in a broad-based, representative and unbiased fashion to ensure a fair and accurate determination of the reason for the price differences, and not focus unfairly on prices and practices of foreign products or producers. We expect that survey data will not be used for purposes which inhibit competition or the operation of market forces.

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
April 6, 1990

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Phone: (202) 566-2041

Dan Snow, Kingwood, Texas Sentenced for Violations of the Cuba Embargo

On April 6, 1990, Mr. Dan Snow of Kingwood, Texas, was sentenced in the U.S. District Court of the Southern District of Texas, Houston, by Judge Sim Lake to serve 90 days in jail, perform 1,000 hours of community service, pay $5,300 in fines, and undergo 5 years supervised release.

Snow arranged, promoted, and conducted pleasure fishing trips to Cuba, under the guise of bass research. He was convicted by a jury on January 26, 1990, on five counts of organizing tourist travel to Cuba in violation of the Trading with the Enemy Act, the Cuban Assets Control Regulations, and the aiding and abetting sections of Title 18 of the United States Code. He was also convicted on one count of criminal contempt.

On February 11, 1985, Snow had been ordered by the Federal court in Houston to cease these activities and on December 11 in the same year was found to be in civil contempt of that order. The criminal convictions of Snow on January 26, 1990, resulted from further acts engaged in by him in violation of the 1985 court order, which were uncovered and investigated by the Enforcement Division of the Office of Foreign Assets Control, which is charged with administering and enforcing the embargo against Cuba. Snow's illegal activities resulted in the transfer of hard currency to the Castro regime, in violation of U.S. foreign policy embodied in the embargo.

Cuban travel transactions are permitted by U.S. residents for official government business, gathering news, making news or documentary films, engaging in professional research, and visiting close family members. Snow contended unsuccessfully that he was leading a group of professional bass researchers.

Richard Newcomb, Director of the Office of Foreign Assets Control, stated that the Snow prosecution is an example of the United States Government's continuing resolve to fully enforce the Cuba economic embargo and to prosecute those who willfully violate the law. Specific questions concerning the Cuban Assets Control Regulations may be addressed to the Office of Foreign Assets Control, at 202-376-0392.

NB-758

april 7, 19

STATEMENT OF THE GROUP OF SEVEN

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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 April 7, 1990, in Paris, for an exchange of views on current global 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 since their last meeting, economic growth had been slowing in several countries to more sustainable levels. However, overall growth prospects remain good, with strong investment providing a major stimulus to their economies, inflation remains contained and external imbalances have been reduced although unevenly.

The Ministers and Governors expressed the need for continued close coordination of their macro-economic and structural policies, to obtain sustained growth, low inflation and greater stability of exchange rates. In this respect, they agreed that current inflation rates require continued vigilance. They agreed that countries with fiscal and current account deficits should reduce budget deficits and increase private savings. They also agreed that countries with external surpluses should, at the same time, continue to contribute to external adjustment by promoting non-inflationary growth of domestic demand, through appropriate macro-economic and structural policies. They also agreed that savings should be promoted in all countries through the use of appropriate structural policies.

The Ministers and Governors discussed developments in global financial markets, especially the decline of the yen against other currencies, and its undesirable consequences for the global adjustment process, and agreed to keep these developments under review. They reaffirmed their commitment to economic policy coordination, including cooperation in exchange markets.

The Ministers and Governors welcomed the reforms in Eastern Europe towards market oriented economies which, they believe, are the most profound in decades. They expressed their willingness to contribute to the success of the ongoing process, through appropriate bilateral and multilateral assistance, through helping countries undergoing reforms to remove obstacles to private capital flows, and exchange of information and expertise. They reviewed and assessed the possible effects of these reforms. They noted that German economic and monetary union could contribute to improved global growth and to a reduction of external imbalances in Europe.

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
April 9, 1990

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $8,213 million of 13-week bills and for $8,223 million of 26-week bills, both to be issued on April 12, 1990, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing July 12, 1990			:	26-week bills maturing October 11, 1990		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.77%	8.04%	98.036	:	7.78%	8.21%	96.067
High	7.80%	8.07%	98.028	:	7.81%	8.24%	96.052
Average	7.80%	8.07%	98.028	:	7.80%	8.23%	96.057

Tenders at the high discount rate for the 13-week bills were allotted 97%.
Tenders at the high discount rate for the 26-week bills were allotted 18%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 55,630	$ 55,630	:	$ 48,740	$ 48,740
New York	25,598,500	6,872,925	:	22,949,110	7,086,570
Philadelphia	26,200	26,130	:	18,820	18,820
Cleveland	56,965	56,635	:	52,995	52,995
Richmond	45,220	38,220	:	52,155	52,155
Atlanta	37,330	37,330	:	37,010	35,135
Chicago	1,569,270	166,195	:	1,435,820	68,620
St. Louis	46,600	27,450	:	34,665	23,025
Minneapolis	21,140	11,140	:	21,410	13,210
Kansas City	42,825	42,825	:	69,325	69,315
Dallas	35,770	25,770	:	36,695	26,695
San Francisco	897,885	82,885	:	906,385	95,685
Treasury	769,705	769,705	:	631,900	631,900
TOTALS	$29,203,040	$8,212,840	:	$26,295,030	$8,222,865
Type					
Competitive	$25,653,445	$4,663,245	:	$22,581,780	$4,509,615
Noncompetitive	1,647,495	1,647,495	:	1,378,220	1,378,220
Subtotal, Public	$27,300,940	$6,310,740	:	$23,960,000	$5,887,835
Federal Reserve	1,795,430	1,795,430	:	1,775,000	1,775,000
Foreign Official Institutions	106,670	106,670	:	560,030	560,030
TOTALS	$29,203,040	$8,212,840	:	$26,295,030	$8,222,865

An additional $26,030 thousand of 13-week bills and an additional $147,370 thousand of 26-week bills will be issued to foreign official institutions for new cash.

1/ Equivalent coupon-issue yield.

NB-759

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
April 10, 1990

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 $16,400 million, to be issued April 19, 1990. This offering will result in a paydown for the Treasury of about $26,900 million, as the maturing bills total $43,303 million (including the 247-day cash management bills issued August 15, 1989, in the amount of $15,020 million and the 16-day cash management bills issued April 3, 1990, in the amount of $13,004 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, April 16, 1990. The two series offered are as follows:

91-day bills (to maturity date) for approximately $8,200 million, representing an additional amount of bills dated January 18, 1990, and to mature July 19, 1990 (CUSIP No. 912794 UV 4), currently outstanding in the amount of $7,646 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $8,200 million, to be dated April 19, 1990, and to mature October 18, 1990 (CUSIP No. 912794 VF 8).

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 April 19, 1990. 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 $3,184 million as agents for foreign and international monetary authorities, and $4,211 million for their own account. These amounts represent the combined holdings of such accounts for the four 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

PRESS RELEASE

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

RESOLUTION FUNDING CORPORATION

FOR IMMEDIATE RELEASE
April 10, 1990
(OB 90-24)

CONTACT: Diane Casey
202-376-5477

REFCORP ANNOUNCES RESULTS OF AUCTION OF 40-YEAR BONDS

The Resolution Funding Corporation has accepted $3,501 million of $8,903 million of tenders received from the public for the 40-year bonds, Series B-2030, auctioned today.[1/] The bonds will be issued April 17, 1990, and mature April 15, 2030.

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

	Yield	Price[2/]
Low	8.86%	100.162
High	8.94%	99.293
Average	8.89%	99.834

Tenders at the high yield were allotted 10%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ ---	$ ---
New York	8,463,750	3,316,750
Philadelphia	10	10
Cleveland	---	---
Richmond	3,000	3,000
Atlanta	---	---
Chicago	332,005	177,505
St. Louis	2,000	2,000
Minneapolis	---	---
Kansas City	1,000	1,000
Dallas	---	---
San Francisco	101,000	1,000
Totals	$8,902,765	$3,501,265

The $3,501 million of accepted tenders includes $126 million of noncompetitive tenders.

1/ The minimum par amount required to strip the REFCORP bonds is $1,600,000. Larger amounts must be in multiples of that amount.

2/ In addition to the auction price, accrued interest of $0.48497 per $1,000 for April 15, 1990, to April 17, 1990, must be paid.

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
April 11, 1990

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 7-YEAR NOTES

The Department of the Treasury has accepted $7,520 million of $19,442 million of tenders received from the public for the 7-year notes, Series E-1997, auctioned today. The notes will be issued April 16, 1990, and mature April 15, 1997.

The interest rate on the notes will be 8-1/2%. The range of accepted competitive bids, and the corresponding prices at the 8-1/2% interest rate are as follows:

	Yield	Price
Low	8.62%*	99.379
High	8.63%	99.328
Average	8.62%	99.379

*Excepting $18,000 at lower yields.

Tenders at the high yield were allotted 47%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 10,561	$ 10,561
New York	18,010,201	7,028,731
Philadelphia	7,500	7,500
Cleveland	13,107	13,099
Richmond	11,900	11,900
Atlanta	12,612	12,612
Chicago	897,397	327,347
St. Louis	19,275	15,275
Minneapolis	5,294	5,294
Kansas City	17,212	17,212
Dallas	6,025	4,495
San Francisco	428,745	63,445
Treasury	2,035	2,035
Totals	$19,441,864	$7,519,506

The $7,520 million of accepted tenders includes $414 million of noncompetitive tenders and $7,106 million of competitive tenders from the public.

In addition to the $7,520 million of tenders accepted in the auction process, $100 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $223 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-761

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
April 12, 1990

CONTACT: Barbara Ann Clay
(202)566-2041

MOROCCAN AGREEMENT WITH COMMERCIAL BANKS

Secretary of the Treasury Brady welcomes the agreement in principle between the Kingdom of Morocco and the Steering Committee of its commercial bank creditors on a two-phase financial package that involves debt and debt service reduction options. This agreement provides a strong medium-term financial framework to support Morocco's ongoing economic reform efforts. We look forward to Morocco entering into a medium-term economic program so as to benefit at an early date from the debt and debt service reduction options contained in phase two of the financial package.

NB-762

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
April 16, 1990

CONTACT: OFFICE OF FINANCING
202-376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $8,218 million of 13-week bills and for $8,215 million of 26-week bills, both to be issued on April 19, 1990, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing July 19, 1990			:	26-week bills maturing October 18, 1990		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.68%	7.94%	98.059	:	7.73%	8.16%	96.092
High	7.72%	7.98%	98.049	:	7.76%	8.19%	96.077
Average	7.71%	7.97%	98.051	:	7.75%	8.18%	96.082

Tenders at the high discount rate for the 13-week bills were allotted 11%.
Tenders at the high discount rate for the 26-week bills were allotted 61%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 50,315	$ 50,315	:	$ 40,195	$ 40,195
New York	23,121,160	6,822,360	:	18,077,145	6,923,145
Philadelphia	20,315	20,315	:	19,945	19,945
Cleveland	44,645	44,645	:	29,470	29,470
Richmond	46,470	46,470	:	38,120	38,120
Atlanta	34,040	33,040	:	41,280	41,280
Chicago	1,807,450	335,200	:	1,546,075	226,575
St. Louis	32,150	12,150	:	29,125	22,345
Minneapolis	26,905	18,005	:	28,905	28,905
Kansas City	38,980	38,980	:	55,240	55,240
Dallas	35,110	25,660	:	30,400	25,400
San Francisco	801,420	244,180	:	876,440	201,990
Treasury	526,830	526,830	:	562,365	562,365
TOTALS	$26,585,790	$8,218,150	:	$21,374,705	$8,214,975
Type					
Competitive	$22,859,435	$4,491,795	:	$17,380,710	$4,220,980
Noncompetitive	1,410,595	1,410,595	:	1,221,995	1,221,995
Subtotal, Public	$24,270,030	$5,902,390	:	$18,602,705	$5,442,975
Federal Reserve	2,242,760	2,242,760	:	2,000,000	2,000,000
Foreign Official Institutions	73,000	73,000	:	772,000	772,000
TOTALS	$26,585,790	$8,218,150	:	$21,374,705	$8,214,975

1/ Equivalent coupon-issue yield.

NB-763

TREASURY NEWS

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

FOR RELEASE UPON DELIVERY
EXPECTED AT 9:30 A.M.

OPENING REMARKS BY
NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
BEFORE THE
WHITE HOUSE CONFERENCE ON SCIENCE AND ECONOMICS
RESEARCH
RELATED TO GLOBAL CHANGE
TUESDAY, APRIL 17, 1990

Good Morning. I am pleased to welcome this distinguished assembly of delegates to the White House conference on global change.

This is the first international conference to bring together experts in the disciplines of economics, science and the environment. Over the next two days we will have the opportunity to explore and discuss the relationship of these disciplines to the issue of global change.

We meet here to acknowledge and explore our common interest in improving and preserving the environment in the face of ever-increasing demands placed on it by the forces of expanding populations, economic growth and development and technological advances. We have gathered here because we recognize that success in managing global environmental issues will only be attained when we have developed coherent policies which fully integrate environmental solutions with economic realities. Only when we have achieved this integration of science and economics can we be assured that we are pursuing policies in the best interest of the peoples of the world.

Our challenge is made all the greater by a lack of consensus among experts as to the true nature, rate and extent of changes in the global climate projected for the future. We cannot resolve these issues in the next two days, but we can advance and clarify the world's understanding of the relationship between the scientific and economic aspects of the environmental challenges we face.

Our work here is the natural extension of work we have already begun in other forums. Our purpose is to complement the efforts of the Intergovernmental Panel on Climate Change as it strives to identify what is known and what is still uncertain in the science of global change.

Here in the United States President Bush has taken the lead in focusing national attention on global climate change issues-- "We face," he said, "The prospect of being trapped on a boat that we have irreparably damaged -- not by the cataclysm of war, but by the slow neglect of a vessel we believed to be impervious to our abuse."

The Bush Administration has formulated general guidelines on issues concerning global change. First, nations can't afford to wait for a final resolution of the scientific uncertainties before they act. Second, while we wait for scientific advances, nations should take those actions already justified on economic and other grounds. Third, any action considered should be specific, focused on a clear goal, and cost-effective. Fourth, the most effective actions will be those that both protect the environment and allow continued economic development.

Here in the United States we are pursuing this policy framework with concrete actions. The President has asked Congress for $1 billion in the next fiscal year to study global change. We estimate this represents more than half of all the money spent on global change research worldwide. A key element of this research is an ambitious 15-year program to gather more accurate data. This includes plans to develop new polar orbiting satellites that will improve our understanding of oceans, clouds and land masses.

The U.S. National Oceanic and Atmospheric Administration of the Department of Commerce also supports a range of work in international climate monitoring and modeling, under The World Meteorological Organization -- work that holds the potential for greater accuracy in predictions of climate trends.

The United States is committed to phasing out chlorofluorocarbons by the year 2000. The U.S. Environmental Protection Agency is working with industry to find alternatives to CFC's and to control emissions of carbon tetrachloride and methyl chloroform. EPA has also extended its assistance to several developing countries who are seeking to reduce their CFC emissions, in conformance with the Montreal Protocol.

By the year 2050, well over half of greenhouse gas emissions are expected to come from developing countries. It is clear that these countries must be a part of any solution to global climate problems. The United States has urged their attention to these issues -- and we welcome developing countries to this conference. We have sought to promote the integration of environmental considerations into the lending programs of the World Bank and the regional development banks. We have encouraged the completion of environmental impact assessments for projects financed by the banks.

At the September 1989 annual meetings of the World Bank and IMF, President Bush called for more emphasis on the environment in national policy making, especially in promoting energy efficiency and conservation and greater protection of tropical forests.

In keeping with the President's instructions, U.S. officials have pursued environmental reforms with the OECD, World Bank, the regional development banks, the UNEP and UNDP. In addition, the U.S. has strongly advocated an environmental emphasis for the programs of the European Bank for Reconstruction and Development. The United States has also supported the use of debt-for-nature swaps to preserve forests and wetlands. In the recent past, such swaps have been signed in Ecuador, Costa Rica, the Philippines, and Madagascar. A swap recently arranged in Zambia will help protect two of Africa's most important wetlands. While the dollar amounts involved in these swaps have been small, an important principle has been established. We have encouraged the World Bank to play a more active role in facilitating these swaps. We hope the Bank will do so. We believe debt-for-nature swaps can be used more innovatively to help address climate change issues.

As these initiatives demonstrate, economic issues are intrinsically and inextricably linked to environmental concerns. We wish to preserve the environment to improve and sustain a certain quality of life for all the peoples of the world. But we must recognize that a great part of that quality of life also rests on economic development and growth. It is largely through economic growth that we can bring the nations of the world freedom from hunger, lower infant mortality, longer life expectancy and liberation from oppressive poverty. Thus we must carefully balance and evaluate the relationship between proposals to address global climate change and economic activities and policies.

Our meetings here can make a valuable contribution to establishing a common understanding and assessment of the issues. Let us work together to establish a consensus that will allow us to advance our ability to make the important decisions in the future. Let us reach agreement on areas of opportunity for cooperative action in scientific and economic research. Let us plan to integrate scientific and economic research into the policy process. Let us begin to build partnerships for pursuing that research. If we can achieve agreement on these issues we will have taken an important step towards meeting the challenge of global climate change.

And as we pursue these goals, let us do so in the spirit of the words spoken by an American Indian chief, "We do not inherit the earth from our ancestors; rather, we borrow it from our children."

I welcome you and look forward to what we can achieve together.

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
April 17, 1990

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 $16,400 million, to be issued April 26, 1990. This offering will result in a paydown for the Treasury of about $9,250 million, as the maturing bills total $25,638 million (including the 52-day cash management bills issued March 5, 1990, in the amount of $10,177 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, April 23, 1990. The two series offered are as follows:

91-day bills (to maturity date) for approximately $8,200 million, representing an additional amount of bills dated January 25, 1990, and to mature July 26, 1990 (CUSIP No. 912794 UW 2), currently outstanding in the amount of $7,640 million, the additional and original bills to be freely interchangeable.

182-day bills (to maturity date) for approximately $8,200 million, representing an additional amount of bills dated October 26, 1989, and to mature October 25, 1990 (CUSIP No. 912794 UR 3), currently outstanding in the amount of $9,769 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 April 26, 1990. 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 $2,944 million as agents for foreign and international monetary authorities, and $3,386 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).

NB-765

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.

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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 Justice

FOR IMMEDIATE RELEASE
TUESDAY, APRIL 17, 1990

AG
202-633-2107
(TDD) 202-786-5731

PROBE ANNOUNCED OF U.S. BANK ACCOUNTS USED BY DRUG LORDS

WASHINGTON, D.C.--Attorney General Dick Thornburgh and Treasury Secretary Nicholas Brady announced today that 173 banks in 23 states have been ordered to produce records of more than 754 bank accounts into which nearly $400 million in illegal Colombian drug profits were deposited. Over three quarters of these accounts, 684, were ordered frozen pending the initiation of forfeiture proceedings by the government.

"The action taken today against the Medellin Cartel, which marks Phase IV of Operation Polar Cap, seeks to lift the veil of secrecy over the financial network of these narco-terrorists including Pablo Escobar and Jorge Ochoa," Attorney General Dick Thornburgh said. "Money is the drug-traffickers' life blood. If we can seize it or disrupt its flow, we can strangle their operations."

Secretary Brady said today's action "is one of the most significant law enforcement undertakings involving bank account seizures in U.S. history.

"These bank records will allow us to continue the hunt for more laundered drug money through further tracing of these accounts. For the first time, we have been able to trace cash

(MORE)

proceeds directly from cocaine and crack sales on the streets of American cities to foreign bank accounts owned by the Medellin Cartel," Brady said.

The Attorney General and the Treasury Secretary pointed out that this latest initiative of federal law enforcement agencies in this operation was "the result of an unprecedented level of cooperation given by eight foreign governments -- cooperation which was unheard of even a year ago.

"The message from us today is that the world community's outrage has unified our efforts to oust the drug trafficking cartels. The message to drug traffickers is that the world is going to be a smaller place for them to hide," Thornburgh said. The Attorney General praised the governments which have assisted in the operation and added that once the United Nations Vienna Drug Law Convention was ratified and fully implemented by all nations, "we will have the necessary tools for these kinds of operations against the drug cartels on a worldwide basis."

Phase IV emanated from a March 6, 1989, indictment in Atlanta by a federal grand jury in which members of the Medellin Cartel were charged with cocaine and marijuana trafficking and the laundering of the cash proceeds from these drug sales. Phases I, II, and III of Polar Cap showed that drug sale profits of over $1 billion were laundered mainly through New York banks into foreign accounts controlled by the Cartel mostly in Panama, Uruguay, and elsewhere.

Through investigation of these New York and other U.S accounts, formal requests were made to the governments of Colombia, Panama, Uruguay, Luxembourg, Switzerland, United Kingdom, Canada and Austria for records of accounts believed to be under the control of the Medellin Cartel.

In January, 1990, after the ouster of Manuel Noreiga, federal agents travelled to Panama and requested the Attorney General of Panama to take the necessary steps under Panamanian law to obtain records of Panamanian bank accounts identified as having been used by cartel money launderers.

Examination of the Panamanian and other foreign accounts showed that between 1987-89 almost $350 million was wire-transferred back to U.S. banks, primarily in New York and Florida, which are included in today's court order issued by the federal district court in Atlanta. Another $50 million is believed never to have left U.S. accounts.

"The Cartel needs these secret U.S. accounts in order to run their illegal business here," Thornburgh said. "The massive scope of the cocaine trade in the U.S. requires large amounts of capital for the operation of the Cartel's daily activities, as well as to maintain the company's payroll. Our ability to examine these bank records may will be the key to

(MORE)

unlocking the totality of the secret financial arrangements of the cartel in the U.S."

The Attorney General commended the joint efforts of the U.S. Customs Service, the Drug Enforcement Administration, the Internal Revenue Service, and the Federal Bureau of Investigation for the continued success in Operation Polar Cap.

Thornburgh praised U.S. Attorneys Ray Rukstele (Acting), Northern District of Georgia; Otto Obermaier, Southern District of New York; Dexter Lehtinen, Southern District of Florida and Assistant U.S. Attorney Wilmer "Buddy" Parker, the Northern District of Georgia, for their work on Phase IV of Polar Cap.

The first results of Operation Polar Cap were announced by Thornburgh and Brady in February 1989. Polar Cap is the largest drug money-laundering investigation ever conducted by United States law enforcement agencies. As a result of Polar Cap, 127 persons have been charged, and more than a ton of cocaine was confiscated along with more than 19,000 pounds of marijuana and $105 million in cash, jewelry, and real estate. More arrests as a result of collateral investigations are expected.

The United Nations Vienna Drug Law Enforcement Convention, which was ratified by the U.S. Senate last year and drafted by over 100 nations, will boost international law

(MORE)

enforcement efforts in the areas of money laundering, international transportation of precursor chemicals used to produce illegal drugs, the tracing and seizure of laundered, illegal-drug trade profits of the drug cartels and the worldwide extradition of drug criminals.

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90-162

TREASURY NEWS

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

For Release Upon Delivery
Expected at 2:00 p.m.
April 18, 1990

Statement of the Honorable
Nicholas F. Brady
Secretary of the Treasury
before the
Committee on Ways and Means
United States House of Representatives
April 18, 1990

Mr. Chairman and Members of the Committee:

I am pleased to appear today to discuss developments in Eastern Europe, the European Community, and foreign investment in the United States. Developments in these areas will have an important bearing on the U.S. economy for the rest of this century and beyond.

EASTERN EUROPE

In Eastern Europe, economic conditions have been a critical factor behind the political changes that have swept across the region during the past year. Most of the Eastern European countries are undertaking comprehensive, market-oriented reform programs. To encourage their efforts, the U.S. Government is providing financial and technical assistance and is negotiating trade, investment, and tax treaties.

Financial Assistance

The United States responded quickly with financial assistance to the developments in Eastern Europe. In fiscal year 1990, the Support for Eastern European Democracy (SEED) Act provided $418 million in aid to Poland and Hungary. The United States, along with other donor countries, organized a $500 million multilateral bridge loan for Poland, which has already been repaid. In addition, the United States coordinated a $1 billion multilateral Stabilization Fund for Poland to provide support for the Polish zloty as the economic reforms -- including limited convertibility -- were implemented. This year the Administration has proposed legislation to expand our assistance effort to all of the emerging democracies of Eastern Europe, requesting $300 million in fiscal year 1991 for this purpose. Finally, a large variety of activities are being undertaken to support private sector development in Eastern Europe, including the establishment of Enterprise Funds for Poland and Hungary under the SEED Act.

Under U.S. leadership, multilateral institutions are also engaged in helping the region. Both the International Monetary Fund (IMF) and the World Bank are actively supporting economic reform in Poland and other countries that are members of the Fund and Bank: Hungary, Romania, and Yugoslavia. The magnitude of this support is impressive. The IMF has committed more than $1.5 billion under stand-by arrangements with Poland, Yugoslavia, and Hungary. The World Bank is extending project and non-project loans to these three countries at the rate of almost $2 billion per year. Recognizing the key role played by these institutions, Czechoslovakia and Bulgaria have recently applied to become members.

European Bank for Reconstruction and Development

A new institution positioned to provide significant funds for Eastern Europe is the European Bank for Reconstruction and Development (EBRD). The Bank is the response of the Western countries to demonstrate their political and economic commitment to and solidarity with the Eastern European countries that had decided to undertake the transition to multi-party democracy and market-oriented economies. The Bank is also viewed as a vehicle which could, through its borrowing in capital markets, leverage contributed funds into larger loanable resources to support much needed economic reforms in these Eastern European countries. This "leveraging" will enable the EBRD to lend about $12 billion in support of Eastern Europe at a total budgetary cost to the United States of only $350 million over the next five years. The U.S. share of the Bank's $12 billion capitalization will be 10 percent, making the United States the largest shareholder.

The United States supported the concept of a multilateral Bank that would facilitate the transition of the borrowing countries to democracy and pluralism and a market-oriented economy. We saw a development bank for Eastern Europe as a unique institution and insisted that these concepts be an integral part of the EBRD's charter. This the first time these principles have been included in a development bank charter.

The charter of the EBRD also requires that at least 60 percent of the EBRD's aggregate annual lending and its lending by country for the first five years be to the private sector or state-owned enterprises that are shifting to private ownership and control.

While the Soviet Union is eligible to be a borrowing member of the EBRD, its borrowing will be limited for a three-year period to the amount of their paid-in subscriptions to the Bank and will be confined to loans for the private sector or to help enterprises operating competitively and moving to a market orientation. Any expansion of Soviet borrowing after the three-year period will require agreement by members holding 85 percent of the voting power.

Technical Assistance

Our technical assistance to Eastern European countries is likely to be more important in the long run, however, than our financial assistance. These countries need technical assistance in virtually every sector of their economies. For example, they need help in setting up business schools to teach enterprise managers how to operate in a market economy. They need foreign expertise to set up effective farm credit programs, and to establish a legal framework for private ownership of property.

The importance of technical assistance has been recognized by the United States and other Western countries, and is reflected in last year's SEED Act and the Administration's proposal for assistance to Eastern Europe in FY 1991. As part of the overall interagency coordination of economic policy with Eastern Europe, a wide-ranging program of technical assistance to Eastern European countries has been developed. We in the Treasury are giving particular attention to financial sector reform, and we are chairing an interagency task force to guide our efforts in this area.

Trade and Investment

The United States has entered into discussions with Eastern European countries aimed at reaching agreements to improve trade, business, and investment conditions. The investment discussions are intended to result in treaties or agreements that include provisions for stable, market-oriented policies towards foreign investment, free transfers of capital and returns on investment, fair dispute settlement procedures, and discipline over the use of performance requirements.

The first treaty, a business and economic relations treaty with Poland, was signed last month. It will be submitted to the Senate for approval in the near future. This treaty goes beyond the areas in our model bilateral investment treaty by extending protection to commercial activities, such as representative offices of U.S. companies seeking sales in Poland. The treaty also includes important commitments by Poland with regard to the protection of intellectual property, expropriation, and investment screening.

We had preliminary discussions with Hungary on investment issues prior to its recent elections. We will propose negotiating with the new government a business and economic relations agreement similar to that recently concluded with Poland.

Last week, we signed a trade agreement with Czechoslovakia that mutually applies GATT rules on trade, provides for protection of intellectual property, and guarantees non-discriminatory treatment in access to currency and banking accounts. Our investment treaty discussions with Czechoslovakia are underway, but are not near agreement.

Tax Treaties

We have income tax treaties currently in effect with some Eastern European countries, and we hope to begin negotiations soon on treaties with others.

These treaties form an important economic link with Eastern Europe, as with other countries, because they facilitate bilateral investment flows and business opportunities. Specifically, such treaties reciprocally raise the thresholds of business activity necessary for a foreign country's income tax system to apply. They also reduce foreign taxes on investment income, such as dividends, interest and royalties earned by U.S. residents. In addition, and often of equal importance, the treaties provide for the elimination of double taxation, through a reciprocal guarantee of a foreign tax credit or similar mechanism and through harmonizing technical rules. Finally, treaties establish a government-to-government tax dispute resolution system to which taxpayers can turn.

By undertaking treaty negotiations promptly with the countries of Eastern Europe where treaties do not now exist or need revision, we will make it more attractive for U.S. investors to enter those markets. Other industrial countries, such as France, Germany, Japan, and the United Kingdom have been concluding modern tax treaties with Eastern Europe. We want U.S. investors to operate under conditions no less favorable.

We have income tax treaties with Romania, Poland, and Hungary. These have been in effect for more than a decade, and are close to our model and the OECD model for income tax treaties. They have stood the test of time fairly well. In the restructuring of their economies, Eastern European countries may enact new laws, or modify existing laws, in such a way that revision of the tax treaties becomes necessary. Because the treaties are close to our model, however, many changes toward a more typical income tax system by these countries will be adequately accommodated by the existing treaties.

We expect to meet with representatives of Bulgaria later this spring to begin negotiations. We hope to begin similar talks with Czechoslovakia soon thereafter, and to resume negotiations with Yugoslavia once their tax reforms are completed. Treaty issues with East Germany depend on the progress and nature of unification with the Federal Republic of Germany.

EUROPEAN COMMUNITY

The United States strongly supports European economic integration. The reinvigoration of the EC's efforts towards the eventual goal of economic and monetary union has significant implications for the United States and world economy. Treasury has followed closely the full range of issues with a focus on financial and investment issues.

Banking and Finance

The EC's plan to liberalize European financial markets would essentially create a single EC capital market and banking systems that permit universal banking. It takes steps towards mutual recognition of EC national financial supervisory systems. These changes would lead to more efficient and competitive capital markets and a more efficient allocation of capital, providing benefits throughout the EC economy.

We have worked with our EC colleagues engaged in preparing EC banking and securities directives to take effect January 1, 1993. Early in the process it appeared possible that the banking directive and investment services directive would contain strict reciprocity provisions which could damage U.S. interests. The EC subsequently revised the directives, substantially alleviating our concerns.

Investment

The Administration is reviewing the investment implications of EC 1992. Our tentative conclusion is that the EC 1992 rules on mergers and acquisitions will enhance U.S. investment opportunities. However, the manner in which the EC implements the new rules will be the determining factor. We will monitor implementation closely.

We also are monitoring developments to assure that national treatment of foreign-owned firms in the EC is not abridged by the process of creating a single market. We anticipate that U.S.-owned subsidiaries will be treated as EC-country companies for all purposes within the single European market, just as we accord EC and other foreign-owned companies national treatment in the United States. We expect the same treatment of U.S. companies within the EC.

Taxes

With regard to taxes, we are closely following tax issues associated with EC 1992. The pace of harmonization in the area of taxation, particularly income taxation, is slow. This is to be expected, considering that the EC member states have strongly held and diverse views on tax issues, and that EC tax directives require unanimous consent. In many cases, EC members have a system of bilateral tax treaties with other EC members that resolve many conflicts.

In July of this year, remaining capital controls within the Community will be removed by most EC countries. Some EC member states and the EC Commission have been concerned about the effect of free capital movement on their tax revenues. We have had informal and preliminary talks about a multilateral response to these difficult issues.

Within the EC, authority in the area of taxation is retained by each individual state. The member states have not developed a multilateral tax treaty for use with the rest of the world. Therefore, the United States will continue its current policy of negotiating and concluding income tax treaties with individual states. A single tax treaty between the United States and the EC is not a realistic possibility in the foreseeable future.

Monitoring Developments

The financial, monetary, and tax issues relating to EC economic integration will be of paramount importance. Therefore, I established an Economic Policy Council (EPC) Policy Group on European Monetary Reform and Financial Liberalization with participation from the key economic agencies and relevant financial regulators. This group will report to the EPC on the macroeconomic and financial implications of economic and monetary union.

The Treasury is currently coordinating a National Treatment Study on financial services. This study, mandated by the 1988 Trade Act, is due this December. It will be more extensive than any previously prepared.

FOREIGN INVESTMENT

We welcome foreign direct investment and encourage other countries to do likewise. U.S. policy is based on the conviction that when capital is free to flow to its most efficient use, the results are greater productivity and enhanced international competitiveness.

The benefits of an open investment policy are not just a matter of economic theory; they are tangible. Foreign direct investment provides benefits in the forms of advanced technology, new management skills, jobs, and larger payrolls. These are important at the national level in terms of the overall health of this economy, as well as at the factory gate.

At at time of relatively low domestic savings, foreign investment helps us maintain high levels of investment which is so important to our economic performance. A major goal of the Administration is to improve national savings and domestic capital formation.

Foreign Investment and National Security

The United States has consistently provided foreign investors non-discriminatory treatment as a matter of law and practice. We maintain exceptions to such treatment only as necessary to protect national security.

The 1988 Trade Act included the Exon-Florio provision which empowers the President to investigate and to prohibit or suspend foreign acquisitions that threaten to impair the national security. The President delegated his authority to investigate transactions to the Committee on Foreign Investment in the United States (CFIUS), an interagency committee which I chair.

The Committee will continue to implement the Exon-Florio provision to fulfill its spirit and intent. This will be done within the context of a continued commitment to an open investment policy.

TAX POLICY ON INBOUND INVESTMENT

Our tax policy toward foreign investment in the United States is to tax foreign investors fairly, reasonably, and in accordance with international norms that reduce tax barriers to international transactions. While we must continue to monitor new developments, we believe in general that our tax policy toward foreign investment is sound and effectively serves the United States' best interests.

Tax Treaties

In discussing the United States' overall policy on foreign investment, it is important to note that U.S. investors own extremely large amounts of foreign assets. Thus, the decisions we make about foreign investment in the United States will affect the large volume of U.S. investment abroad.

To promote bilateral trade, investment and cultural relations, we have entered into a broad network of tax treaties. These treaties conform substantially to standards well-established in the international community. The value of this treaty network to U.S. businesses and investors is discussed above in my remarks on Eastern Europe. This network helps U.S. businesses and U.S. investors achieve the same "open door" that we are willing to offer foreign subsidiaries here, both through treaties and domestic legislation.

Taxes on Investment Income

An important aspect of our tax policy toward international investment is that investment income generally should be subject to a relatively low tax rate in the country where the income has its source. This principle is reflected primarily in our income tax treaties, but also in the Code for certain types of income, such as most types of interest income and gains from sales of securities.

Low withholding taxes promote a more efficient world-wide allocation of capital with respect to both foreign capital invested in the United States and U.S. capital invested abroad. Low withholding taxes on investment income is a good general policy because residence country taxation is often a more accurate means of determining, on a world-wide basis, the investor's overall income, expenses, gains, and losses. A policy of low withholding taxes on investment income does not, of course, dictate a zero level of withholding.

Taxes on Interest Income

An important issue concerning source country taxes on investment income that has received attention recently, both in Europe and in the United States, is the question of withholding taxes on interest income. The issue was debated in 1984, when Congress enacted the "portfolio interest" rules. These rules exempt from U.S. tax much of the interest paid from U.S. sources to unrelated foreign lenders. Treasury supported this legislation on the grounds that it would help to provide U.S. borrowers more efficient access to the Eurobond market, to lower domestic borrowing costs, and to promote valuable capital inflows directly to the United States. Thereby, it would contribute to capital formation and substantial economic growth in the United States. We continue to support these rules.

Questions have nevertheless persisted about the proper general treatment of interest payments to foreign investors. These questions relate to concerns about revenue, as well as capital flight and tax evasion. There are no simple answers to these questions. However, we believe that issues such as these are best addressed through multilateral discussions. We believe, in general, multilateral agreements offer the best hope for solutions to many difficult international tax problems.

Overriding Tax Treaties

Finally, I would like to address what internationally may be the single most controversial issue concerning U.S. tax policy toward foreign investors -- the increased willingness of Congress in recent years to override our treaty obligations.

Although we are encouraged by recent developments, particularly the willingness of the Congress to improve the treaty posture of the "earnings stripping" provision in last year's Reconciliation Bill, we continue to be concerned. Treaty overrides have resulted in threats of retaliation and, more tangibly, in the clear prospect of less desirable outcomes for the United States in recent treaty negotiations. Foreign negotiators insist on greater concessions from us than would otherwise be fair or balanced when they are uncertain whether or not our side of the bargain will be kept.

I believe the solution to this problem lies in regular consultation with Congress. Such consultations should assure that legitimate legislative goals will not be frustrated by a rigid or antiquated tax treaty program, while at the same time permitting our treaty program to continue to meet changing conditions and needs.

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
April 18, 1990

Monthly Release of U.S. Reserve Assets

The Treasury Department today released U.S. reserve assets data for the month of March 1990.

As indicated in this table, U.S. reserve assets amounted to $76,303 million at the end of March, up from $74,173 million in February.

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/
1990					
Feb	74,173	11,059	10,216	43,913	8,985
Mar	76,303	11,060	10,092	46,424	8,727

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-767

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
April 18, 1990

CONTACT: Office of Financing
202/376-4350

TREASURY TO AUCTION $10,500 MILLION OF 2-YEAR NOTES

The Department of the Treasury will auction $10,500 million of 2-year notes to refund $9,826 million of 2-year notes maturing April 30, 1990, and to raise about $675 million new cash. The public holds $9,826 million of the maturing 2-year notes, including $750 million currently held by Federal Reserve Banks as agents for foreign and international monetary authorities.

The $10,500 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 price of accepted competitive tenders.

In addition to the public holdings, Federal Reserve Banks, for their own accounts, hold $1,434 million of the maturing securities that may be refunded by issuing additional amounts of the new notes at the average price of accepted competitive tenders.

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

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Attachment

NB-768

HIGHLIGHTS OF TREASURY
OFFERING TO THE PUBLIC
OF 2-YEAR NOTES
TO BE ISSUED APRIL 30, 1990

April 18, 1990

Amount Offered:
To the public .... $10,500 million

Description of Security:
Term and type of security .... 2-year notes
Series and CUSIP designation Y-1992
(CUSIP No. 912827 YU 0)
Maturity date .... April 30, 1992
Interest rate .... To be determined based on the average of accepted bids
Investment yield .... To be determined at auction
Premium or discount .... To be determined after auction
Interest payment dates .... October 31 and April 30
Minimum denomination available .. $5,000

Terms of Sale:
Method of sale .... Yield auction
Competitive tenders .... Must be expressed as an annual yield, with two decimals, e.g., 7.10%
Noncompetitive tenders .... Accepted in full at the average price up to $1,000,000
Accrued interest payable by investor .... None

Payment Terms:
Payment by non-institutional investors .... Full payment to be submitted with tender
Deposit guarantee by designated institutions .... Acceptable

Key Dates:
Receipt of tenders .... Wednesday, April 25, 1990, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):
a) funds immediately available to the Treasury .. Monday, April 30, 1990
b) readily-collectible check .. Thursday, April 26, 1990

EMBARGOED FOR RELEASE
AT 4:00 P.M. EDT
APRIL 18, 1990

DEPARTMENT OF THE TREASURY

Report to the Congress

on

International Economic and Exchange Rate Policy

April 1990

EMBARGOED FOR RELEASE
AT 4:00 P.M. EDT
APRIL 18, 1990

DEPARTMENT OF THE TREASURY

Report to the Congress

on

International Economic and Exchange Rate Policy

April 1990

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PART I: INTRODUCTION

Section 3005 of the Omnibus Trade and Competitiveness Act of 1988 (Pub. L. 100-418) requires the Secretary of the Treasury to submit to the Committee on Banking, Housing and Urban Affairs of the Senate and the Committee on Banking, Finance and Urban Affairs of the House of Representatives an annual report each October 15 on international economic policy, including exchange rate policy. In addition, Section 3005 requires that the Secretary shall provide a written update of developments six months after the initial report. Annual reports, pursuant to Section 3005, have been submitted in October of 1988 and 1989. The first written update of developments was submitted in April 1989. This report represents the second written update of developments submitted to Congress.

Part II of this report reviews the economic situation in the industrial countries, including the U.S. economic and balance of payments situation. Part III analyzes the situation in the foreign exchange markets, including the dollar's movement in terms of the currencies of major U.S. trading partners and U.S. foreign exchange market intervention. Part IV reviews efforts by the major industrial countries to coordinate economic policies. Part V provides a status report on negotiations with Korea, which was considered in the October 1989 report to be "manipulating" its exchange rate, within the meaning of the legislation. It also reviews developments in Taiwan. The final part provides conclusions on the principal issues discussed in the report.

PART II: ECONOMIC SITUATION IN THE INDUSTRIAL COUNTRIES AND THE U.S. BALANCE OF PAYMENTS

o Overview

The economic expansion in the industrial countries continued through its seventh consecutive year in 1989, at an average rate that was, as expected, somewhat below the very strong pace of 1988. Aggregate real GNP growth is expected to ease a bit further this year, to a still satisfactory rate of about 3.0 percent, with a greater divergence in the performance of individual countries reflecting both policy measures and cyclical factors. Prospects for continued steady growth remain good.

Substantial progress was made last year in reducing the trade and current account imbalances of the United States and Japan. However, the external imbalances of other major countries, such as Germany and the United Kingdom, increased further in 1989, and the underlying pace of the overall adjustment process appears to have slowed in some important respects. Nevertheless, market opening measures in Eastern Europe and, particularly, the economic integration of West and East Germany, could provide substantial impetus to the external adjustment process over time, especially within Europe.

Consumer price inflation in the industrial countries rose by approximately one percentage point in 1989, to an average rate of about 4.5 percent. The increase, which was broadly consistent with expectations, in part reflected the influence of some special, transitory, factors during the first half of the year. Since then, however, price pressures have generally moderated or stabilized, and the average inflation rate is likely to slip back marginally to slightly below 4 percent in 1990. (See Table 1.)

o Economic Growth

Basic developments in real GNP and its components were remarkably uniform in the major industrial countries in 1989. Specifically, after GNP growth rates picked up strongly in 1988 (to what, for several countries, were decade highs), there was a broadly shared slowdown in 1989. Japanese growth dipped to 4.9 percent (still the strongest rate in the G-7), and U.S. growth to 3.0 percent; the largest declines were registered for the United Kingdom and Canada (to 2.3 and 2.9 percent, respectively); only in Germany was GNP growth stronger in 1989 than in 1988 (4.0 percent vs. 3.6 percent). Aggregate GNP growth for the G-7 countries was an estimated 3.4 percent last year, after 4.5 percent in 1988. Domestic demand followed a similar course, with G-7 growth easing from 4.7 percent in 1988 to 3.4 percent in 1989.

Two major factors accounted for the bulk of last year's domestic demand slowdown. First, while investment activity remained generally strong, there was a fairly widespread easing from the unexpectedly high growth rates in 1988. Contributing to the slowdown were a moderate scaling back of investment plans in the wake of the large increases in recent years, narrowed profit margins, and anticipation of a period of somewhat weaker demand growth ahead. Second, private consumption growth declined in each of the G-7 countries in 1989, pulling the aggregate growth rate from 3.7 percent in 1988 to about 3 percent; among the contributing factors were the limiting effects of selected tax and social payment increases and higher inflation on real disposable income gains, as well as, in some cases, higher household saving.

Aggregate macroeconomic developments in the United States and Japan continued to provide solid support for the current account adjustment process. In the United States, domestic demand grew more slowly than GNP for the third consecutive year, and improving net exports once again provided a significant growth impetus. The reverse was the case in Japan, where domestic demand growth again substantially exceeded GNP growth and net exports declined significantly. In Germany, however, domestic demand growth weakened appreciably (due in part to fiscal tightening), and lagged GNP growth by a considerable margin; rising net exports were thus an important source of overall growth. Macroeconomic developments in the United Kingdom (with a very large current account deficit) moved strongly in the direction of adjustment in 1989 as domestic demand growth cooled from its unsustainably high rate in 1988. Nevertheless, domestic demand growth in the United Kingdom (as well as in Canada) remained in excess of GNP growth.

Macroeconomic trends are expected to be broadly supportive of external adjustment within the G-7 again this year. As domestic demand growth eases further in the largest deficit countries (the United States, the United Kingdom and Canada), net exports should also improve. Although domestic demand growth in Japan is not likely to be as strong as in 1989, it should again exceed GNP growth, with net exports contracting further. Modest real external adjustment is likely in Germany as well this year, as a tax cut and economic integration with the German Democratic Republic boost domestic demand. Over the longer term, German economic and monetary union should have a positive and substantial effect in reducing Germany's external imbalances.

o Trade and Current Account Developments

World trade in 1989 largely reflected the macroeconomic developments discussed above: trade volume growth was not quite as robust as in 1988 (at 9.1 percent, the best year of the decade), but nevertheless remained quite strong (about 7.5 percent). Thus, the relationship between trade and output growth continues to track well with historical experience (roughly a 2:1 ratio).

The external imbalances of the two largest economies, the United States and Japan, declined substantially in 1989. Latest available data indicate that the U.S. current account deficit fell about an additional $21 billion in 1989, from $126.5 billion to $105.9 billion (2.0 percent of GNP); the trade deficit fell to $113.2 billion (2.2 percent of GNP). Japan's current account surplus declined from $79.6 billion in 1988 to $57 billion in 1989 (2.0 percent of GNP), and its trade surplus from $95 billion to $77.1 billion (2.7 percent of GNP). The aggregate current account surplus of the European Community (EC) fell to nearly zero last year after having been as high as $51 billion in 1986.

However, the overall external adjustment of the EC conceals some major imbalances that have developed among Community members. In particular, Germany's trade and current account surpluses continued to rise in 1989; at $72 billion and $53 billion, respectively, the German imbalances represent 6.5 and 4.4 percent of GNP, the largest such ratios in the G-7. The bulk of the increase in German surpluses has come in trade with other EC member countries, with which Germany's surplus has more than tripled since 1985. However, the impact of the growing German surpluses on the overall external position of the EC has been essentially offset by rising deficits in other member countries, especially the United Kingdom and Spain. The trade and current account deficits of the United Kingdom increased somewhat further in 1989, to $37 billion (4.5 percent of GNP) and $33 billion (4 percent of GNP), respectively.

These external account trends in 1989 partly reflect developments in the relative growth rates of exports and imports in individual countries. In the United States, real exports of goods and services (measured on the national accounts basis) increased nearly 11 percent (the third consecutive year of double digit growth) while import growth was 6.4 percent. Import growth of 21 percent in Japan again exceeded export growth (about 15 percent), though the latter strengthened substantially last year. In Germany, however, export growth accelerated to just over 10 percent, exceeding import growth of about 7 percent; and while import growth in the United Kingdom slowed and export growth strengthened, the former still exceeded the latter by about 7 percent to 4 percent.

Thus, underlying trade flows present a mixed picture of adjustment. U.S. trends continue to favor adjustment, though the pace of export growth has cooled; in Japan, import growth remains strong, but export growth has revived considerably; export growth revived strongly as well in Germany, but imports picked up only marginally.

Against the background of these underlying trends, and in light of the macroeconomic projections reviewed above, further external adjustment in the industrial countries is expected this year, but the composition and extent of the adjustment is open to question. In the United States and Japan, where adjustment has been the greatest in recent years, additional progress is likely to be much smaller and a modest widening of nominal imbalances cannot be excluded. Basic developments have brightened the adjustment prospects for Germany, but the very large existing imbalances suggest that substantial imbalances will remain.

However, developments in Europe could provide substantial impetus to the industrial country adjustment process over the next few years, with early signs perhaps beginning to emerge later this year. The unification of the two German economies is likely to be especially significant. The large population inflow into West Germany is already raising German domestic demand, due in part to the fiscal stimulus associated with higher transfers and infrastructure outlays. The additional demand can be met without undue inflationary consequences by diverting West German exports to domestic uses and by increasing imports. The net effect, over time, could thus be a significant reduction in the German surplus and a substantial increase in trade opportunities for non-German suppliers.

o <u>Inflation</u>

The increase in average inflation rates in the industrial countries in 1989 reflected the combined impact of several developments, including higher oil prices, excise tax increases in various countries, and generally higher capacity utilization rates. However, the bulk of the price runup occurred during the first half of the year, and for most countries inflation rates have tended to level off or subside since then.

A number of other factors appear likely to reinforce this more recent trend, which should push inflation moderately lower, on average, this year. Slower output and demand growth, coupled with the vigorous investment activity of the past few years, should ease pressures arising from higher capacity utilization and wage demands; and, the monetary and fiscal authorities are, for the most part, likely to continue to pursue a fairly restrictive course.

As a result, consumer price inflation is forecast to ease somewhat in each of the major industrial countries this year and to decline to slightly below 4 percent in the industrial countries in aggregate. Japan, Germany and France are expected to remain at the lower end of the G-7 group, with the United States and Canada in the middle, and Italy and the United Kingdom at the upper end.

U.S. Balance of Payments Developments and Trends

o Developments in 1989

The U.S. trade deficit, after declining markedly (by $32 billion) to $127 billion in 1988, fell further in 1989 to $113.2 billion. The 1989 trade deficit was the lowest since 1984. The improvement occurred largely in the first half of the year as the pace of adjustment slowed over the course of 1989.

The continued, but slowed decline in the trade deficit reflected moderation in both export and import growth. In 1989, exports rose 13.4 percent in value (11.8 percent in volume), well below the corresponding performance in 1988 when export values had surged 27.6 percent (23.5 percent in volume). Most commodities shared in the rather general, small slowing of export value growth in the latter half of 1989. The largest changes occurred in foods, feeds and beverages, and in the typically "lumpy" completed civilian aircraft sector. Import growth also slowed -- from 8.8 percent (6.5 percent in volume) in 1988 to 6.4 percent (5.6 percent in volume) in 1989. (See Table 2.)

Two on-going phenomena affected 1989 imports, and are likely to continue to influence U.S. trade data. Petroleum imports were up by $10.9 billion in value, to $50.2 billion in 1989, their highest level since 1985. Oil prices rose 19 percent; quantities were up 7.75 percent to 8.06 million barrels per day, a figure not seen since 1979. Total automotive imports actually declined in 1989; those from Japan declined for the third consecutive year. Along with a softening of demand for autos generally, the increases in production and sales by foreign-owned auto producers in the United States were a major factor slowing automobile imports.

Geographically, the 1989 decline in the trade deficit was concentrated in Western Europe; that bilateral trade deficit dropped $12.1 billion to $3.6 billion. Deficits with other countries or regions fell by lesser amounts: the deficit with the newly industrialized countries of the Far East fell $4.3 billion, to $25 billion; that with Japan dropped $2.9 billion, to $49.7 billion; and that with Canada by $2.4 billion to $8.5 billion. The only major bilateral trade deficit to increase was that with OPEC which was up $8.4 billion to $17.1 billion.

The 1989 deficit on the balance on current account was also the lowest since 1984. It stood at $105.9 billion, down $20.6 billion from $126.5 billion in 1988. For the year as a whole, the reduction in the trade deficit accounted for about two-thirds of the current account decline (some $14 billion), while an improved position on services (see below) accounted for the remaining third (about $7 billion).

The difference between the trade balance and the balance on current account largely reflects U.S. performance in services. The surplus on service transactions had peaked in 1981 at $43.8 billion; until 1986, the balances generally indicate an underlying deterioration in these accounts. However, in 1988 and 1989, the services surpluses were $15.4 and $22 billion respectively. Last year, services trade shifted from approximate balance in the first half to a surplus of almost $22 billion in the second. But that shift incorporated a swing from capital losses (some $8 billion) in the first half to capital gains (also $8 billion, for a total swing of $16 billion) in the second. Those losses and gains reflect the effects of exchange rate changes on the conversion of U.S. foreign investors' foreign currency profits to dollars. Whether, therefore, the full-year figure for 1989 services trade suggests some reversal of the previous declining trend in that position remains uncertain.

The recorded net inflow of capital in 1989 was $125.7 billion; unrecorded transactions (the statistical discrepancy) were $34.9 billion. Major contributors to the gross inflow were a record amount of inward direct investment ($61.3 billion, up from the previous high of $58.4 in 1988), and foreign private purchases of U.S. securities ($40.3 billion). On the outflows side in 1989, there was a substantial increase ($25.3 billion) in U.S. official reserve assets, reflecting exchange market intervention activity; direct investment outflows rose strongly (by $14.8 billion) to $32.3 billion, while purchases of foreign securities nearly trebled to $22.6 billion. (See Table 3.)

Prospects for 1990

As has been discussed, the U.S. trade deficit continued to decline in 1989, following its significant fall in 1988 from its 1987 peak. However, the pace of external adjustment slowed.

The outlook for 1990 is difficult to project with certainty. Most model-based forecasts project a modest widening in the U.S. current account deficit, although some project little change or even a slight improvement. These projections, however, are influenced by assumptions such as no policy changes, constant exchange rates, and unchanged structural characteristics of the U.S. and other major economies.

While conventional models provide very important information, they cannot capture the full range of factors at play in a dynamic world economy. For example, these models for the most part do not take into account the structural implications of recent developments in Eastern Europe and the prospective reunification of the two German economies. Also, they do not take into account the most recent exchange market developments, nor do they explain the strong role foreign direct investment may be playing in producing longer term and continuing adjustment of the current account. Furthermore, important developments that have taken place in the performance of the U.S. services account are less well understood than the merchandise trade accounts.

Despite our view that positive factors are at work in encouraging medium term external adjustment and that these factors are not captured by conventional models, it would appear that further improvement in the U.S. current account position in 1990 is likely at best to be very modest. Furthermore, the possibility of deterioration in the current account cannot be excluded.

PART III: FOREIGN EXCHANGE MARKET DEVELOPMENTS

o Overview

Over the past six months, foreign exchange market activity was characterized by an appreciation of the German mark in late 1989 and a depreciation of the yen in early 1990.

Since the October 1989 report, the German mark has appreciated by 10 percent against the dollar, while the Japanese yen depreciated by 11 percent (as of April 10). Against the mark, the yen depreciated by 19 percent. Continental European currencies generally mirrored the movement of the mark against the dollar. The British pound ended the period little changed. Early in this period, the market perceived the G-7 as favoring a lower dollar and remained generally wary of dollar intervention sales. (See Table 4.)

The period since the October 1989 report can be subdivided into two parts. The first, from October 1989 to January 1990, was characterized by appreciation of the mark in the aftermath of the September 1989 G-7 Statement and in response to developments in Eastern Europe, including East Germany. The second, from January through mid-April, was highlighted by a sharp depreciation of the Japanese yen.

In market intervention, U.S. authorities sold $2.5 billion between October and January.

October 1989 through January 1990: DM Appreciation

In the October-January period, the exchange value of the German mark rose in the aftermath of the September 1989 G-7 Statement, in response to changes in monetary policies in Germany and the United States, and in reaction to favorable perception of political changes occurring in Eastern Europe, notably the opening of the East German border and growing prospects for German unification, which were seen as providing attractive opportunities for real investment. During this time, the U.S. economy showed signs of slowing, and participants anticipated that changes in interest differentials would tend toward favoring placements in foreign currencies. However, foreign investor interest in German assets paused after the turn of the year, as uncertainties regarding German Economic and Monetary Union (GEMU) raised concerns about its potential inflationary risks. Such concerns moderated somewhat after the East German election in mid-March.

Foreign exchange markets were impressed by the forcefulness of the September 23, 1989, Statement of the G-7, which noted:

> "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 on exchange markets."

The G-7 monetary authorities intervened aggressively in the weeks immediately following the Statement.

Following the G-7 Statement and coordinated intervention, participants anticipated changes in official interest rates that would reinforce the desired trend in exchange rate movements. In the event, the Bundesbank raised its official rates by 1 percentage point (discount rate to 6 percent, Lombard rate to 8 percent) on October 5, 1989. The Bank of Japan raised its discount rate by 1/2 percentage point to 3-3/4 percent on October 11, 1989, and to 4-1/4 percent on December 25, 1989. The Federal Reserve eased reserve conditions in successive steps, with the result that the Fed funds rate fell from 9 percent at the end of September to 8-1/4 percent by the end of December.

With these changes in the relative stances of monetary policies, around mid-November, German interest rates neared U.S. interest rates, and this narrowing of interest rate differentials supported the mark's appreciation in late 1989. Meanwhile, indications of slowing U.S. economic activity fostered market expectations of moderating growth, diminished price pressures, and further declines in U.S. yields. (The October 13 stock market drop only sharpened market participants' focus on the perceived weakening in U.S. economic fundamentals, and by early December, the softness in the economy was viewed as confirmed by the U.S. November employment data.)

Elsewhere, economic activity remained more buoyant, and the West German economy in particular was thought to be operating near capacity. The opening of the East German border in early November was seen as likely to provide a further stimulus to growth and investment and, consequently to raise real yields on DM assets. German monetary officials welcomed the DM's rise against the dollar. Also, in late October, German monetary officials reportedly had begun expressing interest in a revaluation of the DM within the European Monetary System (EMS), and this contributed to the rise of the DM into early January, when the Italian lira was realigned in the EMS and Italy joined the narrower $\pm$2-1/4 percent band.

Around mid-January, however, flows from dollars into marks stalled as the market grew increasingly concerned about the potential inflationary implications of GEMU. Meanwhile, flows into dollars were supported by some perceptions of a pickup in U.S. economic activity. The mark then began trading within a moderate range, slightly off its January highs, with its movements against the dollar at times influenced by developments in Eastern Europe and the Soviet Union.

February - April: Bearishness Toward the Yen

Between October and January, the yen traded in a fairly narrow range against the dollar. However, the yen had already declined considerably against the German mark in late 1989, as market concern about the inflation of Japanese asset values became evident. Substantial flows from Japan into German equities were registered at that time, although the effect on Japanese asset values was masked by the climb of Japanese stock prices to record levels by end-December.

Since mid-February, the yen has weakened substantially against other major currencies more generally, including the dollar, in response to to political uncertainties in Japan, market perceptions about the stance of official Japanese interest rate policy, and unease associated with the decline in Japanese equity markets. The decline of the yen became particularly pronounced in March. Also, during this period, U.S. interest rates rose and some participants took the view that U.S. economic growth might be "bottoming out."

Sentiment towards the yen in late January and early February was affected by political uncertainties ahead of the mid-February elections and the reluctance to tighten monetary policy further. The depreciation of the yen accelerated after the Japanese monetary authorities did not hike interest rates in the wake of the ruling Liberal Democratic Party's February 18 election victory and as Japanese equity markets declined. Market perceptions that an opportunity to raise official rates had been missed seemed to crystallize pessimism toward the yen. Subsequently, bearishness toward the yen increased rapidly in light of the market's concerns about Japanese economic policy and political conditions. Market perceptions of U.S.-Japan trade tensions were also bearish for the yen.

In this period, expressions of concern about yen depreciation by leading Japanese monetary officials, and about attendant risks to Japanese inflation and trade adjustment, were outweighed in the market's eyes by the absence of a change in the discount rate and the political uncertainties. Moreover, some Japanese monetary authorities repeatedly suggested that, barring a sharp drop of yen, they would rely on intervention rather than interest rates to support the yen. At the same time, however, the market came to believe increasingly that the yields on yen assets should be adjusted upward. A 1 percentage point discount rate hike (to 5-1/4 percent on March 20) came amid active buying of dollar assets that kept the yen, and Japanese stocks and bonds, under pressure throughout March. This hike had been largely discounted in advance, and the market looked for another hike in the near term.

In early March, President Bush and Prime Minister Kaifu reaffirmed cooperation on exchange rates. Later, market participants concluded that a meeting between U.S. Treasury Secretary Brady and Japanese Finance Minister Hashimoto did not produce commitments to support the yen. However, reports that the G-7 would meet on April 7 instilled caution into the markets.

The G-7 Ministers and Governors stated at their April 7 meeting that the decline of the yen against other currencies was having undesirable consequences for the global adjustment process. After appreciating slightly immediately following the G-7 announcement, the yen eased back to levels slightly below those prevailing prior to the meeting.

During the February through April period, the DM has traded narrowly against the dollar. Despite market concerns over the implications of GEMU in this period, participants felt GEMU would also support German growth. They also reacted favorably to the mid-March election outcomes in East Germany.

PART IV: ECONOMIC POLICY COORDINATION

In recent years, the major industrial countries have developed the G-7 economic policy coordination process to put in place the consistent and compatible economic policies necessary for sustained growth with low inflation, reduced external imbalances and greater stability of exchange rates. Under this process, substantial progress has been made in achieving the G-7's shared objectives.

The economic expansion has been sustained for eight consecutive years. Economic growth is slowing in several countries this year to more sustainable levels. However, overall growth prospects remain good. Inflation remains contained, reflecting the vigilance of authorities as well as the subsiding of temporary factors last year. External imbalances have been reduced, particularly in Japan and the United States.

These favorable developments have occurred in part due to the important role of the coordination process in promoting greater stability of the international monetary system in the face of significant changes, at times, in the world economy. Since the October report, further significant fundamental changes have taken place, including most notably the efforts of Eastern European countries to restructure political and economic life, and developments in global financial markets, particularly in Japan. Economic policy coordination, including cooperation in exchange markets, represents the most effective means of assuring that these profound changes now underway are managed in an orderly manner that contributes to the G-7's shared objectives.

Against this background, the G-7 Finance Ministers and Central Bank Governors met in Paris on April 7 to take stock of these changes and to review economic and financial developments in their countries. They noted that the major countries will need to continue their close cooperation on macroeconomic and structural policies and remain vigilant against current inflation rates. Both surplus and deficit countries have a shared responsibility to promote an open and growing world economy. Deficit countries, including the United States, should further reduce budget deficits and increase private savings. Surplus countries must contribute to external adjustment by promoting non-inflationary growth of domestic demand.

The depreciation of the Japanese yen has occurred in the context of a significant adjustment in Japanese equity prices as well as a correction in other Japanese asset values. The yen's weakness is a matter of concern, with undesirable consequences for the global adjustment process. The G-7 will keep these developments under review.

The restructuring of Eastern European economies away from central planning towards market-orientation will represent one of the key challenges of the 1990s. In this regard, the prospective unification of the German economies should contribute to improved global growth, to increased investment opportunities, and to a further reduction of external imbalances. Strong German domestic demand growth and a reduced current account surplus would be most welcome, especially in light of Germany's extremely large current account surplus and forecasts suggesting this surplus could widen further this year to roughly $65 billion, equivalent to nearly 5 percent of GNP.

PART V: ASIAN NEWLY INDUSTRIALIZED ECONOMIES (NIEs)

Overview

Since the release of the October 1989 report, both Korea and Taiwan's exchange rate have depreciated against the dollar. The New Taiwan (NT) dollar was stable following the October report, depreciated in early March, and has since firmed slightly. On balance, NT dollar depreciation since October has totaled 2 percent. The Korean won has steadily depreciated since the October report by a total of 5 percent against the dollar. Over the longer term, however, the NT dollar has strengthened by 54 percent and the Korean won by 27 percent since the Plaza Agreement in September 1985. (See Table 5.)

The Treasury Department began discussions with the Asian NIEs in summer 1986 on their exchange rate and related policies against the backdrop of their rising external surpluses, particularly their surpluses with the United States. The U.S. merchandise trade deficit with the Asian NIEs as a group -- Korea, Taiwan, Hong Kong, and Singapore -- peaked in 1987 at $34.1 billion and has declined a total of 29 percent since then. In 1989 alone, the trade deficit with the Asian NIEs fell $3.9 billion to $24.3 billion, a 14 percent decline from 1988. This compares to an 8 percent decline in the overall U.S. trade deficit from 1988 to 1989. As a proportion of the overall U.S. trade deficit, the deficit with the NIEs fell from 24 percent to 22 percent in the same period.

Under Section 3004 of the 1988 Trade Act, the Secretary of the Treasury is required to "consider whether countries manipulate the rate of exchange between their currency and the U.S. dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade." It was concluded in the October 1988 and April 1989 reports that both Taiwan and Korea "manipulated" their exchange rates, within the meaning of the legislation. Pursuant to Section 3004, the Treasury was required to initiate bilateral negotiations with Taiwan and Korea for the purpose of ensuring that these two economies regularly and promptly adjust the rate of exchange between their currencies and the U.S. dollar to permit effective balance of payments adjustment and to eliminate the unfair advantage. Subsequently to the October 1988 report, the Treasury Department initiated bilateral negotiations with both Taiwan and Korea on their exchange rate policies, as well as continuing talks with them on their associated macroeconomic and structural policies.

In October 1989, in view of the change in Taiwan's exchange rate system that had occurred during the course of the negotiations, and certain other factors, the Treasury concluded that there were no clear indications that Taiwan was "manipulating" its currency for competitive advantage within the meaning of the legislation. We also indicated, however, that we would continue to monitor Taiwan's exchange rate policy closely, in view of the importance of such policy in furthering the adjustment of Taiwan's large external surpluses. Regarding Korea, the Treasury determined that there were indications of continued exchange rate "manipulation."

Following is a summary of the economic and exchange rate developments in Taiwan and Korea since our October 1989 report.

Taiwan

The appreciation of the NT dollar since 1985 has been a central element in the decline of Taiwan's external trade surpluses. In the past year, the NT dollar's appreciation has stalled, although other factors -- rising wages, inflationary pressures, and reduction of trade barriers -- have contributed to lowering the external surpluses. We expect this adjustment process to continue.

o Exchange Rate Developments

Since the October 1988 report, Taiwan's exchange rate has appreciated by 10 percent, more than that of any other major trading partner. Much of this appreciation occurred in a short period following the April 1989 report. The NT dollar thereupon fluctuated within a narrow range from May 1989 until early March of this year. At that time, the exchange rate depreciated by 1 percent. It has since rebounded slightly and stabilized.

The recent depreciation of the NT dollar was the result of a number of factors. Most importantly, there has been widespread attention in the local foreign exchange market to political uncertainties, especially prior to the March Presidential election. As such, large net capital outflows were reported in the first quarter of this year. The depreciation of the NT dollar was slowed by sizable sales of U.S. dollars by Taiwan's Central Bank.

There is some domestic pressure in Taiwan to depreciate the NT dollar. This view, however, ignores the fact that the recent depreciation was mostly due to speculators seizing on factors that may be short term. In this regard, the Central Bank has rightly noted that depreciation may not reflect Taiwan's still strong economic fundamentals and would have some adverse consequences. For one, the external surpluses, although declining, are still at unsustainably high levels. Real GNP growth also remains strong. Moreover, any potential benefit to exporters from devaluation would likely be negated by a fueling of inflation. Inflation, which has climbed primarily due to the build-up of excess liquidity generated by the large external surpluses, currently may pose the greatest threat to the economy. In addition, depreciation would send the wrong signals to producers by not encouraging the move toward higher value-added goods and weakening the role of domestic demand in economic growth.

o <u>Trade and Economic Developments</u>

In absolute terms, Taiwan's global current account surplus rose 9.5 percent in 1989 to $11.2 billion. As a proportion of GNP, this surplus translated into a decline to 8 percent from 8.5 percent in 1988 and 18.1 percent in 1987. Taiwan's overall trade surplus (cif basis) increased by 27 percent to $14 billion. Our bilateral trade deficit with Taiwan grew 3 percent last year to $13 billion.

The above data include extraordinary purchases of $2.5 billion of gold from the United States by Taiwan's Central Bank in 1988. If these one-time purchases are excluded, the trend in the external accounts continued downward in 1989. For example, the current account surplus fell 15 percent last year, if the 1988 gold purchases are excluded, and the U.S. bilateral trade deficit with Taiwan declined by 14 percent.

These surpluses, whether including or excluding the 1988 gold purchases, are excessively high.

The appreciation of the NT dollar from 1985 to 1989 has had an overall positive impact on the restructuring of the economy. Appreciation has encouraged the production of higher value-added goods and the movement of lower value-added production offshore. In addition, domestic demand has replaced exports as the main source of growth for the economy, with Taiwan's consumers benefiting from years of high savings. At the same time, unemployment, at 1.7 percent, is at an historical low.

Following years of very rapid growth, real GNP growth has been at a more sustainable level since 1988. Last year growth fell slightly to 7.2 percent. Inflation climbed from 1.3 percent in 1988 to 4.4 percent last year. Despite credit tightening measures and capital outflows, inflationary pressures continue to be a serious problem.

As a result of a rise in net capital outflow, Taiwan posted its first overall balance of payments deficit since 1977 last year. This led to a slight fall in foreign exchange reserves to $73 billion, the world's second largest stock at the end of 1989.

In the first three months of this year, Taiwan's overall trade surplus declined by 35 percent over last year to $1.8 billion. In February there was an overall trade deficit of $300 million, although this owed much to special factors including imports delayed during end-January's Chinese New Year holiday and the delivery of a passenger airplane.

According to Taiwan's data, the trade surplus with the United States was down by 23 percent to $1.9 billion in the first quarter of this year. Over the last three months for which U.S. data are available (November 1989 to January 1990), our trade imbalance with Taiwan at $3.4 billion is lower by 18 percent from the same period in the previous year and by 29 percent from the preceding three-month period. If this latest quarter were annualized, it would still lead to a large bilateral trade imbalance of $11.3 billion.

- <u>Exchange Rate System</u>

Taiwan instituted a new exchange rate system at the time of the April 1989 report that significantly reduced the authorities' ability to manipulate the rate. The system allowed for most foreign exchange transactions to be freely determined. Thereafter, Taiwan took a number of measures to further liberalize the system and reduce capital controls.

Currently there is no evidence that the Central Bank has been substantially intervening directly in the market to gain competitive advantage. In fact, as noted earlier, the Central Bank has recently intervened in the market to control downward pressure on the NT dollar.

In the October 1989 report, a number of remaining impediments to liberalization of the Taiwanese financial system were identified. Since the October 1989 report, Taiwan has addressed several of these impediments. The ceiling on a foreign exchange bank's short (oversold) position in spot transactions was doubled in December. Taiwan also raised the limit on foreign liabilities of foreign exchange banks by 30 percent, effective March 10. This should permit banks to increase their foreign exchange activities.

Taiwan also established the Foreign Exchange Development Foundation in late February to operate the interbank foreign exchange market and the new U.S. dollar call market, which reduces the cost of short-term foreign exchange funds. Taiwanese authorities are developing a plan to introduce foreign exchange dealers into Taiwan in one or two years.

In another positive step, the limit on annual foreign exchange inflows was raised to $1 million per entity in November. This limit, however, is still one-fifth the size of permissible capital outflows and impedes market forces. Given that there has been no surge in capital inflows and the NT dollar is stable, there is little justification for not soon raising the limit to at least the level of that for outflows.

Despite the recent relaxation of ceilings on "long" and "short" foreign exchange positions, their existence, plus the method of calculating the foreign exchange positions of a bank, effectively prevents a forward foreign exchange market from functioning. Contrary to international practice, Taiwan shifted from an accrual to a cash basis for calculating a bank's foreign exchange position in 1987 to discourage speculation on an appreciating NT dollar. On a cash basis, forward foreign exchange positions are not calculated. In addition, although the ceilings have not been reached they also discriminate against foreign banks since they are based on local assets. These assets are relatively small since Taiwan has restrictions on foreign banks' operations and branches.

o <u>Assessment</u>

We are encouraged by the fall -- albeit modest -- in Taiwan's external surpluses (adjusted for the 1988 gold purchases) over the past year and the continued liberalization of the exchange rate system, which more accurately reflects market forces. On balance, we are of the view, as expressed in the October 1989 report, that there is no evidence of direct exchange rate manipulation for competitive purposes.

We remain concerned, however, about the persistence of Taiwan's large external surpluses. Moreover, it can be argued that, despite the lack of evidence of direct exchange rate "manipulation," Taiwan's remaining exchange and capital controls -- recent liberalization notwithstanding -- constitute a mechanism for indirect "manipulation" by distorting supply and demand in the market. These factors underscore the importance of continued liberalization of remaining exchange and capital controls and, more generally, of exchange rate policy in contributing in the months ahead to the necessary further reduction of Taiwan's unsustainably large external surpluses.

<u>Korea</u>

The Korean won has depreciated about 6 percent in nominal terms against the U.S. dollar since the won's strongest point in April 1989, but remains some 27 percent stronger against the dollar than it was at the time of the Plaza Agreement in September 1985. In 1988, the won began to strengthen significantly against other G-7 currencies, particularly the yen, resulting in broad appreciation on a trade-weighted basis. These currency movements, aided by wage and other developments, contributed to a substantial decline in Korea's external surpluses in 1989. A further, but smaller, decline is possible this year.

Notwithstanding the decline in Korea's external surpluses in 1989, exchange rate policy continues to have an important role to play in Korea's external adjustment, including the needed further reduction of the trade imbalance between the United States and Korea. In this context, the steady depreciation of the won against the U.S. dollar since April 1989 raises some concerns. Introduction of the new "market average rate" system of exchange rate determination on March 2, 1990, is an important development. The eventual success of this system, however, depends on how it is implemented. In particular, liberalization of pervasive foreign exchange and capital controls is necessary to give greater scope to the forces of supply and demand in the exchange market.

Another development since the October 1989 report was the initiation of Financial Policy Talks between the Ministry of Finance and the Department of the Treasury. These talks provide a possible mechanism for addressing problems that U.S. banks and securities firms face in gaining access to the Korean financial services market. The initial round of these talks was held in late February, but much remains to be done before U.S. banks and securities firms can compete on an equal footing with their Korean counterparts.

o <u>Exchange Market Developments</u>

New Exchange Rate System (MAR)

The "market average rate" (MAR) system of exchange rate determination was introduced on March 2. Under this system, the won/dollar exchange rate at the beginning of each business day is equal to the weighted average rate of transactions in the inter-bank market on the preceding business day. Exchange rates between the won and third currencies are set in accordance with dollar rates in international currency markets.

During each business day, the won/dollar inter-bank rate is permitted to fluctuate within a band of ± 0.4 percent. Foreign exchange banks, including 53 foreign bank branches, are free to set customer rates within bands of ± 0.4 percent for won/dollar telegraphic transfer (TT) transactions and ± 0.8 percent for dollar-third currency TT transactions. A ± 1.5 percent band is established for cash customer transactions.

Recent Exchange Rate Movements

During the the first five weeks of operation of the MAR system:

-- The won depreciated 1.8 percent against the U.S. dollar in nominal terms and 1 to 4-1/2 percent against most other G-7 currencies and the new Taiwan (NT) dollar.

-- The won appreciated 3.6 percent against the yen, reflecting the weakness of the yen in international markets, offsetting on a trade-weighted basis most of the won's appreciation against the other currencies.

-- Foreign banks accounted for the majority of transactions in the inter-bank market.

-- The Bank of Korea (BOK) was not a direct participant in the market; and other government-owned banks accounted for a small share of inter-bank activity.

Since late April 1989, when the won reached its strongest point at 665/U.S. dollar, the won has depreciated nearly 6 percent against the U.S. dollar, 2-8 percent against the British pound and Canadian and NT dollars, and 15-16 percent against the German mark, French franc, and Italian lira. In the same period, however, the won has appreciated 13 percent against the yen, reflecting the generalized depreciation of the yen. Thus, on a trade-weighted basis, the won is virtually unchanged from its April 1989 level.

Given these developments, the won's cumulative nominal appreciation against the U.S. dollar since the Plaza Agreement in September 1985 has fallen to 27 percent. For the same period, the won's cumulative nominal appreciation now totals 6 percent against the Canadian dollar and 4 percent against the British pound. The won remains roughly 18-20 percent weaker in nominal terms than the yen, the French franc, Italian lira, and NT dollar, and 26 percent weaker than the German mark in nominal terms than it was in September 1985. Taking these various currency movements into account, the won is estimated to be roughly equal to its September 1985 level in trade-weighted terms.

Recent Changes in Foreign Exchange Controls

The government eased some foreign currency and capital controls as of March 1 to: allow certain Korean companies to purchase and hold up to $10 million in foreign currencies; raise the limits on overseas investment by Korean securities firms from $30 million to $50 million and by Korean insurance and investment and trust companies from $10 million to $30 million; and allow Korean banks for the first time since 1987 to obtain up to $2 billion of long-term capital from foreign banks or from the issuance of bonds in foreign markets.

- Trade and Economic Developments in 1989

GNP Growth

Economic performance in 1989 was weak by Korean standards, but strong by any other. Real GNP grew 6.7 percent. This compares with over 12 percent in each of the three previous years and was the lowest rate since 1981's 5.9 percent. Construction boomed (up 15.4 percent), but manufacturing was weak (up 3.7 percent) and agriculture declined (- 0.7 percent). On the expenditure side, consumption was up 9.5 percent, surpassing for the first time in several decades the rate of growth of GNP. Investment remained healthy, increasing 16.2 percent, including a 12.3-percent increase in plant and equipment. Inflation eased from 7.1 percent to 5.7 percent. Unemployment remained virtually unchanged at 2.6 percent.

Wages increased 21 percent on average for the 30 largest manufacturing companies through end-October, compared with increases of 12 percent and 20 percent in 1987 and 1988, respectively. Labor-management unrest lowered productivity gains to 7.1 percent in 1989, compared with 12 percent in 1987 and 1988, and resulted in production losses equal to an estimated 3.1 percent of GNP.

External Accounts

The current account surplus dropped 64 percent to $5.1 billion (2.5 percent of GNP), compared with $14.2 billion (8.4 percent of GNP) in 1988. The trade surplus also fell -- 61 percent to $4.5 billion, compared with $11.4 billion in 1988. Exports grew only 2.7 percent in value and declined 5.4 percent in volume. Footwear, toys, and especially automobiles accounted for most of the volume decline. Textiles, machinery and electronics, which account for more than half of exports, showed volume growth -- about 7 percent in the latter case. It is estimated that labor-management disputes were responsible for export losses of $1.4 billion. Imports expanded 17.8 percent in value and 14.3 percent in volume. Consumer goods, however, accounted for only 14 percent of the total import growth, with raw materials (54 percent) and capital equipment (32 percent) accounting for the rest of the import growth.

According to U.S. customs data, the U.S. trade deficit with Korea has shown no significant growth since the first quarter of 1988. In 1989, it declined 30 percent to $6.3 billion. This decline reflects a 19 percent increase in U.S. exports to Korea (compared with 39 percent in 1988) and a 3 percent drop in U.S. imports from Korea (compared with a 19 percent increase in 1988).

Korea's gross external debt declined to $29.4 billion in 1989, equal to only 14 percent of GNP, compared with 28 percent of GNP as recently as 1987 and 52 percent of GNP in 1985. Total interest and amortization payments as a ratio of exports of goods and services declined from 14 percent in 1988 to only 10 percent in 1989. Excluding Korea's voluntary prepayments of principal, the 1989 debt service ratio was only 8 percent.

With the increase in international reserves to $15.2 billion (3.2 months' import coverage) and in other foreign assets, Korea's net external debt declined to only $3.0 billion by end-1989.

- <u>Trade and Economic Developments in 1990</u>

Preliminary BOK data indicate that Korea registered a $646 million current account deficit in January-February 1990, compared with an $888 million surplus in the same period in 1989. This included a $722 million trade deficit for the two months ($694 million trade surplus in January-February 1989).

Exports fell 12 percent in value in January but rose 6 percent in February, compared with the same months in 1989, while imports grew 6 percent and 23 percent, respectively. Further trade and current account deficits appear likely in March.

According to U.S. customs data, the U.S. bilateral trade deficit with Korea declined a further 33 percent to $455 million in January 1990 (the latest month for which data are available). This was based on a 23 percent increase in U.S. exports to Korea to $1.2 billion, while U.S. imports from Korea were unchanged at $1.6 billion. For the latest three months (November 1989 to January 1990), the U.S. trade deficit with Korea stands 44 percent lower than it did in the same period in 1988-89.

Wage demands in the first quarter were less than half the level in the first quarter of 1989. The number of strikes is 79 percent lower so far this year. These developments should have a favorable impact on both growth and the external accounts. Indeed, production and export losses are only 3-4 percent of what they were in the first quarter of 1989. On the downside, inflation is creeping up to a 12-13 percent annual rate. The government is forecasting stronger economic performance in the second half of the year, and has not changed its projections for 6-7 percent real GNP growth and a $2 billion current account surplus for 1990 as a whole. The government also expects that Korea will be a net international creditor by end-1990.

The recent merger of three leading political parties to create the new, ruling Democratic Liberal Party and the subsequent changes in leadership at the economic ministries have created public expectations in Korea that "growth-first" measures to stimulate the economy, and exports in particular, will be reemphasized. It is also expected that policies designed to improve social welfare and income and wealth distribution, while not neglected, will receive correspondingly less attention.

The new economic policy package announced on April 4, which builds on measures adopted in December 1989, bears out these expectations. To stimulate investment and exports, the package includes:

-- Subsidized interest rates, higher credit ceilings, and tax incentives for investment and R&D in manufacturing and, particularly, exports; lower corporate income tax rates for manufacturing, as compared with services; streamlined government approval procedures for new manufacturing/export investments; and funds for technology development and training, especially aimed at small and medium-sized enterprises.

Other recent policy measures include:

-- Indefinite postponement of introduction of the requirement to use real names in conducting financial transactions.

-- Higher taxes, tighter credit, and possible economic and social sanctions to discourage "professional" or "habitual" real estate speculators.

-- Tax reform to ease the burden on low-income wage earners along with other measures to increase incentives for construction of rental or low-income housing, employee education, and other benefit programs.

-- Wage guidelines and controls and reductions in charges on public utilities.

-- Tight restrictions on consumer credit, higher excise taxes, income tax assessments based on observed "standard of living" rather than reported income, and restraints on overseas travel expenditures (December 1989 policy package).

o <u>Financial Policy Talks</u>

Korea's impressive economic growth in recent years has not been matched by comparable development and liberalization of its financial system. Despite some steps to liberalize controls and provide national treatment to U.S. and other foreign financial institutions, the system remains characterized by pervasive government intervention in financial intermediation and significant constraints on the ability of U.S. and other foreign financial institutions to compete on an equal footing with Korean institutions.

With these problems in mind, the Treasury Department and the Korean Ministry of Finance initiated a new series of Financial Policy Talks in late February. These talks will provide a mechanism for addressing specific market access problems that U.S. banks and securities firms face in doing business in Korea and also allow a dialogue on the need for broader liberalization of Korea's financial, capital, and exchange markets.

In the first round, the Korean government gave positive signs of its willingness to address some specific issues, but necessary follow-up actions remain to be taken. We will be continuing these talks in the period ahead. The October 1990 report on International Economic and Exchange Rate Policy and the December 1990 report to the Congress on Foreign Treatment of U.S. Financial Institutions provide target dates for achieving substantial progress on these matters.

o <u>Assessment</u>

Korea has achieved a large and welcome reduction in its current account surplus, from 8.4 percent of GNP ($14.2 billion) in 1988 to 2.5 percent of GNP ($5.1 billion) in 1989. Also, the U.S. bilateral trade deficit with Korea declined by 30 percent in 1989 to $6.3 billion. These imbalances, although sharply reduced, remain large and there is room for further reductions. In this regard, it is noteworthy that Korea's current account registered a deficit for the first two months of this year, although a surplus is expected for the year.

The won has depreciated 5 percent against the dollar since the October report, and by 1.8 percent since the introduction of the new exchange rate system on March 2. The depreciation against the dollar in the latter period, however, appears largely attributable to Korea's trade and current account deficits in the first two months of this year and capital outflows associated with concerns about the possible introduction of the "real name" financial system (now indefinitely postponed). Moreover, on a trade-weighted basis, the won's value has not significantly changed in this period. There is no evidence of the government conducting transactions in the inter-bank market for the purpose of directly influencing the exchange rate.

In view of these developments in Korea's external accounts and in its exchange markets, there are no clear indications at this time that the Korean won continues to be directly "manipulated," within the meaning of the legislation, by the authorities to gain unfair competitive advantage.

Nonetheless, exchange rate policy continues to have an important role to play in fostering external adjustment. Introduction of the "market average rate" system of exchange rate determination was a positive step forward. The real significance of this step, however, will depend on the government's willingness to ease the pervasive controls on capital flows and the types and amounts of permissible foreign currency transactions that give it effective tools for indirectly "manipulating" supply and demand in the currency market and, thus, the exchange rate itself. In this regard, the recent liberalization of controls on certain foreign currency transactions by large Korean corporations and on overseas investments of Korean financial institutions should increase pressure for the won to depreciate. Controls on capital inflows should be liberalized to offset this effect. It is not clear, however, that the net impact of the allowable $2 billion in foreign borrowing by Korean banks will accomplish this. If the proceeds of these borrowings are on-lent in foreign currencies for the overseas expenses of Korean corporations, there may be little effect on the exchange rate.

Despite the lack of evidence of direct government "manipulation" of the exchange rate via transactions in the market, we remain concerned about the won's nominal depreciation against the U.S. dollar since April 1989 (although, in trade-weighted terms, there appears to be little change). By raising the cost of Korea's dollar-denominated imports, including its oil imports, depreciation will add to inflation, the increase in which is already a concern to policymakers. The resulting loss of real purchasing power could well lead to higher wage demands over the long-term, offsetting any beneficial short-term impact of depreciation on competitiveness. Moreover, as the United States is Korea's largest export market, depreciation against the dollar is likely to encourage the inefficient production of certain lines of exports in which Korea has already been losing competitiveness relative to lower wage-cost Asian competitors.

The recent policy measures signal greater government intervention in the economy and add to our concern. While we understand the government's concern about the sharpness of the declines in Korea's external surpluses in 1989, this reflects largely the long delay in beginning the adjustment process (the won did not begin to appreciate significantly against the dollar and, especially, the major non-dollar currencies until 1988). On balance, the new policies appear likely to delay the adjustment process. Aimed at increasing exports and suppressing domestic demand, the new measures may reinforce Korea's dependence upon exports as a source of growth and jeopardize the encouraging shift that appeared to have begun in 1989 toward greater reliance upon domestic demand as a source of growth.

In the period ahead, we will continue to monitor Korea's trade developments and the operation of the new exchange rate determination system closely. In the Financial Policy Talks, we will continue to encourage liberalization of Korea's financial, capital, and exchange markets as well as seek improved treatment for U.S. financial institutions.

PART VI: CONCLUSION

This report has provided an update of developments since October 1989, when the second annual report on international economic and exchange rate policies was submitted to Congress.

Global economic performance has remained favorable since the October 1989 report. The economic expansion in the industrial countries has been sustained for eight consecutive years. Economic growth is slowing in several countries, but to more sustainable levels. Strong investment is providing a major stimulus to the G-7 economies, and the prospects for overall growth remain good. Inflation remains contained, reflecting the vigilance of authorities and the subsiding of several temporary factors, last year, which placed upward pressures on inflation rates.

Substantial reductions in external imbalances have been achieved, particularly in Japan and the United States. The U.S. trade deficit fell further in 1989, by nearly $14 billion to $113 billion, and the current account deficit fell by some $21 billion to $106 billion. The pace of global external adjustment has slowed, however. Despite our view that positive factors are at work in encouraging medium term adjustment and that these factors are not captured by conventional models, further improvement in the U.S. current account position in 1990 is likely at best to be modest. Furthermore, the possibility of deterioration in the current account next year cannot be excluded.

The economic policy coordination process has contributed importantly to the favorable performance of the world economy in the current expansion. Continued economic policy coordination, including cooperation in exchange markets, will be essential in assuring that the profound changes underway in the world economy -- most notably, the changes in Eastern European political and economic life and developments in global financial markets -- are managed in an orderly manner that contributes to sustained growth, low inflation, and reduced external imbalances.

- Both surplus and deficit countries have a shared responsibility in this regard. Surplus countries must sustain non-inflationary growth of domestic demand. Deficit countries should further reduce budget deficits and increase private savings.

- All countries should promote appropriate structural reforms.

-- The depreciation of the Japanese yen has occurred in the context of a significant adjustment in Japanese equity prices as well as a correction in other Japanese asset values. This depreciation is a matter of concern, with undesirable consequences for the adjustment process. The G-7 will keep these developments under review.

-- The restructuring of Eastern European economies towards a market basis and the reunification of the German economies should contribute to improved global growth and to a reduction of external imbalances. This will be a most welcome development, especially in light of Germany's massive and growing external surpluses.

Other economies have a clear and complementary responsibility in promoting sustained non-inflationary world growth and adjustment of external imbalances. In the October 1988 and April 1989 reports on International Economic and Exchange Rate Policy, it was determined that Taiwan and Korea, within the meaning of Section 3004 of the Omnibus Trade and Competitiveness Act of 1988, were "manipulating" their exchange rates against the U.S. dollar to prevent effective balance of payments adjustment or gain unfair competitive advantage in international trade. In the October 1989 report, it was concluded that there were no clear indications Taiwan was "manipulating" its currency within the meaning of the legislation, but that there were indications of continued exchange rate "manipulation" by Korea.

Taiwan, last April, instituted an exchange rate system that allowed for most foreign exchange transactions to be freely determined. Since last October, a number of impediments to liberalization of the Taiwanese financial system have been addressed.

The appreciation of the NT dollar since 1985 has been a central element in the decline of Taiwan's external surpluses in recent years. Last year, however, Taiwan's global current account surplus rose by 9.5 percent to $11.2 billion and as a share of GNP it declined slightly to 8 percent. The U.S. bilateral deficit with Taiwan also rose in 1989. The rise in Taiwan's external surpluses in 1989 in part reflected the effects of extraordinary purchases of $2.5 billion of gold from the United States in 1988. Excluding these one-time purchases, Taiwan's current account surplus fell 15 percent and our bilateral deficit with Taiwan fell 14 percent. Nonetheless, these surpluses, whether including or excluding the 1988 gold purchases, remain excessively high.

Between May of 1989 and early March of this year, the NT dollar fluctuated narrowly against the U.S. dollar. Subsequently, it depreciated by 1 percent, before rebounding slightly. The decline reflected a number of factors, including significant capital outflows in response to continuing political uncertainties, and was resisted by the Central Bank. There is no evidence that the Central Bank has been intervening directly in the market to gain unfair competitive advantage. Moreover, the Central Bank has rightly noted that NT dollar depreciation does not reflect Taiwan's still strong economic fundamentals and would have some adverse consequences.

On balance, we remain of the view, as expressed in the October 1989 report, that there is no evidence of exchange rate "manipulation" by Taiwan. There is still reason, however, to be concerned about Taiwan's unsustainably large external surpluses. The adjustment process must continue. Liberalization of remaining exchange and capital controls and, more broadly, exchange rate adjustment need to play a role in this process. The Treasury Department will continue to monitor the situation carefully.

Korea has achieved a large and welcome reduction in its current account surplus, from 8.4 percent of GNP ($14.2 billion) in 1988 to 2.5 percent of GNP ($5.1 billion) in 1989. Also, the U.S. bilateral trade deficit with Korea declined by 30 percent in 1989 to $6.3 billion. Korea's current account registered a deficit for the first two months of this year, although a surplus is expected for the year as a whole.

Korea introduced a new "market average rate" system of exchange rate determination on March 2. Since this system's introduction, there is no evidence that the government is conducting transactions in the inter-bank market in order to directly influence the exchange rate.

The won has depreciated 5 percent since the October 1989 report, and by 1.8 percent against the dollar since the introduction of the new exchange rate system. But the depreciation in the latter period appears largely attributable to Korea's trade and current account deficits in the first two months of this year and capital outflows associated with concerns about the possible introduction of the "real name" financial system (now indefinitely postponed). In trade-weighted terms, the won appears to have changed little since April 1989.

In view of these developments in Korea's external accounts and exchange market, there are no clear indications at this time that the Korean won continues to be "manipulated," within the meaning of the legislation, by the authorities to gain unfair competitive advantage.

Nonetheless, exchange rate policy continues to have an important role to play in fostering external adjustment. In particular, the government needs to allow supply and demand to function more freely in the exchange market. The government's pervasive controls on capital flows and the types and amounts of permissible foreign currency transactions give it effective tools for indirectly influencing supply and demand in the currency market and, thus, the exchange rate itself. Thus, these controls should be rapidly liberalized. The recent easing of controls on certain foreign currency transactions by large Korean corporations and on overseas investments of Korean financial institutions, however, could increase pressure for the won to depreciate. There should be a corresponding liberalization of controls on capital inflows to offset this effect.

Although there is a lack of evidence of direct government "manipulation" of the exchange rate, we remain concerned about the won's depreciation. Recent policy measures, aimed at increasing exports and suppressing domestic demand, add to our concerns. They are likely to delay the adjustment process, jeopardizing the encouraging shift that appeared to have began in 1989 toward greater reliance upon domestic demand as a source of growth.

In the period ahead, we will continue to monitor Korea's trade developments and the operation of the new exchange rate determination system closely. In the Financial Policy Talks, we will continue to encourage liberalization of Korea's financial, capital, and exchange markets as well as seek improved treatment for U.S. financial institutions.

APPENDIX

TABLES

TABLE 1

Economic Performance of Major Industrial Countries

	GNP 1/			Domestic Demand 1/		
	1988	1989	1990	1988	1989	1990
U.S.	4.4	3.0	2.4	3.3	2.4	2.2
Japan	5.7	4.9	4.6	7.6	5.7	4.8
Germany	3.6	4.0	3.2	3.7	2.8	3.1
France	3.4	3.4	3.1	3.9	3.2	3.2
U.K.	4.5	2.3	1.3	7.4	3.9	0.0
Italy	4.2	3.2	3.0	4.3	3.7	3.4
Canada	5.0	2.9	1.6	5.8	5.2	1.6
G-7 2/	4.5	3.4	2.8	4.6	3.4	2.7

	Inflation 3/			Current Account 4/		
	1988	1989	1990	1988	1989	1990
U.S.	4.1	4.8	4.0	-2.6	-2.0	-2.0
Japan	0.7	2.3	1.7	2.8	2.0	2.0
Germany	1.3	2.8	2.5	4.0	4.4	4.9
France	2.7	3.5	3.1	-0.4	-0.4	-0.3
U.K.	4.9	7.9	7.2	-3.1	-4.0	-3.1
Italy	5.0	6.3	5.5	-0.6	-1.1	-1.0
Canada	4.0	5.1	4.9	-1.7	-2.9	-2.7
G-7 2/	3.3	4.5	3.8			

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* Data for 1988 and 1989: national sources and International Monetary Fund. Data for 1990: For U.S. - Administration projections; for other countries - International Monetary Fund, World Economic Outlook (forthcoming).

1/ Annual average rates in real terms.

2/ Average of indivdual country rates, weighted by GNP.

3/ Consumer prices; annual average.

4/ Calculated as percent of GNP; negative indicates deficit.

Table 2

SUMMARY OF U.S. TRADE AND CURRENT ACCOUNT DEVELOPMENTS
($ billion, seasonally adjusted)

	YEARS			1988				1989			
	1987	1988	1989	QI	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Exports	250.266	319.251	361.872	76.447	78.471	80.604	83.729	87.783	91.284	90.691	92.114
Agricultural	29.547	38.142	41.433	9.021	9.405	9.927	9.789	10.777	10.879	9.683	10.099
NonAgricultural	220.719	281.109	320.439	67.426	69.066	70.677	73.940	77.006	80.410	81.008	82.015
Imports	-409.766	-446.466	-475.120	-109.893	-109.882	-110.943	-115.748	-116.138	-118.813	-119.249	-120.920
Petroleum & Prods	-42.944	-39.309	-50.250	-10.068	-10.248	-9.775	-9.218	-10.845	-13.424	-13.018	-12.963
NonPetroleum	-366.822	-407.157	-424.870	-99.825	-99.634	-101.168	-106.530	-105.293	-105.389	-106.231	-107.957
TRADE BALANCE	-159.500	-127.215	-113.248	-33.446	-31.411	-30.339	-32.019	-28.355	-27.529	-28.558	-28.806
Net Investment Income	22.284	2.229	1.029	2.795	-2.465	-2.590	4.489	-2.484	-6.104	2.860	6.757
Direct Investment	45.256	31.517	36.164	8.490	4.927	5.567	12.533	5.984	3.070	11.647	15.463
(of which: Capital Gains/Losses on US Investments Abroad)	16.174	-0.144	-.394	0.858	-2.487	-2.585	4.069	-3.512	-4.626	3.182	4.562
Portfolio Investment	-22.972	-29.288	-35.135	-5.695	-7.392	-8.157	-8.044	-8.468	-9.174	-8.787	-8.706
Net Other Services	7.731	13.096	20.616	1.969	3.291	3.964	3.872	3.934	4.461	6.271	5.950
Military	-2.857	-4.607	-5.662	-0.964	-1.033	-1.006	-1.604	-1.498	-1.518	-1.175	-1.471
Travel & Fares	-6.252	-1.923	1.176	-1.496	-0.493	-0.039	0.105	-.229	.095	.766	.544
Other Transport	-1.073	-0.711	-.384	-0.358	-0.226	-0.116	-0.011	-.057	.007	-.249	-.085
Fee, Royals & Misc	17.913	20.337	25.486	4.787	5.043	5.125	5.382	5.718	5.877	6.929	6.962
Unilat Transfers	-14.213	-14.657	-14.277	-3.364	-2.899	-3.376	-5.018	-3.487	-2.829	-3.485	-4.476
Remits & Pensions	-4.063	-4.280	-4.029	-1.131	-0.971	-1.088	-1.090	-1.147	-.972	-.975	-.935
Government Grants	-10.150	-10.377	-10.248	-2.233	-1.928	-2.288	-3.928	-2.340	-1.857	-2.510	-3.541
NET INVISIBLES	15.800	.667	7.378	1.400	-2.074	-2.001	3.342	-2.036	-4.470	5.649	8.235
CURRENT ACCOUNT BALANCE	-143.700	-126.548	-105.870	-32.046	-33.485	-32.340	-28.677	-30.391	-31.999	-22.909	-20.571

Source: SURVEY OF CURRENT BUSINESS, March 1990
Details may not sum to totals due to rounding.

4/17/90

Table 3

SUMMARY OF U.S. CAPITAL FLOWS
Inflows(+) Outflows (-) Billions

	YEARS		1988				1989			
	1989	1988	QI	Q2	Q3	Q4	Q1	Q2	Q3	Q4
U.S. Reserve Assets										
(incr(-) decr (+))	-25.293	-3.566	1.503	0.039	-7.380	2.272	-4.000	-12.095	-5.996	-3.202
Other U.S. Govt Assets	1.036	2.999	-1.673	-0.829	2.001	3.499	0.869	-.254	.543	-.121
Foreign Official Assets:	7.369	38.882	24.631	5.895	-2.234	10.589	7.478	-5.201	12.097	-7.005
Industrial	-1.398	30.215	20.689	7.238	-3.106	5.393	1.371	-7.219	6.653	-2.203
OPEC	10.680	-3.109	-1.547	-1.776	-0.459	0.672	7.143	.433	4.515	-1.411
Other	-1.913	11.776	5.489	0.433	1.331	4.524	-1.036	1.585	.929	-3.391
Banks, net:	10.739	14.351	-1.871	17.853	-2.938	1.307	-8.871	5.816	4.477	9.317
Claims	-47.244	-54.481	15.266	-12.602	-26.229	-30.916	-22.132	27.238	-20.700	-31.650
Liabilities	57.983	68.832	-17.137	30.455	23.291	32.223	13.261	-21.422	25.177	40.967
Securities, net	43.220	36.230	2.689	14.937	9.271	9.334	14.057	4.476	11.106	13.581
Foreign Securities	-22.551	-7.846	-4.539	1.333	-1.592	-3.047	-2.568	-5.737	-10.392	-3.854
U.S. Treas. Securities	29.411	20.144	5.928	5.458	3.422	5.336	8.590	2.252	12.714	5.855
Other U.S. Securities	36.360	23.932	1.300	8.146	7.441	7.045	8.035	7.961	8.784	11.580
U.S. Dir. Invest. Abroad	-28.290	-15.017	-5.476	.612	-4.899	-5.254	-4.962	-6.613	-8.642	-8.073
Reinvested Earnings	-21.437	-15.170	-3.901	-2.721	-4.489	-4.058	-3.856	-3.619	-9.575	-4.387
Equity & Inter-Co. Debt	-6.853	.154	-1.575	3.333	-.409	-1.196	-1.106	-2.994	.933	-3.686
For. Dir. Invest. in U.S.	61.262	58.436	9.616	13.885	11.896	23.038	19.161	13.267	12.436	16.397
Reinvested earnings	3.363	6.560	1.774	1.357	2.083	1.347	0.208	1.807	1.189	.159
Equity & Inter-Co. Debt	57.898	51.875	7.842	12.528	9.814	21.692	18.953	11.460	11.247	16.238
Other U.S. Corp.,net	.921	4.874	1.500	-6.502	2.605	7.271	4.687	-3.315	-.451	-
Claims	.608	-1.684	-0.065	-6.443	0.255	4.569	1.835	-2.954	1.727	-
Liabilities	.313	6.558	1.565	-0.059	2.350	2.702	2.852	-.361	-2.178	-
NET CAPITAL FLOWS	70.964	137.189	30.919	45.891	8.324	52.056	28.419	-3.919	25.570	20.894
Statistical Discrepancy	34.914	-10.641	-3.364	-12.015	28.603	-23.865	-2.425	35.807	2.285	-.753
TOTAL	105.878	126.548	27.556	33.875	36.926	28.191	25.994	31.888	27.855	20.141

Sources: SURVEY OF CURRENT BUSINESS, March 1990.

Table 4

Measurements of Dollar Movements (for key dates)
Versus G-7 Currencies
Percent dollar appreciation (+) or depreciation (-)

As of April 10, 1990

Value of the Dollar in Terms of:	Since Dollar Peak 26-Feb-85 to date	Since Plaza Accord 20-Sep-85 to date	Dollar Lows 31-Dec-87 to date	Over Last Year 10-Apr-89 to date	Since Previous Report 13-Oct-89 to date
Japanese yen	-39.6	-34.8	+30.0	+19.0	+9.6
German mark	-51.3	-41.4	+7.1	-9.9	-11.1
British sterling	-36.2	-17.2	+14.5	+3.7	-4.9
French franc	-46.5	-35.5	+6.1	-10.4	-12.0
Italian lira	-42.7	-36.0	+6.4	-9.9	-10.6
Canadian dollar	-17.1	-15.6	-10.6	-1.8	-1.0

Source: New York 9:00 a.m. exchange rates

TABLE 5

ASIAN NIES: TRADE AND CURRENCY CHANGES

Cumulative Change against US$ as of April 10, 1990

from:	(Plaza) 9/20/85	end-86	end-87	(Report) 10/14/88	end-89	Rate on 4/10/90
HK$	0.21%	-0.11%	-0.50%	0.19%	0.08%	HK$ 7.80
Won	26.59%	21.89%	12.13%	0.52%	-3.95%	W 706.60
Singapore$	17.16%	15.49%	6.15%	7.57%	1.12%	S$ 1.88
NT$	54.19%	35.08%	8.64%	9.97%	-0.44%	NT$ 26.28
Yen	53.69%	1.29%	-21.55%	-19.76%	-8.83%	Y 157.56
DM	72.20%	15.71%	-4.73%	7.66%	0.90%	DM 1.68

* [-] signifies depreciation against the U.S. dollar.

U.S. Trade Balance with Asian NIEs [1]
(U.S. $ Billions)

	1985	1986	1987	1988	1989
Hong Kong	-5.6	-5.9	-5.9	-4.6	-3.4
Korea	-4.1	-6.4	-8.9	-8.9	-6.3
Singapore	-0.8	-1.3	-2.1	-2.2	-1.6
Taiwan	-11.7	-14.3	-17.2	-12.6	-13.0
TOTAL NIEs	-22.1	-27.8	-34.1	-28.2	-24.3
Total U.S. Trade Balance	-132.1	-152.7	-152.1	-118.5	-108.6
NIEs as % Total U.S. Trade Bal.	17%	18%	22%	24%	22%

[1] U.S. customs value data, not seasonally adjusted.
Totals may not equal sum of components due to rounding.

TREASURY NEWS

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**PREPARED STATEMENT OF THE HONORABLE CHARLES H. DALLARA
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
on the
U.S.-JAPAN STRUCTURAL IMPEDIMENTS INITIATIVE
before the
SUBCOMMITTEE ON ASIAN AND PACIFIC AFFAIRS
and
SUBCOMMITTEE ON INTERNATIONAL ECONOMIC POLICY AND TRADE
COMMITTEE ON FOREIGN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C.**

April 19, 1990

Introduction

Mr. Chairman and Members of the Committee, I am pleased to have this opportunity to discuss the U.S.-Japan Structural Impediments Initiative (SII).

It has been just two weeks since the U.S.-Japan Working Group completed its interim report and assessment of progress to date in the SII. This report followed nine months of intensive research and negotiations with the Japanese aimed at identifying and implementing solutions to structural problems in both economies that impede trade and balance of payments adjustment.

The interim report contains a number of commitments from the Japanese covering a wide range of structural problems in their economy -- from the distribution system to inadequate levels of infrastructure investment, from business practices that exclude outsiders to a policy toward foreign direct investment which is too restrictive. These structural impediments are generally systemic in that they run through the Japanese economy and cut across many sectors. They are deep-seated and complex, and will take time to fully correct.

Actions to address these rigidities are a matter of urgency. We believe that the Japanese commitments reflect substantial progress at this stage of the SII talks. They represent important plans for action and, if fully implemented, they should contribute to the goals of opening markets and reducing trade and current account imbalances.

It is important to bear in mind, however, that the undertakings spelled out in the interim report are in large part commitments to act rather than actions themselves. It is critical that these commitments be fleshed out in the final report, that they be extended and strengthened in some areas, and that they be fully implemented on a timely basis. This will require some form of ongoing monitoring and follow-up efforts, the details of which will be worked out before the final report.

Of course, from the very start, the SII talks have been a two-way street. If they are to be successful, Japanese action on their structural impediments must be complemented by U.S. action on our structural impediments, particularly our inadequate level of public and private savings. The commitments made by the U.S. Government in the interim report reflect the Administration's clear awareness of structural problems in the U.S. economy and our determination to resolve these problems. In the interim report, the Administration outlined a broad range of initiatives -- from steps that would increase national saving to an action plan for improving the quality of education and training in the United States. These initiatives, many of which are contained in the President's budget for FY 1991, address many of the concerns raised by the Japanese Government in the SII talks. These measures should improve the competitiveness of the U.S. economy while contributing to a reduction in our trade and current account deficits.

<u>Origins of the SII</u>

For a number of years, the United States, Japan, and other industrialized countries have been engaged in a cooperative effort to reduce global payments imbalances through the macroeconomic policy coordination process. This process has been successful in beginning to reduce global imbalances. Changes in domestic demand patterns and a significant realignment of exchange rates since 1985 have produced considerable improvement in global payments imbalances.

Nevertheless, the imbalances remain large, and it was clear to us as we surveyed the situation a year ago that our trading position with Japan had been more rigid than that with other countries. It appeared that there were numerous structural barriers in the Japanese, as well as the U.S., economies that were obstructing trade and slowing the process of reducing trade imbalances. The SII talks were designed to complement the more traditional efforts to address the macroeconomic roots of trade and current account imbalances, as well as to open markets. Our experiences with both the economic policy coordination process and sectoral trade negotiations suggested that structural impediments were particularly serious in Japan, often cutting across many key product sectors and slowing the process of reducing their surplus and our deficit.

We recognize that macroeconomic factors (in the U.S. and elsewhere) are very important in affecting a nation's overall trade and current account balances, especially in the long run. Thus exchange rate movements and the rate of U.S. domestic demand growth relative to GNP have a major effect on U.S. imports, while growth in trading partner countries has a major effect on U.S. exports. However, the U.S. trade position is also affected by a wide range of other factors, including tariff barriers, non-tariff obstacles to effective competition by U.S. exporters, as well as the structural impediments that are the focus of this initiative.

It is important to note that the structural reforms to be adopted under the SII involve a mixture of macroeconomic and microeconomic changes. In the case of saving and investment patterns, we are actually setting a goal for a shift in these macroeconomic variables, although we have also suggested some microeconomic/structural measures to facilitate achievement of this goal. Stronger Japanese government infrastructure investment should help to reduce the amount by which Japanese investment falls short of Japanese saving, thus helping to reduce Japan's current account surplus. In other areas, we are seeking microeconomic/structural changes, which will eventually affect macroeconomic variables in the desired direction. For example, changes in distribution practices would allow U.S. firms to sell U.S. goods more effectively as well as to charge more competitive prices by reductions in distribution costs.

The SII process has been a joint effort, with certain agencies taking the lead in researching and negotiating particular issues. I would like now to summarize briefly the principal commitments made by the Government of Japan in the areas for which the Treasury Department has had primary responsibility. I am sure my colleagues will do the same for the areas in which they have taken the lead. In describing the measures to be taken by the Japanese Government, I included where appropriate a discussion of the proposed timing for implementation of each of these measures, as well the expected effect of these actions on our trade and current account positions.

Saving and Investment Patterns

A principal objective of the SII talks is the reduction of trade imbalances and current account imbalances. By definition, a nation's current account balance is equal to the difference between domestic saving and investment. As with other surplus countries, Japan's external surplus is equal to the gap between domestic investment and saving. Thus a reduction in the shortage of investment compared to saving in Japan is a necessary corollary to a reduction in the nation's current account surplus. We proposed to the Japanese Government that they do this by increasing public investment in domestic infrastructure, which will help improve the quality of life in Japan, facilitate correction of other structural problems (such as improvement of the distribution system), and reduce the trade and current account surpluses.

In light of this close relationship between domestic and external imbalances, we are encouraged by the Japanese Government's commitment in the SII interim report to reduce the shortage of investment relative to savings in Japan and thereby contribute to a reduction of the nation's current account surplus. Specifically, the Japanese agreed to:

- o Increase substantially investment in infrastructure in order to reduce the shortage of investment relative to GNP and help to reduce Japan's current account surplus.

- o Start immediately on the formulation of a new 10-year comprehensive plan of public investment to achieve this increase.

- o Specify the aggregate expenditures in this new comprehensive investment plan in the final report.

- o Prepare on a fast-track basis eight new long-term sectoral plans to replace the existing plans when they expire at the end of Japanese fiscal year 1990, i.e., on March 31, 1991. These plans cover key infrastructure areas such as housing, airports and port facilities, parks and sewers.

- o This program would both reduce the shortfall of public investment compared to public saving and create infrastructure which could be used for importing and distributing foreign goods and services.

These commitments represent substantial progress for the purposes of the interim report in the area of saving and investment. Further action and specification will, of course, be needed in order to ensure a substantial increase in investment in Japan relative to saving, and as a share of GNP.

Land Use

Existing Japanese tax and urban policies hinder balance of payments adjustment by contributing to Japan's shortage of land for residential, commercial and public investment and by constraining demand for housing-related goods such as consumer durables. The resulting high land prices make establishment of new businesses in Japan prohibitively expensive for both Japanese and foreign entrants. At the same time, existing businesses enjoy an advantage because they are able to borrow against the increased value of land-holdings.

In the interim report, the Government of Japan made a number of commitments that will help to correct distortions created by current tax and urban policies related to land. Specifically, the Japanese have committed to:

- o Conduct a comprehensive review of land taxation on the basis of such principles as equity, neutrality, and simplicity. This will include a review of taxation of agricultural land in urban areas, with a view to addressing the exemption (deferment) system for the property and inheritance taxes. The Government of Japan will submit reform legislation to the Diet by the end of fiscal year 1990.

- o Rationalize property assessments for the inheritance tax, with the goal of bringing assessments closer to market value.

- o Review leasing laws, in order to improve legal relationships which greatly favor tenants at the expense of landlords, discouraging the construction of housing and office space.

- o Survey idle land in metropolitan areas, introduce by the end of fiscal year 1990 a reform package of measures designed to convert such land to productive use. The Japanese Government will consider strengthening the penalty tax on idle land.

- o Expand the area under the Urban Promotion Areas (UPAs) zoning designations, to accomodate growing housing demand.

- o Launch a new, larger, long-term plan for investment in housing.

- o Deregulate various land use policies, including relaxation of limits on building height and housing density.

While we welcome these commitments to reform land use policies, the Japanese Government must demonstrate progress in implementing them. The Japanese will need to ensure that studies of land policy result in meaningful reforms in the near future. Further action will be needed in order to: make tax policies more neutral; eliminate tax exemptions for agricultural land in urban areas; reduce capital gains tax rates on the sale of idle land; strengthen penalty taxes on idle land, pending progress to make tax policies more neutral; convert idle land to productive use; correct the legal imbalances between lessors and lessees; provide budget figures for the installation of urban infrastructure; and implement the deregulation measures cited above.

Keiretsu Relationships

Keiretsu are the large groupings of Japanese companies which extend through many sectors of the economy. These disparate companies are tied together through a network of formal and informal links such as cross shareholding and personnel exchanges. For example, the Mitsubishi group, which alone accounted for 2.9 percent of total sales in Japan in 1987, includes among its members Japan's largest chemical company and its largest brewery, as well as the nation's fifth largest bank and its fifth largest automobile company. Keiretsu ties foster preferential group trade at the expense of outside suppliers, hinder foreign direct investment in Japan, and may give rise to anticompetitive business practices.

The Japanese Government had been reluctant to acknowledge keiretsu as a structural problem, arguing that long-term keiretsu ties are economically rational and have made a positive contribution to Japan's economic development. Nevertheless, in recognition of the U.S. concern, the Japanese have now declared its intention to make keiretsu more open and transparent. This is the first time that the Government of Japan has committed itself to action of any kind to address the keiretsu issue. We hope this reflects the Japanese Government's fundamental recognition of the seriousness of the keiretsu problem and its commitment to deal with this issue.

Specifically, we are encouraged by the Japanese commitments to:

- Strengthen monitoring by Japan's Fair Trade Commission (FTC) of keiretsu transactions and enforcement of the Antimonopoly Act, including publication and strict enforcement of a guideline to ensure that keiretsu transactions do not hinder fair competition.

- Restrict cross shareholding or require divestiture of shares where FTC monitoring reveals that the cross shareholding leads to anticompetitive practices.

- Conduct regular FTC analyses of various aspects of keiretsu groups, with special emphasis on the role of the general trading company.

- Improve financial disclosure requirements, and complete, before the final report, a study of further improvements, with a view to enhanced disclosure of related-party transactions.

As I mentioned earlier, one of the effects of keiretsu relationships is to hinder foreign direct investment in Japan. The level of foreign investment in Japan falls far short of that in other OECD countries. Thus, while reaffirming the Administration's commitment to an open investment climate, we stressed the need for the Japanese Government to take steps to encourage foreign direct investment in Japan. In this light, we welcome the Japanese commitments in the interim report to:

- Liberalize Japan's policies on foreign direct investment, including amendment of the Foreign Exchange and Foreign Trade Control Law to:

  - relax or abolish the prior notification requirement for foreign direct investment and the importation of technology into Japan; and

- limit the broad authority of Japanese officials to block foreign direct investment on broad economic grounds such as a potential threat to "the smooth operation of the Japanese economy."

o Submit legislation abolishing the prior notification requirement for takeover bids.

o Issue a policy statement welcoming foreign investment in Japan.

We expect the Japanese Government to build on these commitments in the areas of keiretsu and foreign direct investment by adopting additional actions and commitments in a number of areas, including: issuance of a broader policy statement encouraging the loosening of keiretsu ties; further actions to address the cross shareholding issue; measures to encourage opening of keiretsu procurement practices; further steps to relax or abolish the authority of Japanese officials to restrict foreign direct investment on broad economic grounds; and measures to bolster shareholders' rights in Japan.

<u>U.S. Commitments</u>

We cannot focus only on structural problems in Japan if we are to overcome impediments to balance of payments adjustment. We must also confront our own problems. We have stressed from the start that the SII talks are a two-way street, enabling the governments of both countries to suggest ideas that would improve the economic structure and global competitiveness of the other.

In our discussions of the U.S. economy, it has become clear that we and the Japanese agree on the essentials. Foremost among these is the need to boost national saving. The surest way to boost saving in the United States is to reduce Federal dis-saving -- that is, to cut, then eliminate, the Federal budget deficit. The Japanese argue that we must reduce the budget deficit, and we know that they are right. Many of the ideas presented by the Japanese throughout the SII talks have concerned deficit reduction. We responded to this Japanese concern by making it clear that the Administration is committed to reducing the Federal budget deficit. The President's budget for FY 1991 proposes that deficit reduction be achieved through a combination of:

o spending restraint -- setting priorities for government expenditures and sticking to them;

- o strengthening the Gramm-Rudman-Hollings Budget Law by closing its loopholes; and
- o enhanced rescission authority for the President.

The Japanese Government also stressed the need to stimulate private saving and investment in the United States, both to reduce the current account imbalance between our two countries and to promote the long-term competitiveness of firms in the United States through a lower cost of capital. Elements of the Savings and Economic Growth Act (SEGA), which the President has forwarded to the Congress, address these Japanese concerns. For example, SEGA proposes:

- o lowering the effective tax rates on capital gains, particularly for long-term investments;
- o enhancing the attractiveness of saving with Individual Retirement Accounts; and
- o creating a new type of tax-advantaged saving vehicle, Family Savings Accounts.

By expanding the pool of savings in the United States and enhancing after-tax returns on capital for U.S. investors, we encourage domestic capital formation, which we need to be competitive in the long term.

Members of the Japanese delegation have commented on certain U.S. laws and regulations which raise the cost of doing business in this country and discourage domestic production. The Administration reaffirmed its support for legislation that would reform antitrust treatment of production joint ventures. We cited the President's support for reform of the product liability laws.

The Japanese Government was concerned that some in the United States wished to impose restrictions on foreign direct investment. We reaffirmed the Administration's strong commitment to an open direct investment policy, and we agreed to consider issuing a detailed policy statement to that effect.

In the area of trade, we reviewed recent progress made to deregulate exports. We hope that further progress will be possible in liberalizing export controls as the changes in our strategic position become clear. We hope that recent gains in loosening energy export controls will also continue. Our export efforts will be buttressed by the Commerce Department's new promotional program, which is aimed specifically at increasing U.S. exports to Japan.

The long-term competitiveness of the United States depends on the ingenuity of our people and our ability to put our innovations to work. The Japanese delegation urged us to support domestic research and development efforts, to encourage workforce training and to boost scholastic achievement. The U.S. commitments in this area included:

- o plans outlined in the President's FY 1991 budget to support research and development;
- o a seven-point action plan drawn up by the Labor Department to promote workforce training;
- o proposals outlined in the President's FY 1991 budget to spend public funds to supplement private sector efforts on workforce training;
- o the Administration's ongoing work with the states and local authorities to achieve the ambitious goals for education agreed upon by the President and the nation's Governors at the Education Summit.

As I said earlier, the SII talks work two ways; balance of payments adjustment requires action by both the Government of Japan and the Government of the United States. We cannot expect the Japanese to undertake structural reform in their economy if we do not seek to remedy our own problems with equal vigor. The Administration can and is providing leadership on these issues, but we need support from the Congress. At our most recent round of talks, the Japanese delegation appeared to be impressed by our proposals for reform. It is necessary that we follow through on our commitments just as we expect the Japanese to follow through on theirs.

Closing Remarks

In closing, let me say that the interim report represents a good first step in the SII process. But we recognize that much work remains to be done by both Japan and the United States. The structural issues raised in these talks will require persistent effort by both countries if this process is to contribute to the reduction of our trade and current account imbalances and to the promotion of sustained, non-inflationary growth in the United States.

Thank you very much for your attention.

TREASURY NEWS

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STATEMENT OF THE HONORABLE
DAVID C. MULFORD
UNDER SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY
UNITED STATES SENATE
APRIL 19, 1990

Mr. Chairman and members of the Committee:

It is a great pleasure to be here today to discuss with you the Department of the Treasury's report on international economic and exchange rate policy. This report and the consultations with Congress on U.S. international economic policy have proven to be highly effective in broadening understanding of the world economy and in advancing U.S. international economic objectives.

I would like to examine two aspects of U.S. international economic policy. First, the economic policy coordination process and our efforts to promote a strong and smoothly functioning world economy. Second, developments in Korea and Taiwan, two economies with an important role to play in the international adjustment process, in view of their sizable external surpluses and growing responsibilities in the world economy.

Economic Policy Coordination

The economic policy coordination process has contributed importantly to the strengthened performance of the world economy over the past years. This process has helped policymakers to better understand the international ramifications of their domestic policies. It has also helped them to put in place the consistent and compatible policies necessary for sustained global growth, low inflation, and reduced external imbalances.

The G-7's record of success in this regard is quite impressive. The economic expansion is now being sustained into its eighth consecutive year. Inflation has been substantially reduced from the high levels of the late seventies and early eighties. World trade growth has been robust, facilitating external adjustment. Also, I would note Mr. Chairman -- and this is a point which often does not receive adequate attention -- that the major countries have put in place policies to rein in public spending, reform tax regimes, liberalize financial markets, and reduce excessive red-tape and government regulation in general.

1989 represented another solid year of performance for the G-7 economies. Growth, after recording an extremely vibrant increase of 4.4 percent in 1988, eased to a still healthy and strong 3.4 percent in 1989. Though consumer price inflation rose approximately 1 percentage point in 1989, to an average rate of about 4-1/2 percent, much of this increase took place in the first half of the year and was associated in part with special one-time factors.

Recent data indicate that inflation pressures persist for the G-7 countries as a group, although for some countries the recent increases in large measure reflect temporary commodity price developments more than underlying problems. We continue to expect that important factors -- such as moderating demand growth and the unwinding of some of the negative influences that adversely affected the January and February price indices (oil and food) -- will dampen price pressures this year. As these influences move through the markets into consumer prices, the core rate of inflation is expected to return to previous levels. Nevertheless, it is clear that continued vigilance will be required.

External imbalances again declined substantially in the United States and Japan in 1989. In the United States, the current account deficit fell by a further $21 billion to $106 billion, the lowest deficit since 1984, and substantially down from the $144 billion deficit in 1987. Japan's current account surplus declined from roughly $80 billion in 1988 to $57 billion in 1989 and the overall surplus of the European Community has been reduced to nearly zero.

Moreover, the prospects for G-7 performance in 1990 remain quite favorable. Overall growth prospects remain good, with growth in the major countries projected to ease only slightly from the rate recorded in 1989. World trade should continue expanding solidly.

Despite these achievements, I do not wish to seem complacent. Challenges lie before us in the period ahead.

External imbalances remain large and the adjustment process slowed over the course of 1989. In Europe, significant external imbalances have emerged, with Germany registering a massive current account surplus of $53 billion in 1989, or 4.4 percent of GNP, the largest such ratio in the G-7. Current account trends are difficult to project with certainty, but it would appear that any further improvement in the U.S. current account position in 1990 will at best be very modest, and the possibility of a deterioration in the current account cannot be excluded.

Also, over the past six months, significant changes in the world economy have taken place. These include the changes in Eastern European political and economic life and developments in global financial markets, particularly in Japan. The G-7 Finance Ministers and Central Bank Governors met against this background in Paris on April 7. They reaffirmed their commitment to economic policy coordination as the best means of addressing these developments.

In this context, the Ministers and Governors noted the shared responsibility of surplus and deficit nations in promoting sustained growth, reduced external imbalances, and greater stability of exchange rates. The United States is doing its part. We have achieved significant progress in reducing the U.S. budget deficit. From a peak of 6.3 percent of GNP in FY 1983, the Federal budget deficit was reduced to 2.9 percent in FY 1989 and is projected to decline further to 2.3 percent in FY 1990. Combining Federal, state, and local governments, our deficit in FY 1990 is projected to be around 1 to 1-1/2 percent of GNP. Personal saving is returning to the historical average level in the United States and the Administration has made a number of proposals to improve the national saving rate. The most important step in this process is to continue to reduce the budget deficit.

Developments in Eastern Europe and efforts to achieve market-oriented economies in this region are among the most profound and welcome events in decades. Also, the prospective reunification of the German economies should contribute to improved global growth and to a reduction of external imbalances. This will be a most welcome development, particularly in light of Germany's massive surpluses.

The Japanese yen has depreciated sharply in recent months against the world's major currencies. This is an important matter of concern, and one that may have undesirable consequences for the global adjustment process. The weakness of the yen, and Japanese financial market developments more broadly, must be viewed in the context of the sharp appreciation in Japanese asset values over the past several years. These financial market developments may have been further accentuated by the lack of a deep and liquid money market for yen-denominated instruments. We will continue to address these issues in our yen/dollar talks which take place again in late May.

On balance, the underlying fundamentals of the Japanese economy remain sound. Nonetheless, the depreciation of the yen and Japan's relatively closed markets are not sustainable over time as their continuation would pose important risks for the world economy. We will be keeping these developments under close review and we will continue to cooperate with other G-7 countries on exchange markets.

Asian Newly Industrialized Countries

Other economies have an obligation to assume a greater responsibility for contributing to the reduction of the world's external imbalances and promoting a sound and growing world economy. In particular, the newly industrialized economies of Asia are playing an increasingly important role in the world economy. Some of these economies have sizable external surpluses.

The Omnibus Trade and Competitiveness Act of 1988 recognized that undervalued currencies can be unfairly exploited to build up sizable external surpluses. The Treasury Department concluded in its October 1988 report on International Economic and Exchange Rate Policy that Korea and Taiwan "manipulated" their exchange rates within the meaning of the legislation. Following this report, we initiated bilateral negotiations with Korea and Taiwan, aimed at assuring that their exchange rate and other policies contributed to the adjustment of global imbalances. In October 1989, we concluded that there were no clear indications at that time that Taiwan was "manipulating" its currency for competitive advantage within the meaning of the legislation, given the introduction of its new exchange rate system and certain other factors. Regarding Korea, however, the Treasury determined there were indications of continued manipulation.

We have achieved progress in our bilateral negotiations and discussions with Korea and Taiwan. Both Korea and Taiwan have instituted more market-based systems for determining the exchange rate. Korea's external surplus has sharply declined and Taiwan's gives evidence of moving in the right direction. We still have concerns, however, which I will discuss in the remainder of my testimony.

Since the October 1988 report, the New Taiwan dollar has strengthened by 10 percent against the U.S. dollar, more than that of any major trading partner. Between May 1989 and early March of this year, the exchange rate fluctuated narrowly against the U.S. dollar. Subsequently it depreciated by 1 percent, before strengthening slightly. The depreciation was the result of short-term speculation and capital outflow in response to political uncertainties. The Central Bank resisted the depreciation, recognizing that it did not reflect Taiwan's strong economic fundamentals and would fuel inflation.

In absolute terms, Taiwan's global current account surplus rose by 9.5 percent last year to $11.2 billion. The U.S. trade deficit with Taiwan also increased by 3 percent in 1989 to $13 billion. If, however, one-time extraordinary purchases of gold from the United States by Taiwan's Central Bank in 1988 are excluded, the Taiwanese current account surplus and the U.S. bilateral trade imbalance with Taiwan fell by 15 percent and 14 percent, respectively, last year.

Following our bilateral negotiations last year, Taiwan instituted a new and liberalized exchange rate system in April 1989. Most foreign exchange transactions under the system are now freely determined and the authorities' ability to manipulate the rate has been greatly reduced. Since the October 1989 report, Taiwan has taken further steps to liberalize the system, although remaining capital and foreign exchange restrictions continue to limit supply and demand in the exchange market.

In light of these developments, we remain of the view that there are no clear indications that Taiwan is "manipulating" the exchange rate for competitive advantage. Taiwan's large external surpluses, however, remain unsustainably high. The Taiwanese authorities need to recognize the need for the further reduction of the surpluses and the continued importance of the exchange rate and of the liberalization of remaining capital and exchange controls in advancing this adjustment process. We will continue to monitor the situation closely.

Since the release of the October 1988 report, the Korean won has appreciated by only 1/2 percent in nominal terms against the U.S. dollar. From the won's strongest point, shortly following the April 1989 report, it has depreciated by about 6 percent in nominal terms against the dollar. Since the October report, however, the won has appreciated 25 percent against the yen, including 13 percent since April 1989. Thus, on a trade-weighted basis, the won has appreciated an estimated 7 percent since the October 1988 report.

Following the introduction of a new exchange rate system on March 2, the won has depreciated by 1.8 percent against the dollar, but has appreciated over 3 percent against the yen. These developments largely reflect Korea's trade and current account deficits in the first two months of this year, and capital outflows prompted by the possible introduction of a "real name" financial system (which has now been indefinitely postponed).

Korea made considerable progress last year in reducing its external surpluses. The current account surplus fell 64 percent to $5.1 billion compared to the same period last year. This is equal to 2.5 percent of GNP, following a 8.4 percent ratio in 1988. Also, our bilateral trade deficit with Korea declined by 30 percent to $6.3 billion. On a quarterly basis, our bilateral trade deficit with Korea has shown no significant growth since the beginning of 1988. These declines continued in January-February of this year and the prospects are for somewhat lower imbalances this year than last.

These welcome declines reflect a number of factors. The won's past currency appreciation, both against the dollar and non-dollar currencies, is a principal cause. Large wage increases in 1988-89 exceeding productivity gains are another important factor, contributing both to higher export prices and to higher import demand. Korea's on-going trade liberalization program also facilitated import growth. Severe labor-management disputes also played an important role in restraining Korea's export growth last year.

Korea's introduction of a new "market average rate" system of exchange rate determination in March is an important development. Under this system, the won/dollar exchange rate at the beginning of each business day is set equal to the weighted average interbank rate on the previous day's transactions. This system's success, however, will depend on how it is implemented. The liberalization of pervasive foreign exchange and capital controls is especially necessary to allow market forces to play a greater role.

Also of significance, the Treasury and Korea's Ministry of Finance initiated Financial Policy Talks in late February. We hope to make progress in these talks on problems facing U.S. banks and securities firms in gaining access to the Korean market. The initial round of these talks produced some indications of flexibility in some areas, but follow-up actions have yet to be taken and much more remains to be done in subsequent meetings.

Since introduction of the new exchange rate system, there is a lack of evidence of continued direct government "manipulation" of the exchange rate, within the meaning of the legislation, particularly in view of the developments in the Korean external accounts. We nonetheless remain concerned about the won's nominal depreciation against the dollar. The recent policy measures which aim to increase exports add to our concerns as they could delay the adjustment process. We will, therefore, continue to monitor Korea's trade and exchange rate developments carefully and press for further liberalization of the financial, capital, and exchange markets in the Financial Policy Talks.

Conclusion

The United States is committed to cooperating with its major trading partners to promote the sound world economy and stable financial system on which all countries' prosperity rests. The success of this effort will also require that the Executive Branch and the Congress work closely to deal with difficult domestic issues. Our dialogue on the international aspects of U.S. economic and exchange rate policies is an important element in this effort.

Thank you, Mr. Chairman.

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April 19, 1990

Statement by
John E. Robson
Deputy Secretary of the Treasury

Today I am pleased to announce the publication of the Final Report of the G-7 Financial Action Task Force on Money Laundering. The report is being published today simultaneously in the Task Force member countries. I was privileged to serve as the head of the U.S. Delegation to the Task Force.

This Task Force was convened at the direction of the 1989 G-7 Economic Summit in Paris. The heads of state and government of the G-7 gave the group a mandate to study measures that have been taken to prevent utilization of financial institutions by money launderers and to make recommendations on how to improve international cooperation against money laundering. The report will be addressed at the upcoming G-7 Economic Summit in Houston in July.

As Chair of the 1989 Economic Summit, France also chaired the Task Force. I want to commend the work of French Finance Minister Pierre Beregovoy and his staff, most notably, Denis Samuel-Lajeunesse who served as Chairman of the Task Force. Our French hosts encouraged the orderly and frank exchange of views that resulted in this excellent report being accepted by the members and finished ahead of schedule.

The Task Force consisted of sixteen members: The seven Summit participants, eight other industrialized countries, and the European Community. The Task Force was unique in bringing together participants from finance ministries, financial institution regulatory agencies, foreign and justice ministries, and law enforcement agencies of the member countries.

Contained in the report are 40 action recommendations, which when implemented by the member countries, should establish a network of comprehensive programs to address money laundering and will facilitate greater cooperation in international investigations, prosecutions, and property seizures.

At the same time, the recommendations reflect a recognition that law enforcement objectives need to be balanced with burdens on the financial system.

The Financial Action Task Force was born of the ideas that narcotics trafficking and money laundering are inextricably connected and that money laundering is an international problem that requires an international solution. Countries must link together to have strong domestic anti-money laundering programs for detection and prosecution and must cooperate freely with each other in the many cases that cross international borders. As long as there are weak links in this chain -- countries whose legal or regulatory systems make their financial institutions vulnerable to money laundering -- we will have a difficult time getting control of this problem.

The Task Force recognized that money laundering is a complex economic crime that cannot be effectively attacked by conventional law enforcement methods alone. Law enforcement authorities, finance ministries, financial institution regulators, and financial institutions themselves must work as partners to prevent financial institutions from being used by money launderers, with financial institutions as the first line of defense.

The Task Force acknowledged that this partnership cannot flourish if financial institution secrecy laws are erected as barriers to effective anti-money laundering efforts. Specifically, the Task Force recommends that, as in the United States, financial institutions must be able to report suspicious transactions to law enforcement, in good faith, free from fear of liability under secrecy laws. Suspicious transaction reporting has proven to be very valuable to U.S. law enforcement.

Among the other important recommendations of the Task Force was that financial institutions must have procedures in place to identify and know their customers. The Task Force also recognized that both for domestic and international enforcement it is essential that financial institutions maintain adequate records about customers and transactions, including currency transactions, for use in future criminal investigations and prosecutions. With money laundering cases being investigated months and even years after transactions take place, adequate recordkeeping is essential.

Where do we go from here? Recognition by the Task Force member countries of the need for a united front against money laundering is a major step, but only a first step. The United States is committed to playing a leadership role in seeing that an effective global anti-money laundering network is established. The Task Force recommendations will be a solid foundation for this network.

In closing, congratulations are in order to the many people who contributed to the success of this endeavor: I was ably assisted as head of the United States delegation by former Treasury Assistant Secretary for Enforcement Salvatore R. Martoche. Under Secretary for International Affairs David Mulford played a major role as the Summit Sherpa who laid the ground work for convening the Financial Action Task Force. Robert Mueller, Assistant to Attorney General Thornburg, performed excellent work as Chairman of the Legal Questions Working Group.

The U.S. delegation consisted of representatives from Treasury Departmental Offices, the U.S. Customs Service and Office of the Comptroller of the Currency, the Department of State, the Department of Justice, including DEA and FBI, and the Federal Reserve Board. Every one of my colleagues on the delegation is to be commended for working so effectively to insure that the United States positions were presented and that the final product is one of which they can be justifiably proud.

FINANCIAL ACTION TASK FORCE

ON MONEY LAUNDERING

REPORT

SUMMARY

1 - REPORT

2 - SYNOPSIS OF THE FORTY RECOMMENDATIONS OF THE REPORT

INTRODUCTION

The Heads of State or Government of seven major industrial nations and the President of the Commission of the European Communities met in Paris in July 1989 for the fifteenth annual Economic Summit. They stated that the drug problem has reached devastating proportions, and stressed the urgent need for decisive actions, both on a national and international basis. Among other resolutions on drug issues, they convened a Financial Action Task Force (FATF) from Summit Participants and other countries interested in these problems, to assess the results of the cooperation already undertaken to prevent the utilization of the banking system and financial institutions for the purpose of money laundering, and to consider additional preventive efforts in this field, including the adaptation of the statutory and regulatory systems to enhance multilateral legal assistance. They decided that the first meeting of this Task Force would be called by France, and that its report would be completed by April 1990.

In addition to Summit Participants (United States, Japan, Germany, France, United Kingdom, Italy, Canada, and the Commission of the European Communities), eight countries (Sweden, Netherlands, Belgium, Luxemburg, Switzerland, Austria, Spain and Australia), were invited to join the Task Force, in order to enlarge its expertise and also to reflect the views of other countries particularly concerned by, or having particular experience in the fight against money laundering, at the national or international level.

France held the presidency of the Task Force. Several meetings were held in Paris and one meeting in Washington. More than one hundred and thirty experts from various ministries, law enforcement authorities, and bank supervisory and regulatory agencies, met and worked together. The work of the Task Force, in itself, has improved the international cooperation in the fight against money laundering : contacts were established between experts and law enforcement authorities of member countries, and a comprehensive documentation on money laundering techniques, and national programs to combat them has been compiled. As a result, Task Force countries have already improved their readiness and ability to fight against money laundering, and to cooperate to this end .

To facilitate the work of the Task Force, and to take advantage of the expertise of its participants, three working groups were created, which focused respectively on money laundering statistics and methods (working - group 1, presidency : United Kingdom), on legal questions (working - group 2, presidency : United States), and on administrative and financial cooperation (working - group 3, presidency : Italy). Their comprehensive reports constitute part of the background material of this report, and of possible future work.

Building upon this substantial preparation, the Task Force report begins with a thorough <u>analysis of the money laundering process</u>, its extent and methods (part I) ; then, it presents <u>the international instruments and national programs already in place</u> to combat money laundering (part II) ; and it devotes its most extensive and detailed developments to the formulation of <u>action recommendations</u>, on how to improve the national legal systems, enhance the role of the financial system, and strengthen international cooperation against money laundering (part III).

I - EXTENT AND NATURE OF THE MONEY LAUNDERING PROCESS

A - EXTENT

The financial flows arising from drug trafficking might theoretically be estimated directly or indirectly.

A direct estimation would consist of measuring these flows from the international banking statistics and capital account statistics for the balance of payments. This could be done through an analysis of errors and omissions and other discrepancies. The task force asked the IMF and the BIS to conduct this work. Their conclusion was that although deposits covered by international banking statistics may include a substantial amount of drug money, there is no way in which this aspect can be singled out and it probably accounts for only a small percentage of the totals. The data for banks' liabilities suffers from insufficient coverage of offshore financial centers.

Indirect methods estimate the value of production or sales of narcotics, based on the fact that financial flows arising from drug trafficking are initially the counterparts of flows of drugs themselves. The parties involved in illegal narcotics trransactions inevitably come to hold cash or balances in financial institutions whose connections with illicit activity they will wish to conceal. There is currently insufficient information to evaluate, on the basis of estimates of the value of drug sales, the level of these balances resulting from money laundering.

Three indirect methods of estimation were used to assess the scale of financial flows arising from drug traffic. They are based on estimations of drug production or consumption, valued using the retail price of drugs. Only a part of the calculated amounts are profits available to be laundered : production estimates must be modified by estimates of local consumption and losses in the production and distribution chain.

1 - The first method is based on estimations of world drug production. The United Nations estimated drug trafficking proceeds[1] worldwide at $ 300 billion in 1987. This estimation remains very uncertain.

The role of each kind of drug in the generation of proceeds available for money laundering is also difficult to assess. Estimates of US street yield are in the range of $29 billion for cocaine, $10 billion for heroin, and $67 billion for cannabis. Some drugs generate huge profits for the organisations controlling the traffic, making money laundering of large amounts, through complicated financial channels, a necessity, while some others generate profits mainly for the retailers, who may facilitate the laundering of these profits through very simple financial operations, for instance by bartering drugs for stolen goods, and selling these goods for cash.

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(1) For purposes of estimating the scale of money laundering as discussed above, "proceeds" means the value of the final sale of illegal drugs, without deduction of costs and without respect to whether payment is made with money or things of value.

For purposes of estimating the scale of money laundering as discussed above, "profits" means the value of drug sales less costs incurred by the traffickers (e.g. the cost of acquiring the drugs themselves, the cost of any precursor or essential chemicals, packaging materials, costs of transportation, costs of corruption, legal fees paid to defense lawyers, etc...).

Opium and its derivatives (e.g. heroin) originate mainly from Southeast Asia (the Golden Triangle) and Southwest Asia (the Golden Crescent) and Mexico. Proceeds from the sale of this multi-source drug are partly laundered through a sophisticated network of underground financial channels. Retail distribution networks are nonetheless largely controlled by persons located within Task Force countries.

Coca shrubs are cultivated in the Andean countries of South America (e.g. Bolivia, Colombia, Peru), and are converted into the most marketable form, cocaine hydrochloride, predominantly in Colombia. Several cartels are known to control the processing of cocaine hydrochloride in Colombia. Colombian nationals are also known to be involved in organising and controlling distribution networks in other countries. This means that there is a flow of funds destined to Colombia originating in Task Force countries.

The total global crop of cannabis is extremely difficult to estimate, as it grows uncultivated in many of the producing areas. Nevertheless, in many countries, major cannabis import, wholesale, and retail distribution organisations provide a structure which may also be used for distribution of heroin and cocaine. Large canabis seizures from offshore supply vessels, and bulk consignments of cannabis packed with heroin or cocaine are becoming more common in Europe. There is a rapid and troublesome growth in the size, power, and money laundering capability of some cannabis distribution organisations, raising the spectre of cartels developing in this area. Hence, in law enforcement and money laundering terms, cannabis trafficking constitutes a very serious problem requiring urgent attention.

Although a large part of heroin, cocaine and cannabis production is consumed in industrialized countries, important quantities are also consumed in producting countries, especially heroin, where they also generate profits.

Finally, psychotropic substances such as amphetamines/methamphetamines and LSD are produced in clandestine laboratories, including some within Task Force countries. Large amounts of cash are derived, although not on the same scale as for cocaine and heroin.

However, the production-based method of estimation does not provide for an identification of financial flows within individual countries. Accordingly, all that can be said for certain is that the bulk of proceeds arises at the retail level within the Task Force area.

2 - A second method of estimating laundered drug proceeds is based on the consumption needs of drug abusers. But the information regarding drug use obtained through surveys is frequently of doubtful reliability since the activity is illegal : sample populations surveyed for example in homes or schools may miss a significant proportion of drugs users.

3 - A third method of estimating uses data concerning actual seizures of illicit drugs, and projects the total amounts of drugs available for sale by the application of a multiplier to recorded seizures, which is estimated on the basis of a law enforcement seizure rate varying between 5 % and 20 % according to the type of drug considered, and which, on a weighted average, could be approximately of 10 %. This approach, too, raises significant methodological problems.

Using these methods, the group estimated that sales of cocaine, heroin and cannabis amount to approximately $ 122 billions per year in the United States and Europe, of which 50 % to 70 % or as much as $ 85 billion per year could be available for laundering and investment. One Task Force member estimated global profits at the main dealer level, which might be most subject to international laundering, to be about $ 30 billion per year.

B - METHODS

It would be impossible to list the entire range of methods used to launder money Nevertheless, the Task Force reviewed a number of practical cases of money laundering. It stated that all of them share common factors, regarding the role of cash domestically, of various kinds of financial institutions, of international cash transfers, and of corporate techniques. These common factors indicate clearly where the efforts of the fight against money laundering should focus.

1 - Cash intensiveness

The form of the money obtained through drug trafficking must be changed in order to shrink the huge volumes of cash generated : unlike the proceeds of some other forms of criminal activity, drug cash usually comes in the form of large volumes of mixed denomination notes, and at least in the case of heroin and cocaine, the physical volume of notes received from street dealing is much larger than the volume of the drugs themselves ;

Drugs criminals are faced with major difficulties when in possession of large amounts of cash, and when large transactions cannot be performed in cash without arousing suspicion. A completely cashless economy where all transactions were registered would create enormous problems for the money launderers. Similarly, a rule that cash transactions were illegal above a certain amount for all but certain types of business regularly operating in cash would also create problems for launderers.

This is not to say that the cash intensiveness in one country is by itself correlated with the importance of money laundering. The cash intensiveness of Task Force economies varies greatly between countries. In countries like Switzerland, Germany, the Netherlands, Japan, Belgium and Austria, the cash/GDP ratio lies in the range 6,9 - 8,9 %, whereas at the other extreme are economies such as the UK and France with cash/GDP ratios at about 3 - 4 %. Important cash transactions are increasingly monitored in some countries, such as the United States and Australia, and were recently prohibited in France over 150.000 francs per transaction.

Another observation is that it is easier for the launderer if the cash in which he operates can be directly accepted abroad as a means of exchange. The US dollar in cash is acceptable as a means of exchange in large amounts in many parts of the world : Federal Reserve Board staff have estimated that adult residents of the US held only 11 - 12 % of issued U.S. notes and coins in 1984. The remainder were held by legitimate and illegitimate business enterprises, residents of foreign countries, and persons less than 18 years old.

2 - Role of formal and informal financial institutions.

a) Role of formal financial institutions

Banks and other deposit-taking financial institutions are the main transmitters of money both within the Task Force area and internationally. Clearly the stage of depositing money in institutions is a key one for money launderers. Whether a currency reporting system is in place, or whether the laws in the country only allow or require the reporting of suspicious transactions, many of the Task Force countries have measures in place which would make large cash deposits likely to be brought to the attention of the authorities. Therefore, deposits have to be disguised. In countries where there is cash transaction reporting, deposits have to be broken up into sizes which are lower than the threshold for that reporting ("smurfing"), in order to escape this reporting.

For criminals to avoid suspicion, the reduction of deposit size below reporting requirements is not enough. Deposits may be made in the name of a company whose beneficial owners do not have to be disclosed in the country in which it is headquartered. Those with signing authority for the company in a Task Force country -or receiving payments- do not necessarily know who the beneficial owners are. In some countries, bank accounts can also be opened in the name of trustees, and the beneficiaries under the trust may be kept secret. Deposits may be made by the legal profession in the name of clients to whom the rules of attorney confidentiality may apply.

Even if identity requirements were comprehensive and uniform, it is possible that officials of banks may become corrupt and accept deposits from persons with false identities. Most reputable banks do not open accounts without knowing their customer. But they may be less careful about cash transactions in foreign exchange over the counter, or in providing cashier's cheques or wiring money for non-depositors. It is not believed that automatic teller machines (ATMs) operated by banks cause any particular difficulty at present. But automatic foreign exchange changing machines - already in use in Europe - can provide anonymity during the laundering process. Similarly, any future ATMs which automatically and anonymously convert low value notes into high value ones would also facilitate money laundering.

b) Role of informal financial institutions

It is of course not necessary for criminals to use licensed deposit-taking financial institutions or to establish companies to help deal with their problems. Informal and largely unregulated financial institutions, which can not legally accept deposits, can also be used. The first category of these are Bureaux de Change, which accept money in one currency and convert it into another. This still leaves the cash problem open, but a first transformation has taken place which makes it more difficult to detect the origin of the funds. If informal financial institutions provide this service, they may not record the identity of transactors. Cheque cashers who provide a service mainly after bank hours, if unscrupulous, can work in reverse : selling cheques at a premium for cash.

Informal bankers, including "Hawalla" bankers exist mainly in countries with direct connections with Asia. They are often involved in the gold bullion, gold jewelry or currency exchange business, and may be a member of a family with similar businesses in several countries, or, at the other end of the scale, a street corner confectionery shop. Bona fide employees of foreign banks may operate such systems outside banking hours.

3 - Cash shipments abroad

Drugs proceeds can be deposited abroad in jurisdictions where the banking system is insufficiently regulated and where the establishment of "letter box" companies is permitted. Such jurisdictions may include, for instance, small countries who wish to establish a financial services industry as a supplementary source of income -the sale of banking licenses can constitute a major source of revenue to the authorities- and employment for the population. Such jurisdictions are sometimes also tax havens.

These jurisdictions are part of the world payments system without any restriction. So long as this is the case, cash exports will tend to go to these countries for integration into the financial system there and return by means of wire transfers. This means that detection of the outflow of cash becomes especially important when internal avenues have been blocked.

4 - Corporate techniques

Drug dealers must conceal the true ownership and origin of the money while simultaneously controlling it. To this end, they can use various corporate techniques.

Offshore companies can be used by launderers in ways other than simply as depositories for cash. Launderers can set up or buy corporations, perhaps in a tax haven using a local lawyer or other person as a nominee owner, with an account at a local bank. They can then finance the purchase of a similar business at home through a loan from their corporation abroad (or the bank), in effect borrowing their own money and paying it back as if it were a legitimate loan.

The technique of "double invoicing" can be used whereby goods are purchased at inflated prices by domestic companies owned by money launderers from offshore corporations which they also own. The difference between the price and the true value is then deposited offshore and paid to the offshore company and repatriated at will. Variants of the "double invoicing" technique abound.

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All these techniques, however, involve going through stages where detection is possible. Either cash has to be exported over a territorial frontier and then deposited in a foreign financial institution, or it requires the knowing or unknowing complicity of someone at home not connected with the drug trade, or it requires convincing a domestic financial institution that a large cash deposit or purchase of a cashier's cheque is legitimate. Once these hurdles have been cleared, the way is much easier inside the legitimate financial system.

Hence, key stages for the detection of money laundering operations are those where cash enters into the domestic financial system, either formally or informally, where it is sent abroad to be integrated into the financial systems of regulatory havens, and where it is repatriated in the form of transfers of legitimate appearance.

II - PROGRAMS ALREADY IN PLACE TO COMBAT MONEY LAUNDERING

A - INTERNATIONAL INSTRUMENTS

Various international organisations or groups, including the Council of Europe[1], INTERPOL, among EEC members the Mutual Assistance Group between customs administrations and the TREVI group between ministers in charge of security, as well as the Customs Cooperation Council, have already devoted much attention to the money laundering problem. Besides, two international instruments currently address this issue from different viewpoints : the United Nations Vienna Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (hereinafter "Vienna Convention"), and the Statement of Principles of the Basel Committee on Banking Regulations and Supervisory Practices (hereinafter Basel Statement of Principles), concerning the "prevention of criminal use of the banking system for the purpose of money laundering."

a) <u>The Vienna Convention</u>

This Convention, which was adopted in Vienna on December 20, 1988, focuses on drug trafficking in general, including of course, but not exclusively, drug money laundering. On this last issue, it lays firm ground for further progress in the following directions :

- it creates an obligation to criminalize the laundering of money derived from drug trafficking, thereby facilitating judicial cooperation and extradition in this field, which today are hampered, given the principle of dual criminality, by the fact that many countries do not presently criminalize money laundering ;

- several parts of the Vienna Convention deal with international cooperation. Its implementation would substantially facilitate international investigations ;

- it makes extradition between signatory States applicable in money laundering cases ;

- it sets out principles to facilitate cooperative administrative investigations ;

- it sets forth the principle that banking secrecy should not interfere with criminal investigations in the context of international cooperation.

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(1) The Committee of Ministers to the Member States of the Council of Europe adopted on June 27, 1980, a recommendation concerning measures against the transfer and the sheltering of criminally originated funds.

More than eighty countries have signed this convention, including all Task Force countries. So far, only China, Senegal, the Bahamas and Nigeria have ratified it. Twenty ratifications are necessary for this convention to be brought into force. Given the complexity of the ratification and implementation process, in some countries, its entry into force could take several years.

b) The Basel Statement of Principles

This document, which was agreed to on December 12, 1988, states that public confidence in banks may be undermined through their association with criminals, and outlines some basic principles with a view to combat money laundering operations through the banking system, in the following directions :

- customer identification ;

- compliance with laws and regulations pertaining to financial transactions, and refusal to assist transactions which appear to be associated with money laundering ;

- cooperation with law enforcement authorities, to the extent permitted by regulations relating to customer confidentiality.

All Task Force countries, except Australia, Austria, and Spain, were part of the group that agreed to the Basel Statement of Principles. The bank regulators and supervisors of these three countries, however, have expressed that they consider this Statement as also applicable to their supervised banking systems.

Although it is not in itself a legally binding document, various formulas have been used to make its principles an obligation, notably a formal agreement among banks that commits them explicitly (Austria, Italy, Switzerland), a formal indication by bank regulators that failure to comply with these principles could lead to administrative sanctions (France, United Kingdom), or legally binding texts with a reference to these principles (Luxemburg).

In spite of the fact that the Statement of Principles is a recent text, and furthermore that it was very recently established as an obligation for banks, practical measures have already been taken in many countries, such as the appointment of a compliance officer in each bank, in charge of the application of the internal programs against money laundering. Most Task Force countries have set detailed guidelines for banks, making the Principles precise and practical obligations.

It should be noted that certain of these Principles have been applied in most countries for a long time, as for instance the principles of customer identification and retaining of records of transactions.

B - NATIONAL PROGRAMS

Awareness of the problem of money laundering is recent. However, national programs to combat it are already in place in some Task Force countries, although much remains to be done in most of them.

The group agreed to the following working definition to describe the process of money laundering conduct or behaviour :

- the conversion or transfer of property, knowing that such property is derived from a criminal offense, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in the commission of such an offense or offenses to evade the legal consequences of his actions ;

- the concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of property, knowing that such property is derived from a criminal offense ;

- the acquisition, possession or use of property, knowing at the time of receipt that such property was derived from a criminal offense or from an act of participation in such offense[1].

1 - Money laundering offense

Money laundering is already a specific criminal offense in seven Task Force countries (Australia, Canada, France, Italy, Luxemburg, United Kingdom, United States), and there is pending legislation to create this offence in four additional Task Force countries (Belgium, Germany, Sweden, Switzerland). In the other Task Force countries (Netherlands, Spain, Austria, Japan), there is currently no specific money laundering offense, although, for some of them the general legislation pertaining to the proceeds of crime covers money laundering offenses.

Some differences appear in the scienter requirements, whereas most countries only criminalize intentional money laundering, other countries also criminalize negligence leading to money laundering.

The criminal penalties for these offenses are heavy fines, imprisonment up to 20 years, and sometimes prohibitions against engaging in certain professions.

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(1) Most delegates consider that the final paragraph of the definition, drawn from the Vienna Convention, does not describe money laundering per se, but an economic aspect of crime which must be addressed in any comprehensive scheme against money laundering, whereas a few delegates understand this paragraph as being included in the concept of money laundering.

2 - Freezing, seizure and confiscation of assets

Most Task Force countries have provisional measures concerning freezing, seizure, and/or procedures for asset confiscation relating to drug offenses. However, not all the countries that have established money laundering offenses permit these procedures in relation to money laundering.

The definition of property subject to freezing, seizure and confiscation is generally similar from one country to another, because, in most countries, it also extends to all proceeds of crime, which would normally cover indirect as well as direct profits or proceeds of drug trafficking. In a few countries, it also extends to the property laundered, the instrumentalities used in the crime, or property of corresponding value.

Most Task Force countries allow freezing, seizure or confiscation of assets related to drug trafficking in execution of a formal request of a foreign state, in the framework of their domestic laws, or provided a treaty exists, and subject to additional conditions. Nevertheless, the existing domestic laws and mutual legal assistance treaties do not provide for each Task Force country to obtain freezing, seizure or confiscation of drug-related assets in all other member countries.

3 - Bank secrecy laws and reporting requirements

a) Customer identification

None of the Task Force countries allows anonymous accounts, although Austria allows limited forms of anonymous bearer accounts. Most Task Force countries require the identification of customers using safe deposit facilities. Only in some Task Force members (Australia, Luxemburg, Sweden, Switzerland) does the obligation to identify extend to the beneficial owners.

b) Internal records of transactions

All countries' banks must keep account books and records of transactions, for the purpose of prudential supervision, statistics and tax control. In a few countries, banks must also retain internal records of transactions (either all transactions, and/or large cash transactions and/or international transactions), for the purpose of combatting money laundering and other crimes.

The conditions of access of law enforcement authorities to these records are extremely varied among countries. In most cases, judicial proceedings are necessary to overcome bank secrecy rules.

c) <u>Detection of suspicious transactions</u>

·The detection of suspicious transactions occurring through the financial system, in Task Force countries having specific detection programs, is broadly based on different systems, which can be complementary.

The responsibility for initially detecting suspicious financial flows falls mainly to financial institutions themselves. In some countries, such as Canada, banks have taken on this responsibility ; in other countries, such as the UK, banks have been indirectly obliged to take on this responsibility in order to avoid possible prosecution for money laundering ; while in other countries, such as the US and Australia, this responsibility has been imposed by regulation. The banker, to avoid the risk of being involved in money laundering operations, sets up internal programs to detect suspicious transactions, and declares his suspicions to the competent authorities. Under either system, when banks bring a questionable transaction to the attention of these authorities, they will be protected against judicial actions brought by their customers for failure to respect banking confidentiality. These systems also require confidential relations between bankers and these authorities. Although these systems are recent, the number of declarations -from several hundreds to several thousands each year- received by the competent authorities of countries which apply them, is an indication of their efficiency. In most other Task Force countries, bank secrecy rules do not allow bankers to make such declarations. In some other countries where the reporting of suspicious transactions is mandatory, such as the United States, failure to report suspicious transactions carries administrative penalties.

In addition to mandatory suspicious transaction reporting, competent administrative authorities in two countries rely on the systemactic gathering and analysis of information related to cash movements. This is the system in place in the United States and Australia. In this system, financial institutions report routinely all deposits, transfers and withdrawals of cash over $ 10,000. These reports, together with report of large international transfers of cash and similar instruments over $ 10,000, are fed into a computerized database, with an artificial intelligence system, enabling the detection of questionable transactions. In the United-States, about 6 millions reports are made annually under this system, with a cost for the financial institutions estimated at US $ 17 for each report. In the US, currency reports serve a number of purposes beyond identifying suspicious transactions. The reports are used in many ways to support investigations, prosecutions and confiscation.

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Although recent, there are signs that these programs against money laundering, in countries having such programs, have effective results, by creating increased risks for money launderers. For instance, in the United States, money laundering "commissions" asked by launderers, which amounted to 2 % to 4 % per transaction in the early 1980's, commonly reach 6 % to 8 % now.

Recommendation
numbers

III - RECOMMENDATIONS

A - GENERAL FRAMEWORK OF THE RECOMMENDATIONS

Many of the current difficulties in international cooperation in drug money laundering cases are directly or indirectly linked with a strict application of bank secrecy rules, with the fact that, in many countries, money laundering is not today an offense, and with insufficiencies in multilateral cooperation and mutual legal assistance.

Some of these difficulties will be alleviated when the Vienna Convention is in effect in all the signatory countries, principally because this would open more widely the possibility of mutual legal assistance in money laundering cases. Accordingly, the group
1 unanimoulsy agreed as its first recommendation that **each country should, without further delay, take steps to fully implement the Vienna Convention, and proceed to ratify it.**[1]

Concerning bank secrecy, it was unanimously agreed that **financial institution secrecy laws should be conceived so as not to inhibit implementation of the recommendations**
2 **of this group.**

Finally, **an effective money laundering enforcement program should include**
3 **increased multilateral cooperation and mutual legal assistance in money laundering investigations and prosecutions and extradition in money laundering cases, where possible.**

Nevertheless, this should not be the end point of our efforts to fight this phenomenon. Additional measures are necessary, for at least two reasons :

- <u>the need for rapid and tough actions</u>

As the purpose of the Vienna Convention is the fight against drug trafficking in general, including of course, but not exclusively, the fight against drug money laundering, some countries could have difficulties in ratifying and implementing it for reasons that are not related to the issue of money laundering. It remains crucial, whatever the difficulties may be on legal and technical grounds, to ratify and implement the Convention fully and without delay.

Rapid progress on the issue of money laundering is necessary. Hence, the Task Force's recommendations include important steps that are implied by this Convention. Furthermore, even on the topics mentioned by the Vienna Convention, it seemed to the group that the growing dimension and increasing awareness of the problem of money laundering, would justify a reinforcement of its provisions applicable to money laundering issues.

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[1] However, the Task Force did not undertake to determine what steps would be adequate to meet the requirements of the Vienna Convention. So, the adoption of the proposals and recommendations of the Task Force would not necessarily constitute full compliance with the obligations assumed by Task Force countries as parties to the U.N. Vienna Convention.

- <u>the need for practical measures</u>.

Any discrepancy between national measures to fight money laundering can be used potentially by traffickers, who would move their laundering channels to the countries and financial systems where no or weak regulations exist on this matter, making the detection of funds of criminal origin more difficult. To avoid such a risk, these national measures, particularly those concerning the diligence of financial institutions, have to be conceived in a way that builds upon and enhances the Basel Statement of Principles, and to be harmonized in their most practical aspects, which is not provided for in the Statement.

On these bases, we recommend action steps that, in our view, could constitute a minimal standard in the fight against money laundering for the countries participating in this Task Force, as well as for other countries. Some of these recommendations reflect the view of a majority of delegates, rather than unanimity, so that they are not limited to the weakest existing solution in the participating countries on each topic. Cases where a minority held a significantly different view are also mentioned. Accordingly, the minimal standard we recommend can be viewed as rather ambitious. Nevertheless, it should in no way prevent individual countries from adopting or maintaining more stringent measures against money laundering. Furthermore, as money laundering techniques evolve, anti-money laundering measures must evolve too : our recommendations will probably need periodic reevaluation.

These action steps against money laundering focus on improvements of national legal systems (B), enhancement of the role of the financial system (C), and the strengthening of international cooperation (D).

B - IMPROVEMENT OF NATIONAL LEGAL SYSTEMS TO COMBAT MONEY LAUNDERING

1 - Definition of the criminal offense of money laundering

Each country should take such measures, as may be necessary, including
4 **legislative ones, to enable it to criminalize drug money laundering as set forth in the Vienna**
Convention.

However, the laundering of drug money is frequentely associated with the laundering of other criminal proceeds. Given the difficulty to bring evidence of drug money laundering specifically, an extension of the scope of this offense, for instance to the most serious offenses, such as arms trafficking, etc., might facilitate its prosecution.

Accordingly, **each country should consider extending the offense of drug money**
5 **laundering to any other crimes for which there is a link to narcotics ; an alternative approach**
is to criminalize money laundering based on all serious offenses, and/or on all offenses that
generate a significant amount of proceeds, or on certain serious offenses.

The group agreed that, **as provided in the Vienna Convention, the offense of**
money laundering should apply at least to knowing money laundering activity, including the
6 **concept that knowledge may be inferred from objective factual circumstances.** Some delegates consider that the offense of money laundering should go beyond the Vienna Convention on this point to criminalize activity where a money launderer should have known the criminal origin of the laundered funds. As already mentioned, a few countries would impose criminal sanctions for negligent money laundering activity.

7 In addition, the group recommends that, **where possible, corporations themselves**
-not only their employees- should be subject to criminal liability.

2 - Provisional measures and confiscation

The Vienna Convention provides for provisional measures and confiscation in cases of drug trafficking and laundering of drug money. These measures are a necessary condition to an effective fight against drug money laundering, notably because they facilitate the execution of sentences and help reduce the financial attractiveness of money laundering.

Accordingly, countries should adopt measures similar to those set forth in the
Vienna Convention, as may be necessary, including legislative ones, to enable their competent
8 **authorities to confiscate property laundered, proceeds from, instrumentalities used in or**
intended for use in the commission of any money laundering offense, or property of
corresponding value.

Such measures should include the authority to : 1) identify, trace, and evaluate property which is subject to confiscation ; 2) carry out provisional measures, such a freezing and seizing, to prevent any dealing, transfer, or disposal of such property and 3) take any appropriate investigative measures.

In addition to confiscation and criminal sanctions, countries also should consider monetary and civil penalties, and/or proceedings including civil proceedings, to void contracts entered by parties, where parties knew or should have known that as a result of the contract, the state would be prejudiced in its ability to recover financial claims, e.g., through confiscation or collection of fines and penalties.

C - ENHANCEMENT OF THE ROLE OF THE FINANCIAL SYSTEM

In addressing the subject of money laundering, the group has kept in mind the necessity to weigh the impact of its recommendations on financial institutions, and to preserve the efficient operation of national and international financial systems.

1 - Scope of the following recommendations

The entry of cash into the financial system is of crucial importance in the drug money laundering process. This may occur through the financial system (banks and other financial institutions), and also through certain other professions dealing with cash, which are unregulated or virtually unregulated in many countries.

9 Accordingly, **recommendations 12 to 29 of this paper should apply not only to banks, but also to non-bank financial institutions.**

For maximum effectiveness, these recommendations need to cover as many organisations as possible that receive large value cash payments in the course of their business.

10 Therefore, **the appropriate national authorities should take steps to ensure that these recommendations are implemented on as broad a front as is pratically possible.**

Nevertheless, excessive variation among the national lists of these non-bank financial institutions and other professions dealing with cash, subject to the following recommendations, could potentially facilitate the activity of money launderers. To avoid that, some delegates prefer that a common, minimum list of these financial institutions and professions be accepted by all the countries. As examples of non-bank financial institutions, savings societies including postal savings societies, loan societies, building societies, security brokers and dealers, credit card companies, check cashers, transmitters of funds by wire, money changers / bureaux de change, sales finance companies, consumer loan companies, leasing companies, factoring companies, and gold dealers were mentioned.

It was agreed that, **a working group should further examine the possibility of**

11 **establishing a common minimal list of non-bank financial institutions and other professions dealing with cash subject to these recommendations.**

2 - Customer identification and record keeping rules

Crucial in the fight against money laundering through the financial system, are the ability of financial institutions to screen undesirable customers, and the ability for law enforcement authorities to conduct their enquiries on the basis of reliable documents about the transactions and the identity of clients.

Hence, **financial institutions should not keep anonymous accounts or accounts in obviously fictitious names : they should be required (by law, by regulations, by agreements between supervisory authorities and financial institutions or by self-regulatory agreements**

12 **among financial institutions) to identify, on the basis of an official or other reliable identifying document, and record the identity of their clients, either occasional or usual, when establishing business relations or conducting transactions (in particular opening of accounts or passbooks, entering into fiduciary transactions, renting of safedeposit boxes, performing large cash transactions).**

Furthermore, layering of funds of illicit origin is often facilitated by nominee accounts in financial institutions and shareholdings in companies, where beneficial ownership is disguised.

13 Hence, financial institutions should take reasonable measures to obtain information about the true identity of the persons on whose behalf an account is opened or a transaction is conducted if there are any doubts as to whether these clients or customers are not acting on their own behalf, in particular, in the case of domiciliary companies (i.e. institutions, corporations, foundations, trusts, etc., that do not conduct any commercial or manufactoring business or any other form of commercial operation in the country where their registered office is located).

14 Financial institutions should maintain, for at least five years, all necessary records on transactions, both domestic or international, to enable them to comply swiftly with information requests from the competent authorities. Such records must be sufficient to permit reconstruction of individual transactions (including the amounts and types of currency involved, if any) so as to provide, if necessary, evidence for prosecution of criminal behaviour.

Financial institutions should keep records on customer identification (e.g. copies or records of official identification documents like passports, identity cards, driving licenses or similar documents), account files and business correspondence for at least five years after the account is closed.

These documents should be available to domestic competent authorities in the context of criminal prosecutions and investigations.

3 - Increased diligence of financial institutions

Identification of customers is generally not sufficient to allow financial institutions and law enforcement authorities to detect suspicious transactions.

15 Hence, financial institutions should pay special attention to all complex, unusual, large transactions, and all unusual patterns of transactions, which have no apparent economic or visible lawful purpose. The background and purpose of such transactions should, as far as possible, be examined, the findings established in writing, and be available to help supervisors, auditors and law enforcement agencies.

Where financial institutions suspect that funds stem from a criminal activity, bank secrecy rules or other privacy laws which are presently enforced in most countries prohibit them to report their suspicions to the competent authorities. Thus, to avoid any involvement in money laundering operations, they have no other choice, in that case, than denying assistance, severing relations and closing accounts in accordance with the Basle Statement of Principles. The consequence is that these funds can flow through other, undetected channels, which would frustate the efforts of competent authorities in the fight against money laundering.

16 To avoid this risk, the following principle should be established : **if financial institutions suspect that funds stem from a criminal activity, they should be permitted or required to report promptly their suspicions to the competent authorities. Accordingly, there should be legal provisions to protect financial institutions and their employees from criminal or civil liability for breach of any restriction on disclosure of information imposed by contract or by any legislative, regulatory or administrative provision, if they report in good faith, in disclosing suspected criminal activity to the competent authorities, even if they did not know precisely what the underlying criminal activity was, and regardless of whether illegal activity actually occured.**

There is a divergence of opinion within the Task Force on whether suspicious activity reporting should be mandatory or permissive. A few countries strongly believe that this reporting should be mandatory, possibly restricted to suspicions on serious criminal activities, and with administrative sanctions available for failure to report.

If financial institutions, while making these reports, warned at the same time their customers, the effect might be similar to a refusal to handle the suspected funds : the suspected customers and their funds would flow through undetected channels.

17 **Hence, financial institutions, their directors and employees, should not, or, where appropriate, should not be allowed to, warn their customers when information relating to them is being reported to the competent authorities.**

18 **In the case of a mandatory reporting system, or in the case of a voluntary reporting system where appropriate, financial institutions reporting their suspicions should comply with instructions from the competent authorities.**

19 **In countries where no obligation of reporting these suspicions exist, when a financial institution develops suspicions about operations of a customer, and when the financial institution chooses to make no report to the competent authorities, it should deny assistance to this customer, sever relations with him and close his accounts.**

The group also discussed what actions financial institutions should take when they learn from competent authorities, even in an informal way, that criminal proceedings, including international mutual assistance requests and/or appropriate freezing orders, are pending or imminent. Further examination of the intricate legal and practical aspects of this question would be useful, to avoid a premature withdrawal of funds which would unduly impair the criminal proceedings.

Staff in financial institutions are still only beginning, in most countries, to become aware of money laundering. This is of great help to money launderers. In some countries, complicity of staff may be also a problem.

20 **Hence, financial institutions should develop programs against money laundering. These programs should include, as a minimum :**

a) the development of internal policies, procedures and controls, including the designation of compliance officers at management level, and adequate screening procedures to ensure high standards when hiring employees ;

b) an ongoing employee training program ;

c) an audit function to test the system.

4 - Measures to cope with the problem of countries with no or insufficient anti money laundering measures.

The strengthening of the fight against money laundering in some countries could lead to a simple move of the money laundering channels to countries with insufficient money laundering measures, in a process akin to regulator shopping.

Frequently, a money laundering operation would involve the following stages .

- drugs cash proceeds would be exported from regulated countries to unregulated ones ;

- this cash would be laundered through the domestic formal or informal financial system of these havens ;

- the subsequent stage would be a return of these laundered funds to regulated countries with safe placement opportunities, particularly through wire transfers.

While sovereignty principles make it difficult to prevent this type of displacement of money laundering channels, and other laundering operations using regulation havens, the following principles should be applied by financial institutions in regulated countries :

21 **- financial institutions should give special attention to business relations and transactions with persons, including companies and financial institutions, from countries which do not or insufficiently apply these recommendations. Whenever these transactions have no apparent economic or visible lawful purpose, their background and purpose should, as far as possible, be examined, the findings established in writing, and be available to help supervisors, auditors and law enforcement agencies.**

22 **- financial institutions should ensure that the principles mentioned above are also applied to branches and majority owned subsidiaries located abroad, especially in countries which do not or insufficiently apply these recommendations, to the extent that local applicable laws and regulations permit. When local applicable laws and regulations prohibit this implementation, competent authorities in the country of the mother institution should be informed by the financial institutions that they cannot apply these recommendations.**

Within the context of relations between regulated and unregulated countries, the study of a system to monitor cash movements at the border is of special importance (see point 5 hereunder).

5 - <u>Other measures to avoid currency laundering</u>

It was recognised that the stage of drugs cash movements between countries is crucial in the detection of money laundering. A few delegates strongly support the proposal that a system of reporting of all large international transportations of currency or cash equivalent bearer instruments to a domestic central agency with a computerized data base available to domestic judicial or law enforcement authorities should be established for use in money laundering cases. But this opinion is not shared by the majority of the group.

23 Nevertheless, the group acknowledged that **the feasibility of measures to detect or monitor cash at the border should be studied, subject to strict safeguards to ensure proper use of information and without impeding in any way the freedom of capital movements.**

The detection of suspicious cash operations also could potentially be facilitated if law enforcement authorities were in a position to be informed and to analyze all large cash transactions occuring within their country.

For that purpose, one suggested solution is that these transactions be routinely reported by financial institutions to competent authorities.

However, the efficiency of such a system, which currently exists in two participating countries, is uncertain. The majority of the group was not convinced of the cost effectiveness of this system at this time, and expressed fears that it could lead financial institutions to feel less responsible for the fight against money laundering. On the other hand, it is the view of a few members that a comprehensive program to combat money laundering must include such a currency reporting system together with the reporting of international transportation of currency and currency equivalent instruments.

24 Nevertheless, the group agreed that countries should consider the feasibility and **utility of a system where banks and other financial institutions and intermediaries would report all domestic and international currency transactions above a fixed amount, to a national central agency with a computerized data base, available to competent authorities for use in money laundering cases, subject to strict safeguards to ensure proper use of the information.**

25 Furthermore, given the crucial importance of cash in drug trafficking and drug money laundering, and despite the fact that no clear correlation could be established between the cash intensiveness of a country's economy, and the role of this economy in international money laundering, **countries should further encourage in general the development of modern and secure techniques of money management, including increased use of checks, payment cards, direct deposit of salary checks, and book entry recording of securities, as a means to encourage the replacement of cash transfers.**

6 - Implementation, and role of regulatory and other administrative authorities

Effective implementation of the above recommendations must be ensured.

But the authorities supervising banks and other financial institutions have currently, in many countries, no competence to participate in the fight against criminal activities, because their mission is primarily a prudential one, and because of professional secrecy or other rules.

26 Accordingly, in each member country, **the competent authorities supervising banks or other financial institutions or intermediaries, or other competent authorities, should ensure that the supervised institutions have adequate programs to guard against money laundering. These authorities should cooperate and lend expertise spontaneously or on request with other domestic judicial or law enforcement authorities in money laundering investigations and prosecutions.**

27 The effective implementation of the above mentioned recommendations in other professions dealing with cash is hampered by the fact that, in many countries, these professions are virtually unregulated. Hence, **competent authorities should be designated to ensure an effective implementation of all these recommendations, through administrative supervision and regulation, in other professions dealing with cash as defined by each country.**

28 The establishment of programs to combat money laundering in financial institutions and other professions dealing with cash, would require the support of these competent authorities, particularly to make these institutions and professions aware of facts that should normally lead to suspicions. Accordingly, **the competent authorities should establish guidelines which will assist financial institutions in detecting suspicious patterns of behaviour by their customers. It is understood that such guidelines must develop over time, and will never be exhaustive. It is further understood that such guidelines will primarily serve as an educational tool for financial institutions' personnel.**

**Furthermore, the competent authorities regulating or supervising financial
institutions should take the necessary legal or regulatory measures to guard against control or
29 acquisition of a significant participation in financial institutions by criminals or their
confederates.**

The group acknowledged the risk that, outside the financial sector, industrial or commercial companies also could be acquired by criminals with the aim to use them for money laundering purposes.

D - STRENGTHENING OF INTERNATIONAL COOPERATION

The study of practical cases of money laundering clearly demonstrated that money launderers conduct their activities at an international level, thus exploiting differences between national jurisdictions and the existence of international boundaries. Therefore, enhanced international cooperation between enforcement agencies, financial institutions, and financial institution regulators and supervisors to facilitate the investigations, and prosecution of money launderers, is critical.

1 - Administrative cooperation

a) Exchange of general information

A first step is to improve the knowledge of international flows of drug money, noticeably cash flows, and the knowledge of money laundering methods, to enable a better focus of international and national efforts to combat this phenomenon.

Accordingly, national administrations should consider recording, at least in the aggregate, international flows of cash in whatever currency, so that estimates can be made of
30 cash flows and reflows from various sources abroad, when this is combined with central bank information. Such information should be made available to the IMF and BIS to facilitate international studies.

International competent authorities, perhaps Interpol and the Customs Cooperation Council, should be given responsibility for gathering and disseminating
31 information to competent authorities about the latest developments in money laundering and money laundering techniques. Central banks and bank regulators could do the same on their network. National authorities in various spheres, in consultation with trade associations, could then disseminate this to financial institutions in individual countries.

b) Exchange of information relating to suspicious transactions

Present arrangements for international administrative cooperation and international exchange of information relating to identified transactions are aknowledged to be insufficient. At the same time, this exchange of information must be consistent with national and international provisions on privacy and data protection. Furthermore, several countries consider that exchange of information relating to individual money laundering cases should take place only in the context of mutual legal assistance.

It was agreed that each country should make efforts to improve a spontaneous or "upon request" international information exchange relating to suspicious transactions, persons
32 and corporations involved in those transactions between competent authorities. Strict safeguards should be established to ensure that this exchange of information is consistent with national and international provisions on privacy and data protection.

2 - Cooperation between legal authorities

a) Basis and means for cooperation in confiscation, mutual assistance, and extradition

A necessary condition to improve mutual legal assistance on money laundering cases, is that countries acknowledge the offense of money laundering in other countries as an acceptable basis for mutual legal assistance. The group agreed that countries should consider extending the scope of the offence of money laundering to reach any other crimes for which there is a link to narcotics, or to all serious offenses, and let the definition for this wider money laundering offense open between different options. Furthermore, it agreed that :

- countries should adopt a definition covering the offense of drug money laundering compatible with the definition of the Vienna Convention.

- countries should try to ensure, on a bilateral or multilateral basis, that
different knowledge standards in national definitions -i.e. different standards concerning the
33 **intentional element of the infraction- do not affect the ability or willingness of countries to**
provide each other with mutual legal assistance.

Furthermore, **international cooperation should be supported by a network of**
bilateral and multilateral agreements and arrangements based on generally shared legal
34 **concepts with the aim of providing practical measures to affect the widest possible range of**
mutual assistance.

The current works in the framework of the Council of Europe, concerning
international cooperation as regards search, seizure and confiscation of the proceeds from
crime, could constitute the basis of an important multilateral agreement on this matter.
35 Accordingly, **countries should encourage international conventions such as the draft convention**
of the Council of Europe on confiscation of the proceeds from offenses.

b) Focus of improved mutual assistance on money laundering issues

Experience of international cooperation on money laundering issues shows that improvements are necessary on the following topics :

- Cooperative investigations - **Cooperative investigations among appropriate**
36 **competent authorities of countries, should be encouraged.**

- Mutual assistance in criminal matters - **There should be procedures for mutual**
assistance in criminal matters regarding the use of compulsory measures including the
production of records by financial institutions and other persons, the search of persons and
37 **premises, seizure and obtaining of evidence for use in money laundering investigations and**
prosecutions and in related actions in foreign jurisdictions.

- Seizure and confiscation - **There should be authority to take expeditious action**
in response to requests by foreign countries to identify, freeze, seize and confiscate proceeds or
38 **other property of corresponding value to such proceeds, based on money laundering or the**
crimes underlying the laundering activity.

- Coordination of prosecution actions - **To avoid conflicts of jurisdiction,**
consideration should be given to devising and applying mechanisms for determining the best
venue for prosecution of defendants in the interests of justice in cases that are subject to
39 **prosecution in more than one country. Similarly, there should be arrangements for coordinating**
seizure and confiscation proceedings which may include the sharing of confiscated assets.

- Extradition - Countries should have procedures in place to extradite, where
possible, individuals charged with a money laundering offense or related offenses. With respect
to its national legal system, each country should recognize money laundering as an extraditable
offense. Subject to their legal frameworks, countries may consider simplifying extradition by
allowing direct transmission of extradition requests between appropriate ministries, extraditing
40 persons based only on warrants of arrests or judgments, extraditing their nationals, and/or
introducing a simplified extradition of consenting persons who waive formal extradition
proceedings.

CONCLUSION

The delegates to the Financial Action Task Force agreed that the presidency of the Task Force would address this report to finance ministers of participating countries, which would submit it to their Heads of State or Government, and circulate it to other competent authorities.

The group agreed that decisions from the Summit of the Heads of State or Government of seven major industrial nations, which convened the Financial Task Force, would be crucial for the implementation of the recommendations and further work and studies. Political impetus would also be particularly necessary to crystallize strong coordinated overall international action, and to define the best ways to associate other countries, including drug producing countries, to the fight against money laundering.

While discussing the most adequate ways by which the follow-up to its works could be organized, the group emphasized that the wider the number of countries applying these recommandations (including countries which have weak or no regulations against money laundering) the greater their efficiency would be. It considered that a regular assessment of progress realized in enforcing money laundering measures would stimulate countries to give to these issues a high priority, and would contribute to a better mutual understanding and hence to an improvement of the national systems to combat money laundering.

SYNOPSIS OF
THE FORTY RECOMMENDATIONS
OF THE REPORT

A - GENERAL FRAMEWORK OF THE RECOMMENDATIONS

1 Each country should, without further delay, take steps to fully implement the Vienna Convention, and proceed to ratify it.

2 Financial institution secrecy laws should be conceived so as not to inhibit implementation of the recommendations of this group.

3 An effective money laundering enforcement program should include increased multilateral cooperation and mutual legal assistance in money laundering investigations and prosecutions and extradition in money laundering cases, where possible.

B - IMPROVEMENT OF NATIONAL LEGAL SYSTEMS TO COMBAT MONEY LAUNDERING

Definition of the criminal offense of money laundering

4 Each country should take such measures, as may be necessary, including legislative ones, to enable it to criminalize drug money laundering as set forth in the Vienna Convention.

5 Each country should consider extending the offense of drug money laundering to any other crimes for which there is a link to narcotics ; an alternative approach is to criminalize money laundering based on all serious offenses, and/or on all offenses that generate a significant amount of proceeds, or on certain serious offenses.

6 As provided in the Vienna Convention, the offense of money laundering should apply at least to knowing money laundering activity, including the concept that knowledge may be inferred from objective factual circumstances.

7 Where possible, corporations themselves -not only their employees- should be subject to criminal liability.

Provisional measures and confiscation

8 Countries should adopt measures similar to those set forth in the Vienna Convention, as may be necessary, including legislative ones, to enable their competent authorities to confiscate property laundered, proceeds from, instrumentalities used in or intended for use in the commission of any money laundering offense, or property of corresponding value.

Such measures should include the authority to : 1) identify, trace, and evaluate property which is subject to confiscation ; 2) carry out provisional measures, such a freezing and seizing, to prevent any dealing, transfer, or disposal of such property and 3) take any appropriate investigative measures.

In addition to confiscation and criminal sanctions, countries also should consider monetary and civil penalties, and/or proceedings including civil proceedings, to void contracts entered by parties, where parties knew or should have known that as a result of the contract, the state would be prejudiced in its ability to recover financial claims, e.g., through confiscation or collection of fines and penalties.

C - ENHANCEMENT OF THE ROLE OF THE FINANCIAL SYSTEM

Scope of the following recommendations

9 Recommendations 12 to 29 of this paper should apply not only to banks, but also to non-bank financial institutions.

10 The appropriate national authorities should take steps to ensure that these recommendations are implemented on as broad a front as is pratically possible.

11 A working group should further examine the possibility of establishing a common minimal list of non-bank financial institutions and other professions dealing with cash subject to these recommendations.

Customer identification and record keeping rules

12 Financial institutions should not keep anonymous accounts or accounts in obviously fictitious names : they should be required (by law, by regulations, by agreements between supervisory authorities and financial institutions or by self-regulatory agreements among financial institutions) to identify, on the basis of an official or other reliable identifying document, and record the identity of their clients, either occasional or usual, when establishing business relations or conducting transactions (in particular opening of accounts or passbooks, entering into fiduciary transactions, renting of safedeposit boxes, performing large cash transactions).

13 Financial institutions should take reasonable measures to obtain information about the true identity of the persons on whose behalf an account is opened or a transaction is conducted if there are any doubts as to whether these clients or customers are not acting on their own behalf, in particular, in the case of domiciliary companies (i.e. institutions, corporations, foundations, trusts, etc., that do not conduct any commercial or manufactoring business or any other form of commercial operation in the country where their registered office is located).

14 Financial institutions should maintain, for at least five years, all necessary records on transactions, both domestic or international, to enable them to comply swiftly with information requests from the competent authorities. Such records must be sufficient to permit reconstruction of individual transactions (including the amounts and types of currency involved, if any) so as to provide, if necessary, evidence for prosecution of criminal behaviour.

Financial institutions should keep records on customer identification (e.g. copies or records of official identification documents like passports, identity cards, driving licenses or similar documents), account files and business correspondence for at least five years after the account is closed.

These documents should be available to domestic competent authorities in the context of relevant criminal prosecutions and investigations.

Increased diligence of financial institutions

15 Financial institutions should pay special attention to all complex, unusual large transactions, and all unusual patterns of transactions, which have no apparent economic or visible lawful purpose. The background and purpose of such transactions should, as far as possible, be examined, the findings established in writing, and be available to help supervisors, auditors and law enforcement agencies.

16 If financial institutions suspect that funds stem from a criminal activity, they should be permitted or required to report promptly their suspicions to the competent authorities. Accordingly, there should be legal provisions to protect financial institutions and their employees from criminal or civil liability for breach of any restriction on disclosure of information imposed by contract or by any legislative, regulatory or administrative provision, if they report in good faith, in disclosing suspected criminal activity to the competent authorities, even if they did not know precisely what the underlying criminal activity was, and regardless of whether illegal activity actually occured.

17 Financial institutions, their directors and employees, should not, or, where appropriate, should not be allowed to, warn their customers when information relating to them is being reported to the competent authorities.

18 In the case of a mandatory reporting system, or in the case of a voluntary reporting system where appropriate, financial institutions reporting their suspicions should comply with instructions from the competent authorities.

19 When a financial institution develops suspicions about operations of a customer, and, when no obligation of reporting these suspicions exist, makes no report to the competent authorities, it should deny assistance to this customer, sever relations with him and close his accounts.

20 Financial institutions should develop programs against money laundering. These programs should include, as a minimum :

a) the development of internal policies, procedures and controls, including the designation of compliance officers at management level, and adequate screening procedures to ensure high standards when hiring employees ;

b) an ongoing employee training program ;

c) an audit function to test the system.

Measures to cope with the problem of countries with no or insufficient anti money laundering measures.

21 Financial institutions should give special attention to business relations and transactions with persons, including companies and financial institutions, from countries which do not or insufficiently apply these recommendations. Whenever these transactions have no apparent economic or visible lawful purpose, their background and purpose should, as far as possible, be examined, the findings established in writing, and be available to help supervisors, auditors and law enforcement agencies.

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22 Financial institutions should ensure that the principles mentioned above are also applied to branches and majority owned subsidiaries located abroad, especially in countries which do not or insufficiently apply these recommendations, to the extent that local applicable laws and regulations permit. When local applicable laws and regulation prohibit this implementation, competent authorities in the country of the mother institution should be informed by the financial institutions that they cannot apply these recommendations.

Other measures to avoid currency laundering

23 The feasibility of measures to detect or monitor cash at the border should be studied, subject to strict safeguards to ensure proper use of information and without impeding in any way the freedom of capital movements.

24 Countries should consider the feasibility and utility of a system where banks and other financial institutions and intermediaries would report all domestic and international currency transactions above a fixed amount, to a national central agency with a computerized data base, available to competent authorities for use in money laundering cases, subject to strict safeguards to ensure proper use of the information.

25 Countries should further encourage in general the development of modern and secure techniques of money management, including increased use of checks, payment cards, direct deposit of salary checks, and book entry recording of securities, as a means to encourage the replacement of cash transfers.

Implementation, and role of regulatory and other administrative authorities

26 The competent authorities supervising banks or other financial institutions or intermediaries, or other competent authorities, should ensure that the supervised institutions have adequate programs to guard against money laundering. These authorities should cooperate and lend expertise spontaneously or on request with other domestic judicial or law enforcement authorities in money laundering investigations and prosecutions.

27 Competent authorities should be designated to ensure an effective implementation of all these recommendations, through administrative supervision and regulation, in other professions dealing with cash as defined by each country.

28 The competent authorities should establish guidelines which will assist financial institutions in detecting suspicious patterns of behaviour by their customers. It is understood that such guidelines must develop over time, and will never be exhaustive. It is further understood that such guidelines will primarily serve as an educational tool for financial institutions' personnel.

29 The competent authorities regulating or supervising financial institutions should take the necessary legal or regulatory measures to guard against control or acquisition of a significant participation in financial institutions by criminals or their confederates.

D - STRENGTHENING OF INTERNATIONAL COOPERATION

Administrative cooperation

a) Exchange of general information

30 National administrations should consider recording, at least in the aggregate, international flows of cash in whatever currency, so that estimates can be made of cash flows and reflows from various sources abroad, when this is combined with central bank information. Such information should be made available to the IMF and BIS to facilitate international studies.

31 International competent authorities, perhaps Interpol and the Customs Cooperation Council, should be given responsibility for gathering and disseminating information to competent authorities about the latest developments in money laundering and money laundering techniques. Central banks and bank regulators could do the same on their network. National authorities in various spheres, in consultation with trade associations, could then disseminate this to financial institutions in individual countries.

b) Exchange of information relating to suspicious transactions

32 Each country should make efforts to improve a spontaneous or "upon request" international information exchange relating to suspicious transactions, persons and corporations involved in those transactions between competent authorities. Strict safeguards should be established to ensure that this exchange of information is consistent with national and international provisions on privacy and data protection.

Cooperation between legal authorities

a) Basis and means for cooperation in confiscation, mutual assistance, and extradition

33 Countries should try to ensure, on a bilateral or multilateral basis, that different knowledge standards in national definitions -i.e. different standards concerning the intentional element of the infraction- do not affect the ability or willingness of countries to provide each other with mutual legal assistance.

34 International cooperation should be supported by a network of bilateral and multilateral agreements and arrangements based on generally shared legal concepts with the aim of providing practical measures to affect the widest possible range of mutual assistance.

35 Countries should encourage international conventions such as the draft convention of the Council of Europe on confiscation of the proceeds from offenses.

b) Focus of improved mutual assistance on money laundering issues

36 Cooperative investigations among appropriate competent authorities of countries, should be encouraged.

37 There should be procedures for mutual assistance in criminal matters regarding the use of compulsory measures including the production of records by financial institutions and other persons, the search of persons and premises, seizure and obtaining of evidence for use in money laundering investigations and prosecutions and in related actions in foreign jurisdictions.

38 There should be authority to take expeditious action in response to requests by foreign countries to identify, freeze, seize and confiscate proceeds or other property of corresponding value to such proceeds, based on money laundering or the crimes underlying the laundering activity. There should also be arrangements for coordinating seizure and confiscation proceedings which may include the sharing of confiscated assets.

39 To avoid conflicts of jurisdiction, consideration should be given to devising and applying mechanisms for determining the best venue for prosecution of defendants in the interests of justice in cases that are subject to prosecution in more than one country. Similarly, there should be arrangements for coordinating seizure and confiscation proceedings which may include the sharing of confiscated assets.

40 Countries should have procedures in place to extradite, where possible, individuals charged with a money laundering offense or related offenses. With respect to its national legal system, each country should recognize money laundering as an extraditable offense. Subject to their legal frameworks, countries may consider simplifying extradition by allowing direct transmission of extradition requests between appropriate ministries, extraditing persons based only on warrants of arrests or judgments, extraditing their nationals, and/or introducing a simplified extradition of consenting persons who waive formal extradition proceedings.

Background on the Financial Action Task Force on Money Laundering

Mandate

The Financial Action Task Force was established by the 1989 G-7 Economic Summit chaired by France, sometimes referred to as the "Summit of the Arch." The language of the Summit communique regarding the Task Force, under the heading "drug issues," was as follows:

> "Convene a financial action task force from Summit Participants and other countries interested in these problems. Its mandate is to assess the results of cooperation already undertaken in order to prevent the utilization of the banking system and financial institutions for the purpose of money laundering, and to consider additional preventive efforts in this field, including the adaptation of the legal and regulatory systems so as to enhance multilateral judicial assistance. The first meeting of this task force will be called by France and its report will be completed by April 1990."

Members

The members of the Task Force were the G-7, Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States, and Austria, Australia, Belgium, Luxembourg, the Netherlands, Spain, Sweden, and Switzerland, the European Community.

Organization

The Task Force was organized into three working groups and a Plenary Group. The Task Force President or Chariman was Denis Samuel-Lajeunesse, Chef du Service des Affaires Internationales, Direction de Tresor, French Ministry of Finance. The U.S. delegation to the Task Force was chaired by John E. Robson, Deputy Secretary of the Treasury. The Working Groups were as follows:

Statistics and Methods - Chaired by the United Kingdom

Administrative and Financial Cooperation - Chaired by Italy

Legal Questions - Chaired by the United States

The Final Report was based on the work of the Working Groups. The Working Groups met four times (October, November, and December, 1989 and January, 1990) and the Plenary Group met five times (September, October, and December, 1989 and January, and

February 1990).

Publicity

There was a understanding among the Task Force members that in order to facilitate the work of the group and endorsement of the report by the member governments the report would not be discussed in detail until a common, agreed-upon publication date, which was set as April 19, 1990.

TREASURY NEWS

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

Prepared for Delivery
April 20, 1990, 1:30 P.M.

Statement by
Secretary of the Treasury
Nicholas F. Brady
at
Press Conference
Miami, Florida

It's a great pleasure to be here today. I've spent the last several hours with some of the most important men and women in this country's fight against drugs -- agents and inspectors of the United States Customs Service.

I had the opportunity to discuss with them their efforts to stop the illegal flow of drugs into the United States. I can only repeat to you what I told them: we're in their debt for all their fine work.

I also had the opportunity to review the money laundering operations here and to tour the new command, control, communications and intelligence center as well as the air and marine operations.

Finally, I've had the opportunity to thank the inspection and control people for the fine work they do here at the Port of Miami. They process over 10,000 cargo containers every month. For the overwhelming majority of people who are honest, law-abiding citizens, it's essential that customs handle their goods efficiently and expeditiously. I'm extremely impressed by the entire customs effort here in Florida.

The most important asset we have in the fight against drugs is cooperation: cooperation between nations, between Federal agencies, and between Federal, state and local enforcement authorities.

Just yesterday the final report from the G-7 Financial Action Task Force on Money Laundering was released. This cooperative effort represents the work of 15 nations that have agreed on 40 recommendations for effective domestic programs and international cooperation against money laundering.

Earlier this week, Treasury and Justice announced the fourth phase of Polar Cap. This extremely successful case has been the result of a cooperative effort between the Department of Treasury and the Justice Department. To date Polar Cap has resulted in 127 persons charged and over $105 million in cash and property seized.

And today we are announcing the Customs Service's seizure of $6.3 million in cash in a case which involved cooperation between Customs, the Metro-Dade Police Department, the Coral Gables Police Department and the Florida Department of Law Enforcement.

Finally, I have a presentation to make. It's part of a Customs Service program where assets seized in drug cases are shared with local law enforcement agencies which participated in the investigation.

Would Eduardo Gonzalez, Deputy Director of the Metro-Dade Police Department, please come forward?

Today's check presentation represents two cooperative investigations between Customs and the Metro-Dade Police Department.

In the First case, during the last half of 1987, the Metro-Dade Police Department was able to develop information regarding a money laundering organization.

Metro-Dade requested assistance from the Customs Service and a joint surveillance and investigation then took place.

On December 9, 1987, due to this joint investigation, the Customs Service was able to seize over $1.5 million in cash, as well as some 14 kilos of cocaine.

In the second case, Metro-Dade, working with the U.S. Border Patrol, was able to seize bank records of a known smuggler and money launderer. Metro-Dade then asked the Customs Service to review these records. Based on that review, on July 20, 1989, the Customs Service was able to seize over $85,000.

These two cases typify the fine working relationship between Customs and the Metro-Dade Police Department.

As part of the U.S. Customs Asset Sharing Program, it gives me great pleasure to present the Metro-Dade Police Department with this check for $1,273,887.

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TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
April 23, 1990

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $8,231 million of 13-week bills and for $8,216 million of 26-week bills, both to be issued on April 26, 1990, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing July 26, 1990			:	26-week bills maturing October 25, 1990		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.75%	8.01%	98.041	:	7.88%	8.32%	96.016
High	7.78%	8.05%	98.033	:	7.92%	8.36%	95.996
Average	7.78%	8.05%	98.033	:	7.91%	8.35%	96.001

Tenders at the high discount rate for the 13-week bills were allotted 97%.
Tenders at the high discount rate for the 26-week bills were allotted 53%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 35,865	$ 35,865	:	$ 43,065	$ 43,065
New York	20,067,640	6,842,015	:	16,820,930	6,930,910
Philadelphia	28,135	28,135	:	18,905	18,905
Cleveland	41,735	41,735	:	53,095	53,095
Richmond	35,735	35,735	:	42,315	42,315
Atlanta	28,410	28,410	:	26,465	26,465
Chicago	1,707,415	372,790	:	1,613,330	346,030
St. Louis	34,570	14,570	:	28,245	20,245
Minneapolis	6,680	6,680	:	5,980	5,980
Kansas City	34,150	34,150	:	41,040	41,040
Dallas	31,080	21,080	:	36,635	29,285
San Francisco	737,255	73,105	:	598,970	104,420
Treasury	696,380	696,380	:	554,695	554,695
TOTALS	$23,485,050	$8,230,650	:	$19,883,670	$8,216,450
Type					
Competitive	$20,089,020	$4,834,620	:	$16,108,810	$4,441,590
Noncompetitive	1,499,370	1,499,370	:	1,277,860	1,277,860
Subtotal, Public	$21,588,390	$6,333,990	:	$17,386,670	$5,719,450
Federal Reserve	1,789,760	1,789,760	:	1,600,000	1,600,000
Foreign Official Institutions	106,900	106,900	:	897,000	897,000
TOTALS	$23,485,050	$8,230,650	:	$19,883,670	$8,216,450

1/ Equivalent coupon-issue yield.

NB-773

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

FOR IMMEDIATE RELEASE April 23, 1990

FEDERAL FINANCING BANK ACTIVITY

Charles D. Haworth, Secretary, Federal Financing Bank (FFB), announced the following activity for the month of March 1990.

FFB holdings of obligations issued, sold or guaranteed by other Federal agencies totaled $135.4 billion on March 31, 1990, posting an increase of $1.9 billion from the level on February 28, 1990. This net change was the result of decreases in holdings of agency assets of $41.4 million and in holdings of agency-guaranteed debt of $90.3 million, while holdings of agency debt increased by $2,013.2 million. FFB made 22 disbursements during March.

On March 19, the Resolution Trust Corporation began borrowing from the FFB under a Commitment Agreement dated February 23, 1990.

On March 31, the Tennessee Valley Authority redeemed $500 million principal amount of 12.955 percent Power Bonds, 1980 Series B.

Attached to this release are tables presenting FFB March loan activity and FFB holdings as of March 31, 1990.

NB-774

FEDERAL FINANCING BANK

MARCH 1990 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual
AGENCY DEBT					
EXPORT-IMPORT BANK					
Note #83	3/1	$ 89,000,000.00	3/3/97	8.576%	8.486% qtr.
Note #84	3/1	14,000,000.00	3/1/04	8.644%	8.831% ann.
Note #85	3/1	517,000,000.00	9/4/90	8.270%	
NATIONAL CREDIT UNION ADMINISTRATION					
Central Liquidity Facility					
+Note #516	3/1	30,000,000.00	4/4/90	8.161%	
RESOLUTION TRUST CORPORATION					
Note No. 90-01					
Advance #1	3/19	1,500,000,000.00	4/2/90	8.312%	
Advance #2	3/23	150,000,000.00	4/2/90	8.296%	
Advance #3	3/26	200,000,000.00	4/2/90	8.270%	
Advance #4	3/28	210,000,000.00	4/2/90	8.298%	
Advance #5	3/29	100,000,000.00	4/2/90	8.245%	
Advance #6	3/30	396,000,000.00	4/2/90	8.222%	
AGENCY ASSETS					
FARMER'S HOME ADMINISTRATION					
RHIF - CBO #57535	3/1	450,000,000.00	3/1/05	8.646%	8.833% ann.
RHIF - CBO #57536	3/1	370,000,000.00	10/1/91	8.439%	8.617% ann.
RURAL ELECTRIFICATION ADMINISTRATION					
Certificates of Beneficial Ownership					
CBO #31	3/31	64,000,000.00	3/31/15	8.758%	
GOVERNMENT - GUARANTEED LOANS					
DEPARTMENT OF DEFENSE					
Foreign Military Sales					
Philippines 11	3/6	256,708.43	3/12/91	8.418%	
Turkey 18	3/6	6,500.00	3/12/14	8.785%	
Morocco 13	3/12	38,545.00	5/31/95	8.801%	
Kenya 12	3/28	2,998.28	7/25/90	8.348%	

+rollover

FEDERAL FINANCING BANK

MARCH 1990 ACTIVITY

BORROWER	DATE	AMOUNT OF ADVANCE	FINAL MATURITY	INTEREST RATE (semi-annual)	INTEREST RATE (other than semi-annual)
RURAL ELECTRIFICATION ADMINISTRATION					
*Cooperative Power Assoc. #156A	3/1	$ 2,396,000.00	3/31/92	8.551%	8.462% qtr.
Tele. Util. of E. Oregon #256	3/12	1,196,000.00	12/31/24	8.760%	8.666% qtr.
Old Dominion Electric #267	3/16	1,204,000.00	3/31/92	8.832%	8.737% qtr.
*Wabash Valley Power #206	3/21	837,000.00	12/31/18	8.629%	8.538% qtr.
TENNESSEE VALLEY AUTHORITY					
Seven States Energy Corporation					
Note A-90-7	3/30	528,768,794.09	6/29/90	8.247%	

*maturity extension

FEDERAL FINANCING BANK HOLDINGS
(in millions)

Program	March 31, 1990	February 28, 1990	Net Change 3/1/90-3/31/90	FY '90 Net Change 10/1/89-3/31/90
Agency Debt:				
Export-Import Bank	$ 11,010.5	$ 10,978.6	$ 31.9	$ 26.9
NCUA-Central Liquidity Facility	82.4	105.1	-22.7	-29.0
Resolution Trust Corporation	2,556.0	0.0	2,556.0	2,556.0
Tennessee Valley Authority	15,325.0	15,877.0	-552.0	-2,142.0
U.S. Postal Service	6,195.0	6,195.0	-0-	-0-
sub-total*	35,168.9	33,155.7	2,013.2	411.9
Agency Assets:				
Farmers Home Administration	52,726.0	52,831.0	-105.0	-585.0
DHHS-Health Maintenance Org.	74.7	74.7	-0-	-0-
DHHS-Medical Facilities	93.0	93.0	-0-	4.9
Rural Electrification Admin.-CBO	4,135.2	4,071.2	64.0	-47.5
Small Business Administration	10.0	10.3	-0.4	-1.6
sub-total*	57,038.9	57,080.2	-41.4	-629.2
Government-Guaranteed Lending:				
DOD-Foreign Military Sales	9,958.3	10,044.0	-85.7	-230.3
DEd.-Student Loan Marketing Assn.	4,880.0	4,880.0	-0-	-30.0
DHUD-Community Dev. Block Grant	261.8	264.1	-2.3	-21.6
DHUD-Public Housing Notes +	1,950.8	1,950.8	-0-	-44.5
General Services Administration +	372.9	372.9	-0-	-5.1
DOI-Guam Power Authority	30.3	31.0	-0.6	-0.6
DOI-Virgin Islands	25.4	25.4	-0-	-0.5
NASA-Space Communications Co. +	1,095.9	1,095.9	-0-	100.7
DON-Ship Lease Financing	1,672.4	1,672.4	-0-	-48.2
Rural Electrification Administration	19,221.0	19,218.6	2.4	-53.9
SBA-Small Business Investment Cos.	489.5	500.3	-10.8	-65.8
SBA-State/Local Development Cos.	773.3	778.1	-4.8	-26.1
TVA-Seven States Energy Corp.	2,307.7	2,296.1	11.6	12.8
DOT-Section 511	24.1	24.2	-0.1	-13.2
DOT-WMATA	177.0	177.0	-0-	-0-
sub-total*	43,240.5	43,330.8	-90.3	-426.2
grand total*	$ 135,448.3	$ 133,566.7	$ 1,881.6	$ -643.6

*figures may not total due to rounding
+does not include capitalized interest

TREASURY NEWS

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

For Release Upon Delivery
Expected at 10:30 a.m., E.D.T.
April 24, 1990

STATEMENT OF KENNETH W. GIDEON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to present the views of the Administration on proposals to repeal and to replace section 2036(c), relating to "estate freeze" transactions. In particular, we commend the Committee for circulating the discussion draft of March 22 so that testimony today could focus on specific legislative language.

BACKGROUND

"Estate freezes" may be structured in many ways but all have as their common objective limiting or reducing the value of an interest in a business or other property includible in a transferor's estate. Typically, this is accomplished by having an older-generation transferor retain a non-appreciating interest in a business (e.g., preferred stock or a promissory note) while transferring the equity interest (which will benefit from future appreciation) to a younger-generation transferee.[1]

The Treasury Department does not object to estate freezes so long as the value of the business or other property for gift tax purposes is properly measured. This is because the value of the right to future appreciation will be taken into account in setting the current value of the business or other property. However, during the early 1980s, taxpayers made increasing use of techniques that were designed to value the various interests in a business in a way that effectively eliminated the transfer

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[1] Illustrations of a variety of freeze transactions appear in the Appendix.

tax on a significant portion of the fair market value as of the transfer date.

These techniques usually involved retention by the transferor of rights which the transferor had discretion to exercise. In fact, many of these rights were likely not to be exercised at all in the family context since their exercise would undermine the transfer tax benefits of the freeze transaction, if not undo the freeze completely. However, because fair market value must normally be determined for transfer tax purposes according to what a willing buyer would pay a willing seller, these rights were assigned value by appraisers on the assumption that they would be exercised as if held by an unrelated third party. This encouraged planners to include as many of these rights as possible in the retained interest in order to maximize the value of the retained interest and minimize the value of the transferred interest. This, in turn, minimized the gift tax consequences of the transfer. Thus, virtually the entire value of the business would be "soaked up" by the discretionary rights retained by the transferor. For this reason, these features are often referred to as "soak-up features."

One of the common ways in which this "soak up" was accomplished was by structuring the right to receive income or cash flow (e.g., dividends on preferred stock) so that value could easily be passed to the younger generation. For example, planners often structured corporate freezes so that the dividend right on preferred stock was "noncumulative." This means that if dividends were not paid in a particular year, there would be no continuing obligation on the part of the corporation to pay those dividends in a later year. Because the decision whether or not to pay dividends often remained in the control of the older generation after the freeze, the dividends frequently would not be paid at all. These passed dividends would not be included in the transferor's estate, but would stay in the corporation, thereby increasing the value of the common stock held by the younger generation, often without payment of gift tax. Appraisals of the preferred stock for gift tax purposes, however, generally assigned substantial value to the right to receive noncumulative dividends, notwithstanding the likelihood of non-payment in a family context.

The cumulative effect of these valuation techniques was the assignment of virtually the entire value of the business to the retained interest for gift tax purposes, resulting in significant understatement of the value of the transferred interest. When the transferred interest was assigned to the younger generation, little or no transfer tax would be due, even though all future appreciation in the value of the business would inure to the transferred interest. Soak-up features retained by the transferor often escaped transfer tax because of lifetime events, expiration at death, or inconsistent valuation for estate and gift tax purposes. The Internal Revenue Service and the Treasury Department consider such techniques to be abusive.

SECTION 2036(c)

In order to deal with these abuses, Congress enacted section 2036(c) in 1987.[2] Under section 2036(c), the entire value of an enterprise is included in a transferor's estate (or treated as a deemed gift) if the transferor transfers a disproportionately large share of the potential appreciation in the enterprise while retaining an interest in the income of, or rights in, the enterprise. By treating a freeze transaction as a transfer with a retained interest, section 2036(c) therefore reaches not only valuation abuses but also includes future appreciation in the transferor's estate. Serious concerns have been raised about the possible overbreadth of this result, as well as about the uncertain operation of the section.[3]

While sharing many of these concerns, the Treasury Department is strongly of the view that the abuses which Congress sought to remedy by enactment of section 2036(c) are real and that simple repeal would invite the return of those abuses. We therefore support repeal of section 2036(c) today only if a replacement adequate to prevent valuation abuses is substituted for the repealed provision.

DISCUSSION DRAFT

We believe the standard by which a replacement should be judged is whether or not it eliminates the abuses described above while permitting flexibility in intra-family transfers consistent with this objective. Stated another way, does the discussion draft (or any other proposed replacement for section

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[2] Section 2036(c) was enacted as part of the Omnibus Budget Reconciliation Act of 1987 (P.L. 100-203), and was amended in the Technical and Miscellaneous Revenue Act of 1988 (P.L. 100-647).

[3] The Internal Revenue Service issued Notice 89-99 to provide guidance as to how the Service would interpret section 2036(c). This notice has allayed some of the concerns about how the section will be administered. However, the notice does not address all the underlying concerns about the potential scope of the section, which can be addressed only through legislation.

2036(c)) result in the various interests being valued appropriately on the date of the freeze transaction, and does it assure that the subsequent behavior of the various parties will not cause that value, once determined, to be undermined? Judged by that standard, we believe that the discussion draft circulated by the Committee prior to this hearing offers a constructive and workable approach for such a replacement.[4]

The basic mechanism of the draft is straightforward. In valuing a transfer of rights in a business among family members, generally only rights retained by the transferor which are "qualified fixed payment rights" ("QFP") will be valued. Discretionary rights such as put or call options or noncumulative preferred dividends generally will be disregarded, because such "soak-up features" have so frequently been used in cases of valuation abuse.

QFPs are essentially rights to receive payments in specified amounts at specified times.[5] Qualified fixed payment rights are assumed to be paid on schedule for valuation purposes. If they are not, the transferor is considered to have made a "deemed gift" in the amount of the missed payment.

Finally, a minimum valuation rule ensures that the appreciating equity interest (such as the common stock or a non-preferred partnership interest) cannot be valued at less than 20 percent of the total equity in the business, which for this purpose includes debt owed to the transferor.

Thus, the discussion draft attempts to deal with the abuses which existed prior to enactment of section 2036(c) in the following ways:

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[4] Congress could also require inclusion of gift tax paid in the transfer tax base (as is already the case for estate tax purposes), thereby eliminating a substantial advantage of inter vivos transfers over testamentary transfers. This would, in turn, eliminate a significant incentive for freeze transactions.

[5] Generally, the valuation of the right to receive QFPs, such as guaranteed payments from a partnership, will be made using the standard technique of discounting the payment or payment stream to present value, using the market rate of interest or return appropriate for the particular business. Transferors would be free to set the interest or dividend rate at whatever rate they choose, including variable interest rates, recognizing that if the rate selected is below the market rate for that business, the value of the QFP right will necessarily be lower as a result.

- o Discretionary rights (i.e., soak-up features) generally are not given value in intra-family transfers.

- o Rights to receive QFPs, such as fixed principal and interest payments on a note, are given value based on the assumption that they will be paid. However, if they are not paid, a deemed gift will result.

- o The minimum value rule prevents taxpayers from undervaluing the transferred interest, thus ensuring that the right to future appreciation is appropriately taken into account.

In addition, the discussion draft contains certain other rules intended to prevent these basic rules from operating inappropriately:

- o Explicit rules are included to prevent the same value from being taxed twice for estate and gift tax purposes.

- o Transferors may elect to apply the QFP rule to transactions which would not otherwise qualify (such as noncumulative preferred stock or real estate partnerships in which payments are dependent on income or cash flow) to provide flexibility in structuring transactions.

- o The deemed gift rule provides a three-year grace period for corporations and partnerships so that the failure to make QFPs due to temporary cash flow difficulties will not trigger a gift.

- o No deemed gift will occur in any event if the QFP right provides for compound interest and the fully compounded amount is accounted for when the retained interest is transferred.

- o Special rules are provided to mitigate the deemed gift rule if a corporation or partnership that fails to make QFPs is insolvent or bankrupt.

- o The draft does not change the treatment of minority discounts; voting rights will continue to be valued as under current law.

- o The discussion draft would not apply to transfers of the same class of stock which the transferor retains, nor would it apply to transfers of interests none of the rights of which are junior to the retained interest.

- Explicit exemptions are provided for personal residences.

The discussion draft also addresses three related problems: trusts in which the transferor has retained an interest, joint purchase transactions in which the transferor purchases a life or term interest while a family member purchases a remainder interest, and buy-sell agreements.

The primary focus of the trust rule is the grantor-retained income trust ("GRIT"). A GRIT is a trust in which the transferor has retained an income interest for a term of years, while transferring the remainder interest to another person (usually a family member). The various interests in a GRIT are valued according to tables published by the Internal Revenue Service which assume a rate of return specified by statute.[6] Frequently, however, the property placed in a GRIT either does not generate any income or does not generate income equal to the rate of return assumed in these tables. This means that the interest transferred to the younger generation remainderman will have been undervalued, which in turn means that the gift tax paid will have been too low.

Consistent with the approach for corporations and partnerships, the only interest in such a trust that is assigned value for gift tax purposes is a QFP. In the trust context, a QFP is generally[7] defined as the right to receive a fixed annual payment or an annual payment based on the value of the assets in the trust (determined annually).[8] If the trust fails to pay out the required amount, the transferor is treated as having made a deemed gift (just as the failure by a corporation or partnership to make a QFP is treated as a deemed gift).

The discussion draft also applies to certain joint purchases of property. A joint purchase can be structured to work the same way as a GRIT. Joint purchases subject to the rule are purchases of a life or term interest by one family member and the purchase of the remainder interest by another. The discussion draft therefore does not apply where the family

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[6] See IRC Section 7520.

[7] QFPs for trusts also include non-contingent remainders if all other interests in the trust are QFPs.

[8] These trust rules are derived from the rules governing charitable remainder trusts, which were enacted to address similar problems of incorrect valuation of the various interests in such trusts. See IRC Section 664.

members purchase property either as tenants in common or as joint tenants with right of survivorship.

The discussion draft generally treats these joint purchases in the same way it treats GRITs. Thus, only rights to receive QFPs are valued, and failure to make the required payments results in a deemed gift.

The draft also contains a provision concerning buy-sell agreements. Although buy-sell agreements are widely used in closely held businesses and often have legitimate non-tax purposes, they also have potential for suppressing the value of a business interest for transfer tax purposes. The discussion draft requires that, in order for buy-sell arrangements to be taken into account in determining the value of the business interest for estate or gift tax purposes, the buy-sell arrangement must meet certain conditions. These conditions include: (1) the business interest must actually be sold pursuant to the buy-sell arrangement; (2) the purchase price must have been determined pursuant to a formula which was reviewed within three years prior to sale; (3) at the time of review, the formula must have been reasonably expected to produce a price which would approximate the fair market value as of the time of sale; (4) the property does not have a readily ascertainable fair market value; and (5) the property is not resold to an unrelated party within 6 months of the transfer or the decedent's death.

COMMENTS ON THE DISCUSSION DRAFT

We commend the Committee for the substance of the discussion draft. We also commend this process of offering draft statutory language as a focus for public comment. We at the Treasury have benefitted substantially from the opportunity to discuss the draft with interested members of the public, and we have received many constructive comments for improvement of the draft.

We are prepared to support proposed modifications that improve the draft in terms of taxpayer flexibility, simplicity of administration and compliance, and that enhance the overall workability of the statutory framework. We will oppose, however, changes which would effectively undermine the premise of the discussion draft -- proper valuation. We believe that the discussion draft, by attempting to obtain the appropriate valuation of the various interests at the time of transfer, offers the best approach to this problem.

Without attempting to offer a complete list at this time, we believe the following modifications of the discussion draft would be appropriate:

- Allowing transferors to elect to treat percentage leases and share-of-production royalty interests as QFPs;

- Clarifying application of the rules to trusts by separating such rules from the basic rules applicable to corporations and partnerships; and

- Clarifying the application of the rules in the case of generation-skipping transfers.

We are also considering other modifications and we hope to learn more from the testimony to be offered here today.

REVENUE CONSIDERATIONS

The Treasury's Office of Tax Analysis ("OTA") estimates that repeal of section 2036(c) would reduce revenues during the period 1991-95 by $1.021 billion. (See the attached Table).

The revenue loss from repeal of section 2036(c) arises because the provision effectively prevents taxpayers from engaging in freeze transactions. Therefore, interests which otherwise would have been subject to freeze transactions will be retained and continue to appreciate in value in the hands of the older generation. As members of the older generation die holding such appreciated interests, their gross estates will be correspondingly larger, thereby increasing revenues. If section 2036(c) were simply repealed, freezes would resume (including abusive freezes which eliminate current value from the transfer tax base), and the appreciation that would otherwise be includible in the estates of the older generation will not be subject to tax.

OTA also estimates that, if the discussion draft in its current form were enacted to replace section 2036(c), revenues during the period 1991-95 would be reduced by $50 million from current law. (See the attached Table).

CONCLUSION

The Treasury Department looks forward to working with the Congress and interested members of the public to develop a fair and workable replacement for section 2036(c). To retain our support, any proposal must prevent abusive valuations in estate freeze transactions. We are encouraged by the progress made to date.

APPENDIX

Illustrations of Common Freeze Techniques

Corporate Recapitalization. In this transaction, the older generation, owning all or a significant portion of the common stock, recapitalizes the corporation, exchanging its common stock for both preferred and common stock. The preferred stock is structured with non-cumulative dividends and with discretionary features, such as puts, conversion features, rights to compel liquidation, etc.. The preferred stock is typically valued assuming these rights will be exercised in an arms-length manner, including the assumption that dividends will be paid, even though in the family context it is often unlikely that such rights will ever be exercised. This results in the value of the common stock being understated. The common stock is then transferred to the younger generation subject to little, if any, gift tax. The older generation retains the preferred stock. All subsequent appreciation in the value of the business inures to the common stock, effectively freezing the value of the business in the older generation's estate.

Partnership Freeze. The partnership freeze resembles the corporate freeze, and can be accomplished either by forming a new partnership or by restructuring an existing one. In the typical freeze, the older generation receives a limited partnership interest, which provides for a preferred return on the partner's undistributed capital (analogous to dividends on preferred stock). As with preferred stock, discretionary features are added to the limited partner's interest in order to maximize its value and minimize the value of the general partnership interest, which is then transferred to the younger generation subject to little, if any, gift tax. These discretionary features are not likely to be exercised by the older generation, but nevertheless generally are valued as if they were. Because the limited partnership interest does not appreciate, it has effectively been frozen for estate tax purposes, and all future appreciation would inure to the younger generation.

Grantor Retained Income Trust ("GRIT"). A GRIT is a trust in which the grantor has retained an interest for a term of years. On expiration of the term, the property passes to the remainderman (typically a younger generation family member). The grantor will typically retain a reversionary interest or general power of appointment which becomes effective if the grantor dies during the term. The value of the retained interest is determined according to tables provided by the IRS which assume a rate of return equal to 120% of the applicable federal rate. This typically results in a very small value being assigned to the transferred interest (and thus a very small gift tax). Frequently, the property placed in the GRIT is of the type that produces little or no income but will appreciate in value (such as growth stock). Since the income from the trust is less than the rate of return assumed in the valuation tables, the grantor's retained interest will have been overvalued and the transferred interest will have been undervalued. Since no further tax is due when the term expires, this means that a portion of the initial value will have been transferred to the younger generation without gift tax.

Joint Purchases. A joint purchase can be structured to work the same way as a GRIT. However, instead of transferring property that the older generation already owns, the older generation will purchase a term interest in property while the younger generation purchases the remainder interest in the same property. The property is often the type that pays little if any income, but which instead appreciates in value. The values of the respective interests are determined according to the same valuation tables used in the case of GRITs. Thus, in such circumstances the interest of the older generation will be overvalued while that of the younger generation will be undervalued. When the term expires the property passes to the younger generation without transfer tax.

Buy-Sell Agreements. A buy-sell agreement is an agreement among shareholders or partners (or between such individuals and the corporation or partnership). The agreement generally provides for the purchase of the person's stock or partnership interest on the occurrence of some event, such as death. These agreements often have legitimate non-tax purposes. They typically work by fixing the price at which the person's interest will be purchased, either at a set price or according to a formula. However, this price is sometimes set far below what a willing buyer would pay for the interest absent the buy-sell agreement. In some instances, courts have permitted these agreements to set value, notwithstanding Treasury regulations which provide that such agreements will not be taken into account if the agreement is being used as a testamentary device to suppress estate tax values.

Self-Canceling Installment Note. A common use of this device involves an older generation which owns all the common stock of a corporation. The older generation gives a small portion of the common stock to the younger generation, and then causes the corporation to redeem its remaining common stock for an installment note. This would freeze the value of the business in the hands of the older generation. The installment note could provide that any payments due after the death of the older generation are cancelled. If the note had not been fully paid by the death of the older generation, a portion of the corporation's value would have passed to the younger generation free of tax. A similar result could be achieved by use of a private annuity which expired at death.

Table 1

Estimates Related to Estate Freezes

Item	Fiscal Years ($ millions)						
	1990	1991	1992	1993	1994	1995	1990–1995
Repeal Section 2036(c)	0	-3	-58	-176	-314	-470	-1021
Discussion Draft Proposal	0	75	123	14	-83	-179	-50

Department of the Treasury
Office of Tax Analysis

April 23, 1990

TREASURY NEWS

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

FOR RELEASE AT 4:00 P.M.
April 24, 1990

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 $16,800 million, to be issued May 3, 1990. This offering will provide about $1,275 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $15,517 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, April 30, 1990. The two series offered are as follows:

91-day bills (to maturity date) for approximately $8,400 million, representing an additional amount of bills dated August 3, 1989, and to mature August 2, 1990 (CUSIP No. 912794 UN 2), currently outstanding in the amount of $16,682 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $8,400 million, to be dated May 3, 1990, and to mature November 1, 1990 (CUSIP No. 912794 VG 6).

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

The bills will be issued for cash and in exchange for Treasury bills maturing May 3, 1990. 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 $1,617 million as agents for foreign and international monetary authorities, and $2,735 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-776

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 9:30 A.M.
April 25, 1990

STATEMENT OF
MICHAEL E. BASHAM
DEPUTY ASSISTANT SECRETARY OF THE TREASURY
(FEDERAL FINANCE)
BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of the Committee:

My purpose here today is to discuss H.R. 2972, the proposed "Drug War Bond Act of 1989". This bill would require the Secretary of the Treasury to issue up to $4 billion of special bonds in order to raise additional funds for certain Federal anti-drug activities.

Let me first state that the Treasury Department is committed to the Administration's efforts to win this drug war. We must do all we can to promote elimination of this scourge from our society.

Over the years, the Department has received a number of proposals to establish new special purpose Treasury borrowing programs. A few of the more popular requests for special purpose borrowings have been to build battleships, to fund various education and energy programs, to support the environment, to provide assistance to new democracies, and to fund the space program. The Department has traditionally opposed creation of all special purpose borrowing programs, and we feel our opposition is based upon fundamentally sound budget and debt management principles.

- As a general principle of effective budgetary control, Federal receipts from borrowing should not be earmarked for particular expenditure purposes; instead, these funds should be available in the general fund for appropriation by Congress to finance current programs and objectives.

- With special purpose bond issuance, there is no certainty that the amount of funds expected to be raised for the designated purpose will in fact be raised. This could result in substantial and unintended variations in the amounts provided for the designated special program. The amounts that would be available for the program would be determined largely by the amount of special bonds that are purchased, which is independent of any analysis of program needs and sound budget planning.

- To the extent that buyers of existing Treasury issues shift their purchases to the new special purpose bonds, the program would not result in net new borrowings for the Government. Instead, amounts which otherwise would have been available to the general fund to meet current budget priorities would be earmarked for the designated purpose.

- Many special purpose borrowing requests have been patterned after the savings bonds program. Each new special program of this nature would tend only to confuse the public since the special purpose bonds would be viewed as a competitor to savings bonds.

- In addition, a special purpose borrowing done in the same manner as savings bonds would most likely over time not generate substantial funds. In recent years after accounting for administrative expenses, and the difference between redemptions and purchases, the savings bonds program has not raised a significant amount of new funds. In fact, when the accrual of interest is added, the program has resulted in a net outflow of funds for budget purposes.

- It is worth mentioning also that there are generally higher initial and ongoing costs associated with implementing a special borrowing program, which would add to the budget deficit.

- Most importantly, the enactment of even one special purpose borrowing program would set an undesirable precedent for financing other Federal programs via similar special-purpose securities. This would only compound the problems we described here today.

We at Treasury have had discussions with the sponsors of H.R. 2972, and we understand that numerous changes will be made to the bill as introduced which would address most, if not all, of our specific concerns, including those relating to the budget and appropriations process. Nevertheless, because of the Department's longstanding opposition to all special borrowing programs, the Treasury cannot support H.R. 2972.

The Committee should not interpret the Administration's lack of support for this bill as an unwillingness to finance the war on drugs or as an absence of commitment to the problem. For Fiscal Year 1991, the Administration is seeking to expand funding on drug reduction activities to over $10.6 billion -- a 41 percent increase in actual spending in just one year. While funding, as noted in the President's 1990 National Drug Control Strategy, is not considered the entire solution to the problem -- significant increases in assistance have been requested.

The President's National Drug Control Strategy includes a role not only for the Federal Government, but for our State and local governments, the private sector, and community leaders and citizens alike, with significant opportunities for grass roots participation.

This concludes my prepared statement. I will be happy to answer any questions that you may have.

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TREASURY NEWS

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

Prepared For Delivery
Expected at Approx. 1:15 pm (Chicago)

REMARKS BY JOHN E. ROBSON
DEPUTY SECRETARY OF THE TREASURY
MID-AMERICA COMMITTEE LUNCHEON
CHICAGO, ILLINOIS
APRIL 25, 1990

Thank you, Barry [Sullivan, Host of this Mid-America Luncheon]. It's a pleasure to be back in Chicago and to meet with the Mid-America Committee.

My topic is Eastern Europe and the historic potential it presents to those who possess a commitment to political freedom and an entrepreneurial spirit. Many in this room already have visited these newly emerging democracies, as I have. You probably also returned with strong impressions of a difficult and fluid political and economic environment.

The legacy of over four decades of oppression and economic mismanagement presents a daunting challenge to overcome: a deteriorated industrial base; the absence of basic business skills and commercial institutions; massive debt; environmental decay; a tattered economic infrastructure; and, often, psychological uncertainty and aversion to risk-taking brought about by lifetimes of dependence on state-provided and state-subsidized jobs, goods and services.

In large measure the communist governments in Eastern Europe toppled because they had driven their economies to ruin. And it is from these ruins that the fledgling and largely untested democratic governments must guide difficult and uncertain transitions to political stability and free-market economic growth.

Nonetheless, as recent elections throughout the region suggest, and as indicated by the patient reaction of the Poles to the pain attending their country's bold economic reform, there is, at the present time, a widespread willingness by these peoples to confront the challenges and pay the price.

The observations of an anonymous Polish citizen are apt: "No one has done this before," he said. "It's messy. But that's what freedom is all about, and we may as well get on with it."

The United States has a significant stake in the success of these new democracies. In the interest of European stability we have in this century fought two world wars and conducted a protracted cold war struggle to contain communist expansion. But we cannot now become complacent and permit the reemergence of communist totalitarianism or allow the region to again become a tinder box of national rivalry and political instability.

The recognition of America's vital national interest in the future of the region has led some to question whether we are doing enough to protect that interest and others to demand a 1990's version of the Marshall Plan for Eastern Europe. Politically translated, "are you doing enough" means you aren't spending enough money. But I believe such criticism is both inaccurate and reflects a misunderstanding of the nature of the economic circumstances in Eastern Europe.

First, using the same accounting methods as our allies employ to tote their assistance to Eastern Europe--that is counting loans, credits, guarantees, insurance, and debt rescheduling in addition to hard cash outlays -- U.S. overall assistance is among the leaders.

Second, unlike the immediate post World War II situation, assistance to Eastern Europe is a multilateral undertaking where we join powerful and prosperous allies who have equally substantial stakes in the political and economic stability of the region.

And third, while Europe in 1947 was devastated, it possessed the private sector skills and institutions, and the basic infrastructure to absorb and prosper from massive economic assistance. Today, in addition to the need for fundamental reform of macroeconomic policies, these skills, institutions and infrastructure in Eastern Europe must be strengthened before investment and financial aid can effectively take hold. Flooding the region with money without linking it to structural reform and technical competence will only retard change and dissipate our assistance.

So my message is that the road ahead for these transitioning economic democracies is hard but passable; that we fully comprehend the importance of their success; and that the U.S. is assisting in very material ways designed to respond to the realities of the region and a demonstrated commitment to political pluralism, meaningful economic reform and respect for human rights.

The framework for U.S. assistance to the region embraces several guiding philosophies and objectives which I shall take a moment to elaborate upon.

Foremost, is the recognition that each country in the region differs from its neighbors so that a "cookie cutter" approach won't work. Moreover, the velocity of change is such that we need maximum flexibility in our ability to respond with custom tailored assistance when and where needed. And we offer no grand "Made in America" plan for the ultimate political or economic profiles of these sovereign nations. Nothing could be less practical to achieve or more alien to the concepts of political pluralism and free-market economics.

We are, first, prepared to offer short term emergency humanitarian aid to help meet the most pressing shortages of food, medicine and other necessities.

Next, we are emphasizing technical assistance that will help build the essential political and economic infrastructure: assistance to form political parties, hold elections, run legislatures; establish independent judiciaries; create a free press; run free trade unions; develop a banking system and financial institutions; create capital markets and the accompanying regulatory framework; facilitate the privatization of state-owned enterprises; and foster the broad acquisition of basic business and financial skills.

Soon, for example, a Treasury-led financial assistance mission with representation from key U.S. agencies will visit Poland and other countries in the region to determine precise needs and develop a delivery plan that will draw substantially on American private sector expertise.

And in response to an urgent request from Polish Deputy Prime Minister Balcerowicz, Treasury has arranged to provide ten two-man management consultant teams to assist Poland in assessing existing enterprises in key industries for possible restructuring and early privatization. They will review production, personnel management, marketing, and financial management practices. Each team will have a Polish member to afford an opportunity for training.

We are drawing the men and women for these consultant teams from the roster of experienced volunteers who have registered with the International Executive Service Corps. We hope to have these consultants working in Poland within a few weeks.

Over the longer term we will provide transitional economic assistance to countries prepared to take the strong medicine associated with conversion from command economies to free market systems. This process has already begun in the provision of a substantial U.S. contribution to support Poland's currency convertibility and in the establishment of Enterprise Funds for Poland and Hungary which will seed entrepreneurial activity.

In legislation now before Congress, we have asked for expansion of these private sector growth vehicles to all of Eastern Europe. We are moving as well to help with the debt burdens of these countries. Poland has just received the most generous terms ever offered for rescheduling its official debt by the Paris Club, and the U.S. is assisting in Poland's negotiations on its debt to commercial banks.

Our strategy also contemplates a vital role for the World Bank, the International Monetary Fund and similar institutions. These bodies are equipped to support economic transitions in ways that neither governments nor the private sector can--through structural adjustment financing of social safety nets to help absorb the dislocations of price deregulation and the dismantling of state-owned enterprises, and investment in traditionally public infrastructure such as roads. The newly emerging European Bank for Reconstruction and Development will add to the transitional support arsenal.

Underpinning our entire assistance philosophy is the conviction that the success of these economic transformations will depend primarily not on the response of government, but of the private sector and the attraction of investment. To that end, programs that encourage and facilitate private investment, such as the Export-Import Bank and OPIC, are important elements of our Eastern European strategy.

We have also pointed out to Eastern European leaders and aspiring entrepreneurs that their laws, regulations, and commercial practices must offer a hospitable environment for investment and that, in the competition for outside investment, capital will flow to the places with the most attractive investment climate. We have buttressed this with active negotiations to conclude bilateral trade, investment and tax arrangements so that U.S. investors may have confidence and equitable treatment regarding pre-investment approvals, repatriation of profits, protection of intellectual property, access to the financial system, tariffs, taxes, and resolution of disputes.

When Poland's Prime Minister was here last month, we signed a business and economic relations agreement that covers many of these areas. And we have just signed a trade agreement with Czechoslovakia.

These are the governing precepts of the U.S. approach to fostering democratic capitalism in Eastern European countries. As one of three coordinators President Bush has appointed to assist in the process, I might observe that it is not one that could be described as tidy. But this should be expected in an activity that seeks to usefully funnel public resources into widely disparate and rapidly changing situations, and at the same time enlist the powerful alliance of our private sector.

But there are encouraging signs. In Poland the zloty has remained stable, inflation has significantly declined after an initial bulge following price deregulation in January. On the other hand, real wages and production have substantially declined. Yet the vast majority of Poles stand behind the economic reform program which one senior official described to me as "surgery without anesthetics."

In Hungary, private investment has been flowing from major U.S. corporations. Other countries are in earlier phases of economic reform. While it is too soon to make any reliable long-term judgments, there are reasons for optimism.

What should private business do? My advice is to get over there and take a close look.

You will see the deficiencies, the risks and the uncertainties that I have described. You will see that some of these new governments, unsteady on their political feet, may deal cautiously with economic reform. You will worry that the economic situation in the Soviet Union poses a special problem for the COMECON countries which are still heavily dependent on the U.S.S.R. for trade and industrial input. And you will find that the legal and institutional framework will test your creativity.

But you will also find a tremendous enthusiasm and eagerness for American investment and economic presence. They are very conscious of our unflagging commitment to political and economic freedom and they <u>want</u> us there. You will be impressed, I think, with their determination to create market economies coupled with a will to act. And you will find low-wage, relatively well educated workers, plenty of underutilized industrial capacity, and good geographic locations to compete in the markets of Europe.

And you will also find hundreds of Germans, French, British, Swiss, Japanese and other businessmen and women scrambling to get their firms established. While I do not subscribe to the idea that Eastern Europe markets will inevitably be "locked up" by Western Europe, if American business waits on the sidelines until the situation looks stable and tidy, it will be too late.

These will not be ventures where you can expect to make a quick buck. You will have to take a long view. But I believe the potential for profitable investment is there.

And while you will have to decide for yourselves, you cannot make an informed decision sitting in your offices in Chicago.

Think about it.

Thank you.

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
April 25, 1990

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 2-YEAR NOTES

The Department of the Treasury has accepted $10,503 million of $26,124 million of tenders received from the public for the 2-year notes, Series Y-1992, auctioned today. The notes will be issued April 30, 1990, and mature April 30, 1992.

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

	Yield	Price
Low	8.88% *	99.991
High	8.91%	99.937
Average	8.90%	99.955

*Excepting $235,000 at lower yields.

Tenders at the high yield were allotted 71%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 81,320	$ 81,320
New York	22,752,360	8,525,120
Philadelphia	54,910	54,910
Cleveland	87,045	87,045
Richmond	169,955	163,575
Atlanta	69,440	68,145
Chicago	1,498,390	535,490
St. Louis	111,050	95,760
Minneapolis	45,065	45,065
Kansas City	182,295	176,715
Dallas	52,060	47,060
San Francisco	818,035	420,545
Treasury	201,845	201,845
Totals	$26,123,770	$10,502,595

The $10,503 million of accepted tenders includes $1,906 million of noncompetitive tenders and $8,597 million of competitive tenders from the public.

In addition to the $10,503 million of tenders accepted in the auction process, $757 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $1,434 million of tenders was also accepted at the average price from Federal Reserve Banks for their own account in exchange for maturing securities.

NB-779

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

April 25, 1990

DAVID C. MULFORD
Under Secretary for International Affairs
U.S. Department of the Treasury

DAVID C. MULFORD was sworn in as Under Secretary (International Affairs) of the Treasury on May 23, 1989.

Since 1984, Dr. Mulford has been an Assistant Secretary (International Affairs) of the Treasury. As Under Secretary for International Affairs, he will continue in his lead role for international economic policy formulation and implementation. In particular, he will be responsible for exchange market policies and will remain the U.S. G-7 Deputy with responsibility for coordinating economic policies with other industrial nations. In addition, he will maintain his key concentration on the international debt strategy and will continue to focus on economic relations with the newly industrializing economies, trade and investment matters and preparations for the annual Economic Summit.

Prior to serving at Treasury, Dr. Mulford spent 20 years in the international investment banking business. He served as Senior Advisor at the Saudi Arabian Monetary Agency in Riyadh, Saudi Arabia, as well as a Director of Merrill Lynch, Pierce, Fenner & Smith (1974-1984); and Director of White, Weld, & Co., Inc. (1966-1974). Dr. Mulford was a White House Fellow during 1965-66 and served as Special Assistant to the Secretary of the Treasury.

Dr. Mulford earned his doctorate from Oxford University in 1965 and his Master's degree from Boston University in 1962, specializing in African Studies, and also attended the University of Cape Town. He graduated from Lawrence University with a B.A. (Cum Laude) in Economics in 1959. During his academic career, Dr. Mulford held several fellowships and wrote two books, both published by Oxford University Press. He received an Honorary Doctor of Laws Degree from Lawrence University in June, 1984. In April, 1990, Dr. Mulford was awarded the Legion d'Honneur by the President of France.

He was born and raised in Rockford, Illinois. He is married, has two children, and resides in Alexandria, Virginia.

NB-780

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

EMBARGOED FOR RELEASE UNTIL DELIVERY
EXPECTED AT 10:00 A.M. EDT

TESTIMONY OF PHILIP D. MORRISON
INTERNATIONAL TAX COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
WASHINGTON, D.C.
APRIL 26, 1990

Mr. Chairman and Members of the Committee:

It is a pleasure to be here today on behalf of the Administration to reaffirm our support for Senate Bill 712, a bill "To Provide for a Referendum on the Political Status of Puerto Rico." The Administration is also represented today by Assistant Secretary Martin H. Gerry of the Department of Health and Human Services, who can address the HHS-related expenditure issues raised by this bill.

Senate Bill 712 would provide for a referendum, to be held in 1991, in which the Puerto Rican people could decide among the options of statehood, independence, or commonwealth status. Kenneth W. Gideon, Assistant Secretary for Tax Policy, testified before this Committee on November 14, 1989 regarding this bill. Today, I provide a more detailed analysis of the revenue effects which were presented in that prior testimony, particularly in light of new economic studies which have subsequently reviewed this matter. I also summarize the Administration's position on this bill, which was provided in more detail in the written statement submitted for the record at the November hearing.

I. INTRODUCTION

The Administration strongly supports the right of the people of Puerto Rico to decide for themselves the future status of their island. Further, as the President has noted a number of times, he favors the admission of Puerto Rico to the Union as a state, thereby assuring the people of Puerto Rico equal standing with other United States citizens.

The Administration believes that the Puerto Rican people should be given an opportunity to express their will in a manner that recognizes the historic and fundamentally political nature of their decision of self-determination. The decision they face as a people transcends narrow concerns about specific aspects of economic or fiscal structures. We recognize, however, that the significant economic features of the three options must be identified to allow an informed choice and to make the proposed referendum self-executing in its important features.

The Administration endorses the balance between these two concerns which was struck in Senate Bill 712 as reported by the Committee on Energy and Natural Resources. The bill informs the Puerto Rican people of the broad outline of the fiscal and economic structures applicable to each of the three status options. Yet it preserves this essentially political choice free from a welter of details, transitional rules, and administrative provisions best addressed by Congress after the political choice is made.

Our prior written statement covered a number of technical issues, not affecting the basic balance of the bill, that we believe require clarification or other attention in the drafting of this bill. In addition, for many of the bill's fiscal provisions, we anticipate that further legislation by Congress will be necessary after the referendum to cover particular details of the transition. We discussed in our prior written statement a number of issues that such legislation might cover.

The Administration also believes that the substance of the proposed tax and economic results under each of the three options in Senate Bill 712 represents a reasonable resolution of the difficult policy choices faced by the drafters of this legislation. We think the bill achieves, to the extent possible, the three goals set for it by the Committee on Energy and Natural Resources: (1) an even playing field, politically, for the three political parties, (2) a smooth economic transition, and (3) an adjustment that is budget neutral over a period of time.

It is important to note at the outset, however, that there are significant limitations in any attempt to quantify with precision the economic "equivalence" of the three status options. Economic forecasts out to the year 2000 are only projections, not guarantees. The prediction of the economic results under each of the options is further clouded by many intangible factors, including the reaction of the Puerto Rican people and their government to the option chosen, the response to that choice by the business community, and the possibility that Congress will amend the current tax treatment of Puerto Rico under commonwealth status. Each of these factors could significantly alter the comparative economic forecasts under each of the referendum options.

One of the primary issues for this Committee is the overall impact of Puerto Rican status on the federal deficit. With respect to the commonwealth option, the baseline budget deficit, of course, already contains the cost of Internal Revenue Code section 936, which effectively exempts domestic corporations active in Puerto Rico from U.S. tax. Treasury's Office of Tax Analysis (hereinafter, "OTA") estimates that $2.1 billion in net tax benefits were received by section 936 corporations in fiscal year 1990, projected to grow at about 10 percent a year. Under statehood, the Administration estimates that while there is a net increase in the federal deficit under statehood in early years, there is a substantial net decrease in the federal deficit beginning in fiscal year 1996. Using expenditure estimates prepared by the Congressional Budget Office (hereinafter, "CBO") does not alter the conclusion of an eventual deficit reduction, but merely shifts the crossover point to fiscal year 1997. These projections are illustrated in Appendix II.

As an overall legislative package, the current bill reflects a good and defensible balance among the three status options. It is not, however, the only alternative that might have been adopted. For example, a uniform phase-out of section 936 under both the statehood and commonwealth options would eliminate what is perceived by some as a bias in the bill toward commonwealth. Nevertheless, we recognize that section 936 should not be viewed in isolation from the other costs and benefits affected by this referendum. Other provisions in the bill can reasonably be viewed as providing a rough balance to the phase-out of section 936. Accordingly, the Administration accepts the treatment of section 936 proposed in the current bill and the related Congressional judgment that the economic provisions set forth for the three alternatives are fairly equivalent.

Before turning to a review of our economic projections, let me briefly restate the Administration's position with respect to each of the bill's major provisions affecting tax policy.

II. SUMMARY OF ADMINISTRATION'S POSITION ON TAX PROVISIONS

A. Statehood Option

1. Deferred Application of Federal Taxes

We support the decision to defer until January 1, 1994 the application of Federal tax laws, other than those relating to excise taxes. This provision will give both U.S. and Puerto Rican tax authorities the necessary time to ensure a smooth transition to a new Puerto Rican state tax system. In addition, we believe that it will allow adequate time to develop detailed transitional rules for Congress to consider enacting before the January 1, 1994 changeover.

2. Phase-Out of Section 936

We also believe that the proposed phase-out under the statehood option of the section 936 credit during the period from 1994 through 1997 reflects a good and defensible balance among the different interests at stake. We defer to the Justice Department for the conclusion that continuation of section 936 after statehood for a limited transition period passes muster under the uniformity clause of the U.S. Constitution (Art. I, sec. 8, cl. 1), which broadly requires taxes to be uniform throughout the United States. As recommended in the Justice Department's prior testimony on this bill, we also strongly encourage specific fact findings by Congress to support a Congressional determination that providing transitional tax benefits to Puerto Rico is appropriate and that any section 936 transition adopted is well suited to achievement of Congressional goals.

3. Application of Excise Taxes

The bill would extend all federal excise taxes to Puerto Rico as of its date of admission as a state. In general, we agree with this result, but recommend an effective date as of the first day of the calendar year following admission.

4. Statehood Grants and Assistance

The bill provides for transition assistance in the form of a transfer (or "cover-over") to the Puerto Rican Treasury of federal excise taxes derived from Puerto Rico prior to October 1, 1998, as well as the tax collected from the extension of Federal internal revenue laws to the State of Puerto Rico in 1994 and 1995. We agree that Puerto Rico should receive sufficient assistance to ease its transition from commonwealth status. As discussed in our November written statement, however, the cover-over mechanism has presented complex administrative problems in the past. We therefore recommend that Congress preserve its flexibility to address in future legislation the appropriate procedures to be used in measuring and remitting the desired levels of such statehood grants, without restricting its choice to a direct cover-over of collected taxes.

B. Independence Option

1. Elimination of Section 936

The bill would eliminate the benefits of the section 936 credit for income from activity or investments in Puerto Rico upon the proclamation of independence. This automatic repeal is essential to avoid the difficulties that would otherwise arise with respect to a number of income tax treaty partners of the United States who have effectively been granted most favored nation status with regard to tax sparing incentives.

2. Negotiation of Tax Treaties

The bill provides for a Task Force on Taxation to facilitate the negotiation of appropriate tax treaties between the United States and an independent Puerto Rico, which would would be approved by the two governments in accordance with their respective constitutional processes. Due to the economic integration between Puerto Rico and the United States, we strongly support this goal, although we understand that there may be technical legal difficulties with this section as drafted and defer to the Department of Justice on this issue.

3. Interest on Puerto Rican Government Obligations

The bill would continue the current federal tax exemption for interest paid on Puerto Rican bonds outstanding upon proclamation of independence. We recommend clarification that this provision does not apply to either original issuances or refinancings on or after the date of independence and that the continued exemption is subject to the rules governing the exemption for U.S. municipal bonds, as amended from time to time.

C. Commonwealth Option

1. Continuation of Section 936 Benefits

Under the enhanced commonwealth option, the bill would not result in any changes to the substantive tax laws currently applicable with respect to Puerto Rico. Accordingly, the benefits of section 936 would not be phased-out (as under statehood) or eliminated (as under independence). We believe, however, that Congress should make it clear that such benefits cannot be regarded as guaranteed under commonwealth status but rather should continue to be viewed as incentives which Congress will, as it has in the past, review and revise as necessary.

2. Puerto Rican Review of Federal Laws and Regulations

The bill provides for expedited review procedures where the Puerto Rican government determines that federal laws or regulations are inconsistent with the enhanced commonwealth relationship. As described in more detail in our written statement submitted in November, the Administration has serious concerns with respect to these provisions. In the context of legislation and regulations affecting the tax system, we believe such special review procedures would unreasonably complicate fair and efficient tax administration. The standard Constitutional and Congressional procedures governing tax legislation and the rules of the Administrative Procedure Act governing tax regulations provide reasonable and appropriate protections of Puerto Rico's interests.

3. International Agreements

The bill would permit the Governor of Puerto Rico to enter into international agreements to promote the international interests of Puerto Rico as authorized by the President of the United States and consistent with the laws and international obligations of the United States. Currently, Puerto Rico does not have the authority to negotiate or enter into international double taxation conventions or similar agreements in its own right. An outright grant of independent tax treaty authority to Puerto Rico would significantly complicate the negotiations of United States treaties and quite possibly undermine several existing conventions. We recommend that Congress explicitly deny independent tax treaty authority in the commonwealth option.

III. REVIEW OF REVENUE ESTIMATES AND PROJECTIONS

The revenue estimates and projections which were submitted by the Administration in November are updated and submitted as Appendix I to this written statement. As you are aware, two economic studies have been published subsequent to our testimony last Fall which raise questions with respect to some of our conclusions: Potential Economic Impacts of Changes in Puerto Rico's status under S. 712, prepared by the Congressional Budget Office, (April 1990) (hereinafter the "CBO Study"), and Economic and Fiscal Impacts of Puerto Rican Statehood, prepared for the Governor of Puerto Rico by the Policy Economics Group, KPMG Peat Marwick (February 1990) (hereinafter the "Governor's Study"). In response to these studies, this testimony describes in greater detail the assumptions we made in developing our estimates and projections, and reviews how our conclusions relate to those reached in the new studies.

As I previously stated, the economic effects of each of the political options under the bill cannot be estimated with precision. Much would depend upon the decisions made by the government and people of Puerto Rico as they exercise their rights under each of the options, as well as the response of the business community with respect to current and future levels of investment on the island. The choices made would affect the Puerto Rican economy and to some extent Federal tax revenues and outlays. The conclusions to be drawn from the numbers must always be weighed together with the admittedly unquantifiable, though potentially beneficial, effects of the choice of either the statehood or independence options. Both of the new studies recognize this fact and the resulting danger of relying too heavily on those factors which can be quantified.

A. Federal Revenue Effects of Phase-Out or Elimination of Section 936

Both the statehood and independence options under S. 712 assume some form of reduction of the tax incentives currently provided under section 936. As noted, OTA estimates that $2.1 billion in net tax benefits were received by section 936 corporations in fiscal year 1990, and these benefits are projected to grow under existing commonwealth status. Under S. 712, if the statehood option were chosen by the Puerto Rican people, these benefits would be phased out during the period from 1994 to 1997. Under the independence option, the benefits would be eliminated upon proclamation of independence.

As the Governor's Study and the CBO Study agree, the extent to which the reduction of these benefits are actually translated into increased federal tax receipts is the major factor in the determination of the impact of the bill on federal receipts. The projected revenue gain from phasing out section 936 tax benefits represents considerably more than half of the total revenue gain projected under statehood, and over 90 percent of the gain projected under independence. The section 936 revenue figures are also the most controversial, since the Treasury projections of federal gains from personal taxes and other non-section 936 revenue sources are similar to the projections in the other studies.

OTA's estimate of the revenue gains from phasing out section 936 required consideration of several factors. The following discussion reviews how each of these factors contributed to the estimates and projections noted in Appendix I.

1. Developing a Current Law Baseline

As an initial matter, it was necessary to determine a baseline of the federal tax benefit currently derived from Code section 936. For this purpose, OTA used the most recent data available on the income of section 936 corporations in Puerto Rico, based on tabulations of 1985 tax returns filed with the Internal Revenue Service by the companies. In comparing the OTA analysis to the projections in the Governor's Study, it is important to note that the baseline used in the Governor's Study relied on Puerto Rican tax data and seems to miss more than 25 percent of the section 936 income actually reported to the IRS.

OTA divided the section 936 income into its two components: active business income and qualified possession source investment income (QPSII). In recent years QPSII has accounted for about 15 percent of total section 936 net income. Each of these components must be analyzed separately because the phase-out of section 936 would affect them differently. For example, even if a section 936 company attempted to shift its Puerto Rican operations to an overseas location after statehood, the financial component (QPSII) would generally become taxable by the United States. This is because passive earnings of a U.S.-controlled foreign subsidiary are generally deemed to be repatriated and taxed currently at the U.S. shareholder level under subpart F (Code sections 951-964).

Each of the components of section 936 income were projected forward to estimate the level of such income under current law to compare with the phase-out of these benefits under statehood and their elimination under independence. The active income component was projected from 1985 to 1988 using data in the Puerto Rican national accounts on the growth of non-wage income in manufacturing. A growth rate consistent with previous historical trends was used for the years following 1988. In addition, an adjustment was made for the impact of the Tax Reform

Act of 1986 on section 936 income. In particular, the likely shift by many section 936 companies to the 50-50 profit split method as a result of the imposition of a royalty floor in the cost-sharing option was taken into account. The QPSII component was projected using recent trends in growth of financial assets.

2. Effect of Overseas Shift of Current Section 936 Activity

Under the statehood option, if the active business income of section 936 corporations currently shielded from federal taxation by the section 936 credit were to continue to be earned either in Puerto Rico or in any other state,*/ the phase-out of section 936 tax benefits would generally be translated dollar-for-dollar into increased federal tax receipts. If, however, the activities of these corporations were shifted outside of the United States, some portion of the income would not yield increased federal revenue in the near term. This is because certain income earned by U.S.-controlled foreign subsidiaries may be deferred from federal taxation until repatriated. Moreover, even when the income is distributed to the U.S. shareholder, federal tax on such earnings could be offset by foreign tax credits. Accordingly, federal receipts under the statehood option could increase by some figure that is less than the full amount of the current law section 936 baseline.

The possibility of section 936 operations moving to non-U.S. locations is therefore one of the most important issues in projecting the revenue gain from phasing out section 936. Estimating the extent of such movement, however, is also the most difficult step in making this projection.

3. Factors Considered in Estimating Overseas Shift

OTA's estimate of the extent to which section 936 operations would move abroad under the statehood option was based on several considerations. One was the determination for each industry of the extent to which section 936 income was derived from intangible assets. A further consideration was the division of such intangible income between that attributable to marketing intangibles (such as trademarks) and manufacturing intangibles (such as patents).

The above distinctions are relevant since they affect the potential for shifting income-producing activity outside of the U.S. tax jurisdiction. Under current law, the transfer of either

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*/ For the purpose of estimating federal revenues, it is generally unnecessary to determine how much of the section 936 income would stay in Puerto Rico rather than move back to the mainland. As long as the state tax and operating costs on the mainland were comparable to those in Puerto Rico, the federal revenue pickup would be the same since, either on the mainland or in Puerto Rico, such income would be subject to federal tax.

manufacturing or marketing intangibles to an overseas affiliate would require substantial royalties to be paid to the U.S. transferor. These royalties must be "arm's length" and commensurate with the income attributable to the intangible. Where the output of the offshore affiliate was primarily sold in the United States (which is currently the case for most section 936 activity), the affiliate would contribute little additional marketing to the overall income produced and the required royalty payments would thus offset a substantial portion of the affiliate's income. With respect to marketing intangibles, the royalties required would leave very little income offshore. If section 936 companies do choose to move offshore, such royalties would reduce the benefits of a low-cost location and increase the federal revenue pick-up. This, of course, will affect the decision whether or not to move offshore.

U.S. taxation associated with the repatriation, through royalty payments, of the income that can be moved overseas could, however, be somewhat reduced by the U.S. owner's foreign tax credits. If the section 936 company's parent corporation is in an overall excess foreign tax credit position, then royalties paid with respect to intangibles used overseas would generate foreign source income and could be sheltered from U.S. tax by the recipient's foreign tax credits. For this reason, the frequency of excess foreign tax credit positions by industry was also examined.

This foreign tax credit protection would generally not be available, however, with respect to income derived from marketing intangibles related to the U.S. domestic market. Royalties paid with respect to income derived from such marketing intangibles, even after their transfer overseas, would retain their character as U.S. source income and would be fully subject to federal tax. This important factor was overlooked by the Governor's Study.

Further, for some industries, an offshore location would offer lower profitability than Puerto Rico quite apart from the effect of increased royalty payments. This is because the income allocation rules under section 936(h) often permit section 936 companies to claim a return on intangible assets associated with a broader "product" than the product actually produced in Puerto Rico. For example, the section 936 affiliate can often claim all or a part of the return attributable to an intangible even though the highly technical part of the process is still performed by the parent in its U.S. plant. These rules thus permit a greater portion of income to be attributed to the section 936 corporation than would be the case for an affiliate operating in alternative offshore locations. As a result, if such Puerto Rican operations were moved overseas, some income currently allocated to the section 936 company would not be able to follow and would shift to the U.S., even before the imposition of an increased royalty on the overseas income.

The very high rates of return earned by section 936 corporations in the aggregate suggest that intangible assets account for 75 percent or more of total income. A review of 1985 tax return data also indicates that marketing intangibles were significant for a substantial portion of the section 936 corporations. Under Code section 936(h), a section 936 corporation is allowed no return on its intangible income unless it elects either the cost-sharing method or the 50-50 profit split method. Prior to changes introduced by the 1986 Tax Reform Act, the cost-sharing method was generally a more beneficial choice for companies relying on manufacturing intangibles. The significant role of marketing intangibles to section 936 operations, therefore, can be seen from the fact that, as of 1985 (before the 1986 changes took effect), 40 percent of section 936 income was received by companies which had elected the 50-50 profit split option rather than cost-sharing.

Information on the present location of U.S.-controlled operations supplying the U.S. market was also consulted. For example, the electronics industry has demonstrated that substitutes for Puerto Rico appear to be available in the low-tax countries of the Pacific rim. Finally, the availability of low-tax alternatives for particular activities such as pharmaceutical manufacturing was evaluated. In this connection, OTA consulted with foreign government and other experts to gauge the extent to which foreign jurisdictions would offer incentives to section 936 operations.

4. Conclusion

As a result of examining these factors for each industry, OTA concluded that, in the long run, about 35 percent of the active section 936 income in Puerto Rico under the current law baseline would move offshore to non-U.S. locations. As noted, some of this income would have to be repaid to the United States in the form of royalties. Based on the likely royalties that would have to be paid and the excess foreign tax credit positions of the parent corporations in each industry, about 25 percent of active section 936 income would remain offshore. Stated another way, the phase-out of section 936 would result in an addition to the U.S. tax base of 75 percent of the active section 936 income. Adding to this the portion of section 936 income that is passive (the QPSII component) and, as described above, would also not escape U.S. tax, nearly 80 percent of total section 936 income would become subject to U.S. tax after the phase-out.

I would like to stress that projecting the amount of income that would shift to low-tax locations cannot be a simple mechanical process, but must take a number of factors into consideration. For example, the Governor's Study assumed that any operation that can increase its after-tax return by 5 percentage points by moving offshore would necessarily do so. Applying the same logic to operations on the U.S. mainland would lead to the conclusion that virtually no highly-profitable manufacturing would currently take place in the United States. A low mechanical threshold of this type ignores the benefits now available in Puerto Rico that would be difficult to replicate in a foreign location, such as the use of the dollar as the local currency, protection from expropriation and political uncertainty, and the ability to obtain legal protection in a U.S. court. Furthermore, very few (if any) of the foreign locations considered to be potential alternatives to Puerto Rico can offer both the skilled labor force and the proximity to U.S.-based marketing and R&D personnel that are provided by Puerto Rico.

B. The Role of Macroeconomic Considerations in the Revenue Estimates

1. Reliance on Independent GNP Predictions

In estimating the revenue impact of any change in domestic tax policy, OTA revenue analysts hold various macroeconomic variables, such as GNP, employment, total investment, etc., fixed at those values set by representatives from the Council of Economic Advisors, the Office of Management and Budget, and the Economic Policy Office at Treasury. Similarly, the Joint Committee on Taxation staff makes their estimates consistent with CBO's macroeconomic projections.

This convention serves several useful functions. First, although a change in tax policy can affect these macroeconomic variables, the specific impact will generally depend upon the reaction of the Federal Reserve Board and other agencies whose policies may also have macroeconomic effects, and different analysts may have differing views about the magnitude of both the direct effect and the response. Second, without maintaining some overall constraints, it is easy to overstate the effects of a tax policy change. Thus, standard revenue estimating policy calls for assuming that the reduced employment (or investment) in an adversely affected industry will be offset by increased employment (or investment) elsewhere.

This convention has in general been followed in OTA's analysis of the revenue effects of S. 712. The Administration's forecasts for U.S. GNP, which might be expected to be relevant for projecting the growth of section 936 operations, was available only for 5 years, through fiscal year 1995. However, other than the brief interruption after 1982 caused by restrictions in section 936 benefits enacted under TEFRA, P.L. 97-248, the real growth of section 936 income has been relatively stable over a long period of time. This long-term historical growth of section 936 income was thus used to project section 936 income under the current law baseline into the late 1990's.

The representatives of the Council of Economic Advisors, OMB and Treasury, mentioned above, do not project Puerto Rican GNP and income. The OTA projection of increased federal collection of personal and non-section 936 corporate taxes under statehood assumed continued real growth in Puerto Rico, but at a very conservative rate of about 2 percent per year. Following standard revenue estimating conventions, no attempt was made to predict the impact of phasing out section 936 benefits on the growth of the Puerto Rican economy.

2. Impact on Puerto Rico's GNP

Employment in section 936 corporations now accounts for 12 percent of total Puerto Rican employment, or about 100,000 to 110,000 jobs, and the income earned by employees of section 936 corporations represents about 16 percent of total Puerto Rican labor income. Thus, any reduction in the activity of section 936 corporations and their local suppliers of goods and services could potentially reduce the personal income of the residents of Puerto Rico (although, to the extent the activities were transferred to the mainland, the personal income of the residents of other States might increase). Nevertheless, the assumption made in the Governor's Study that those workers displaced by the relocation of section 936 activities would remain unemployed, apparently forever, seems far too pessimistic, since such workers are among the most skilled. They can be expected eventually to find jobs in other activities, although possibly at lower wage rates.

Estimating the impact on Puerto Rican employment of the potential relocation of section 936 activities not only requires determination of the extent to which such relocation would occur, but is also complicated by the other economic changes which would accompany statehood. Federal transfer payments to the residents of the state would grow significantly, increasing demand in Puerto Rico. Thus, the overall impact of statehood upon the gross national product of the State of Puerto Rico is not readily estimated.

The CBO Study utilizes a macroeconomic model of the Puerto Rican economy in order to estimate the impact of statehood and independence. The model attempts to capture the impact of the activities of the section 936 companies on the economy of Puerto Rico. The CBO Study projects that under statehood the Puerto Rican economy would continue to grow, but that the rate of growth may be one to two percentage points slower per year than under the current commonwealth status. These projections reflect only the impact of phasing out section 936 and extending federal expenditure programs to Puerto Rico, which are the only consequences of statehood that CBO could quantify. As the CBO Study concedes at page 1, its analysis

> cannot take into account the unquantifiable gains from statehood, such as the effect of reduced uncertainty about Puerto Rico's future status and increased awareness of the opportunities that it offers. These effects, which generally would work to improve the

economic outlook under statehood, may be significant, though CBO can give no estimate of their size.

The impact of phasing out of section 936 benefits will depend on the response of the Puerto Rican state government. One possible response is a development incentive to replace section 936. Treasury's reports to the Congress on the possessions corporation system of taxation have indicated that section 936 is a very expensive incentive when measured by the jobs created in Puerto Rico. The most recent estimates, those determined for 1983 in the Sixth Report (March 1989), show a revenue cost of about $18,500 per job, or about 125 percent of average compensation. In pharmaceutical manufacturing, which accounts for half of the revenue cost of section 936, the average cost per job was about $58,000. The trend in section 936 income and the growth of manufacturing employment since 1985 suggest that the cost per job is at least as high today, despite the post-1987 drop in the U.S. statutory corporate tax rate to 34 percent. Accordingly, the Puerto Rican state government may well be able to reproduce the job-creating effects of section 936 by designing a much more efficient program.

The difficulty in predicting the impact of statehood on the Puerto Rican economy is further evidenced by the fact that the Governor's Study, which predicts a much greater reduction in section 936 activities within Puerto Rico than does the CBO Study, estimates only a 5 percent reduction in GNP by the year 2000 (although its projection of a 14 percent reduction in reported personal income is more in line with CBO's projection of a 10 to 15 percent reduction). The Governor's Study also does not attempt to quantify the potential indirect benefits resulting from statehood, nor to examine how these non-quantifiable benefits may be enhanced by the subsequent decisions of the government and people of Puerto Rico.

I stated earlier that the OTA forecasts of the increased federal tax collections of section 936 income under statehood did not depend to a significant degree on whether those operations not moving overseas remained in Puerto Rico or moved back to the mainland. This difference would, however, have an impact on Puerto Rico's GNP, although the reduction in section 936 activities on the island does not necessarily translate into a commensurate reduction in GNP.

Predicting how many U.S.-based operations would move back to the mainland is very difficult. It is true that the tax benefits that attracted most of the section 936 companies in the first place would be phased out. Nevertheless, many of the companies now have a substantial investment in physical plant and have developed a highly competent and cost-effective labor force. In view of the relatively long phase-out period for section 936 benefits under statehood contemplated in S. 712, it appears that any actual decline of section 936 operations in Puerto Rico would take place over a long period of time.

3. Impact of Puerto Rico's Change in GNP on Revenue Estimates

As I indicated earlier, the OTA projections of increased federal collections of personal and non-section 936 corporate taxes under statehood assumed continued real growth (albeit at a modest level). The assumed rate of growth was only slightly lower than the average growth rate projected by CBO using its low-growth baseline. A reduction in the Puerto Rican growth rate of the magnitude projected by CBO would change the estimated total federal revenue increase by only a modest amount. Even in fiscal year 2000, by which time the cumulative shortfall in GNP projected by CBO would be 10 to 15 percent, OTA's projected increase in federal revenues would be reduced by less than 5 percent. This is because a reduction in the Puerto Rican growth rate affects only the increased federal revenues from personal taxes and non-section 936 corporate taxes, which constitute a relatively small portion of the overall projected increase in federal revenues.

Furthermore, the increase in individual income taxes projected by OTA is even less than that projected by the Governor's Study. For example, for fiscal year 1997, the Governor's Study projects an increase of individual income tax collections of $914 million in their high relocation scenario in contrast to OTA's projected increase of only $739 million. OTA's projection of increased non-section 936 corporate collections is lower than the Governor's study estimate as well. These results confirm the fact that the projections of increased federal tax from income now benefiting from section 936, which is not sensitive to the state of the Puerto Rican economy, is the only important area of disagreement on revenues.

C. Net Impact of Puerto Rican Status Referendum on the Federal Deficit

A major question to be faced by this Committee is whether S. 712 creates an economic balance for any of the three status options that is likely to increase the federal budget deficit, decrease it, or keep it roughly the same. The baseline budget deficit, of course, already contains the cost of section 936; thus there would be neither an addition nor a reduction to the deficit in the commonwealth option. As stated above, however, OTA estimates that $2.1 billion in net tax benefits were received by section 936 corporations in fiscal year 1990 and these benefits are projected to grow at about 10 percent per year under the existing commonwealth status.

The statehood option, on the other hand, changes the status quo. It increases both revenues and outlays. While the net effect in the early years is a net increase in the deficit under anyone's estimates, in later years there is a substantial net decrease, whether the outlay figures used are the expenditure estimates prepared by CBO or by the Departments of Health and Human Services and Agriculture. The only difference produced by using these alternative estimates, resulting from CBO's higher outlay figures, is the year in which the net figure turns positive (i.e., the year there is no longer an increase in the federal deficit due to Puerto Rican statehood and is, instead, a deficit reduction). Using the expenditure estimates of the Departments of Health and Human Services and Agriculture, this "crossover point" occurs in fiscal year 1996; using the CBO estimates, it occurs in fiscal year 1997. This crossover point for the Administration's estimates is illustrated in Appendix II.

It is important not to misinterpret the conclusions in the CBO Study which refer to an $18 billion "net transfer" to Puerto Rico over the the nine-year period between 1992 and 2000. The CBO Study states at page 27 that this "net fiscal benefit from statehood would likely be permanent." These figures are based on Table 7 in that study, which describes the federal expenditures to Puerto Rico net of new federal taxes derived from the island. As stated in a footnote to that Table 7, however, the increase in federal taxes does not include the additional federal revenues from the phase-out of section 936. Rather, the reference to "net transfers" in the CBO Study's conclusion is limited to the payments to and from Puerto Rico (which do not include increased federal taxes paid by domestic corporations formerly benefiting from section 936). The focus of this Committee, however, must cover the full effects of statehood on the federal deficit, including the very significant revenues to be derived from the section 936 phase-out. The effect of the section 936 phase-out thus accounts for the crossover point illustrated in Appendix II and an eventual net deficit reduction from statehood, even where "net transfers" to Puerto Rico continue beyond the crossover year.

D. Effects of Statehood on Federal Tax Revenues: A Detailed Analysis

1. Phase-out of Section 936 Benefits

The revenue effects of S. 712 under the statehood option over the fiscal year period 1992-2000, are presented in Appendix I. This table indicates that the revenue effects of the phase-out of the section 936 benefits, described in detail above, is the largest component during and after the phase-out period (changes in the federal income taxes under statehood are scheduled to become effective on January 1, 1994). By fiscal year 2000, the revenue pick-up from this source is estimated to be nearly $4 billion.

2. Federal Excise Taxes

Puerto Rican residents do not currently pay federal excise taxes, but would be subject to these taxes under statehood. This would result in an increase in annual revenues of $200 million to $400 million, which, under S. 712, would be rebated to the Puerto Rican government as a statehood grant at least through October 1, 1998.

3. Federal Income Taxes

The extension of the federal income tax to individuals and corporations in Puerto Rico would result in additional federal revenues. Net of the earned income credit, the individual income tax is estimated to annually raise between $650 million and $850 million during the period between fiscal years 1994 and 2000. Under statehood, federal corporate taxes would also be collected from Puerto Rican businesses that do not now fully benefit from section 936. This includes locally incorporated as well as foreign corporations. As shown in Appendix I, these annual revenues are estimated to range from $250 million to $550 million between fiscal years 1994 and 2000. As noted in Appendix I, under S. 712, a portion of these taxes are scheduled to be "covered-over" to the government of Puerto Rico.

4. Other Federal Revenues

As noted in Appendix I, about $100 million to $175 million per year in customs duties would continue to be collected between fiscal years 1994 and 2000. Beginning in 1994 through at least October 1, 1998, these revenues would be covered-over to the government of Puerto Rico. Rum excise taxes, of about $250 million per year, would also continue to be covered-over to the government of Puerto Rico until 1998.

5. Interaction of the Federal and Puerto Rican Tax Systems

The government of Puerto Rico collected approximately $900 million in individual income taxes in their 1989 fiscal year, which is about 5 percent of reported personal income. Puerto Rico also collects about $1 billion annually in business taxes, which represent about 10 percent of business income. Together with the federal taxes to which they would be subject, the total tax burden on Puerto Rican residents would thus be quite high. As a state, Puerto Rico could design a tax system which would maintain current tax revenues. It might also choose to follow other states in relying more heavily on sales taxes. Or alternatively, Puerto Rico can modify both its tax system and the level of its expenditures, as well as modify the role of government enterprises in the economy.

E. Revenue Implications of Independence

Under the independence option, the elimination of the section 936 benefits would also result in increased federal revenues, as shown in Appendix I. Some section 936 activities (for example, those engaged in apparel manufacturing or food processing) might choose to reincorporate as Puerto Rican corporations, permitting deferral of the federal tax on a portion of such income until repatriated to the U.S. owners. In addition, Puerto Rican taxes paid with respect to U.S. corporations that retain their Puerto Rican activity would generate a foreign tax credit (rather than a state tax deduction as under the statehood option). For these reasons, the federal revenue gain from the elimination of the section 936 benefit is not expected to be as great in later years as under the statehood option.

As an independent country, federal excise taxes (primarily that on rum) and customs duties would apply only on goods imported into the United States; the federal government would not collect any customs duties on goods imported into Puerto Rico. Federal income taxes would apply only to the extent income earned in Puerto Rico were repatriated to the United States (or deemed to be repatriated under Subpart F rules), and some Federal withholding taxes might be collected on the payment of income earned in the United States to Puerto Rican residents.

APPENDIX I
ESTIMATED AND PROJECTED FEDERAL REVENUE INCREASES UNDER S.712

The following chart shows the Federal revenue collections that are estimated to result from implementation of either the statehood or the independence option under S. 712 through fiscal year 1995 and projections of revenues for the five fiscal years thereafter. Because economic projections are not made by the Treasury, Council of Economic Advisors, or the Office of Management and Budget for years after 1995, the projections shown for 1996-2000 are based on a continuation of the fiscal year 1995 economic forecast in later years. The section 936 projections, however, are based on the historic patterns of section 936 tax expenditure growth which have been significantly in excess of U.S. economic growth.

Except in the case of customs duties and rum excise taxes, these figures reflect projected increases in Federal revenue collections over existing law. As indicated below, many of these amounts would be subject to a cover-over to the State of Puerto Rico until either fiscal year 1996 or 1998. Except as otherwise indicated, these figures reflect an effective date of 1/1/94 for Federal tax law changes. These figures do not assume any change in Puerto Rican tax law.

(IN $ MILLIONS)

	ESTIMATES				PROJECTIONS				
	FISCAL YEARS								
	1992	1993	1994	1995	1996	1997	1998	1999	2000
STATEHOOD									
Phase-Out Sec. 936	45	128	538	1204	1889	2610	3325	3741	3994
New Excise Taxes#	213*	295*	309*	325*	341*	358*	376*	395	414
Personal Tax									
Gross U.S. Collections (Net of EIC)	..	..	645	676	707	739	773	809	846
Cover-Over to P.R.	..	..	482*	666*	168*	..	..	..	..
Net U.S. Collections	..	..	163	10	539	739	773	809	846

	ESTIMATES				PROJECTIONS				
	FISCAL YEARS								
	1992	1993	1994	1995	1996	1997	1998	1999	2000
STATEHOOD (CONT'D)									
Corporate Tax									
Gross U.S. Collections	..	..	249	427	448	471	495	519	545
Cover-Over to P.R.	..	..	249*	427*	174*	..	..	..	..
Net U.S. Collections	..	..	0	0	274	471	495	519	545
Customs Duties	..	..	97*	134*	141*	148*	155*	163	171
Rum Excise Tax	..	188*	252*	255*	257*	260*	262*	265	268
INDEPENDENCE									
Eliminate Sec. 936**	45	1501	2579	2738	2876	3095	3327	3555	3816
Rum Excise Tax**	..	188	252	255	257	260	262	265	268

* Taxes subject to cover-over to Puerto Rico in years designated by asterisk.

Reflects 1/1/92 extension of Federal excise taxes to Puerto Rico (other than the rum excise tax which already applies).

** Assuming proclamation of independence occurs on 1/1/93.

APPENDIX II

Effect of the Statehood Option on the Federal Budget Based on Administration's Estimates and Projections of Federal Tax Revenue Gains and Outlay Increases

	Fiscal Year ($ Billions)								
	1992	1993	1994	1995	1996	1997	1998	1999	2000
Tax Revenue Gains**	*	.1	.7	1.2	2.7	3.8	4.6	5.1	5.4
Outlay Increases***	.8	.9	1.4	2.2	2.6	3.0	3.3	3.7	4.1
Increases in Surplus (+) or Deficit (-)	-.7	-.8	-.7	-1.0	+.1	+.8	+1.3	+1.4	+1.3

* Less than $50 million gain

** Revenue gains estimated by Office of Tax Analysis, Department of the Treasury

*** Outlay increases estimated by Departments of Health and Human Services and Agriculture

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
April 26, 1990

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Press Briefing by
John E. Robson
Deputy Secretary of the Treasury
on the
Caribbean Conference on Drug Money Laundering

It's a pleasure to be here today with Prime Minister Oduber of Aruba and to express the Bush Administration's support for the establishment of the Caribbean Conference on Drug Money Laundering. We salute the Prime Minister and other leaders in the Caribbean area for this important step in the fight against drug money laundering.

The Caribbean Conference has been inspired by the success of the G-7 Financial Action Task Force on Money Laundering. The G-7 Task Force was convened at the direction of the 1989 Economic Summit in Paris. It was born of the idea that narcotics trafficking and money laundering are inextricably linked and that money laundering is an international problem that must be addressed through international solutions.

Just last week, the final report of the G-7 Task Force was released around the world by Task Force member countries. This effort represents the work of 15 nations to facilitate greater cooperation in international investigations, prosecutions and property seizures. They have agreed on 40 action recommendations which, when implemented by the member countries, should help establish a global network of programs to attack money laundering.

The report reflects recognition by the G-7 Task Force member countries that in order to effectively combat international money laundering, individual countries must have sound domestic programs to attack money laundering and they must cooperate with each other in the many cases that cross international borders.

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I am pleased with the accomplishments made by the G-7 Task Force and I am hopeful that the advances we made in understanding the problem of international money laundering and identifying ways to attack the problem will serve as a solid foundation for the work of the Caribbean Conference.

It is my hope that the countries participating in the Caribbean Conference will endorse the recommendations developed by the G-7 Task Force as well as develop other recommendations that address money laundering problems specific to their region.

Once again, let me commend Prime Minister Oduber. Mister Prime Minister, on behalf of Secretary Brady, I will chair the U.S. delegation with assistance from the Departments of Justice and State and our law enforcement and bank regulatory agencies. I look forward to working with you and the other members of the Caribbean Conference in the months ahead. I offer you whatever assistance we may provide to help the Conference develop strong weapons to fight international drug money laundering.

Thank you.

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Testimony of the Honorable John E. Robson
Deputy Secretary of the
Treasury before the Senate Foreign Relations Committee
April 27, 1990

I would like to thank the Chairman and the Committee for this opportunity to update you on activities of the Department of the Treasury to combat international money laundering.

My testimony today will touch on the work of the G-7 Financial Action Task Force on Money Laundering and related initiatives, measures that the Endara Government in Panama has taken against money laundering, and current progress in pursuing agreements under section 4702 of the Anti-Drug Abuse Act of 1988.

The overall message I would like to convey to the Committee is that we are seeing advances in the international community in helping countries to understand the nature and global scope of the money laundering problem and the steps necessary to address it. The United States is committed to the ultimate goal of a worldwide network of countries linked together with a common resolve to close the doors of our financial institutions to money launderers. We also recognize that forging this chain of dozens of sovereign nations with different laws, practices, and financial systems is not quickly or easily achieved.

Treasury Role

Before turning to these matters, I would like to discuss the role of Treasury in the area of money laundering and financial enforcement.

Money laundering is a complex economic crime that demands a thorough understanding of how our financial institutions operate in order to prevent their abuse. Treasury brings to the problem the perspective of a law enforcement agency, a financial institution regulatory agency, and the agency concerned with the overall condition of our domestic and international financial systems. Our recent experience with the G-7 Financial Action Task Force, which I will discuss, demonstrates that Treasury's understanding of law enforcement and the financial system is very useful in dealing with our foreign counterparts, many of whom are grappling with developing anti-money laundering programs for the first time.

We understand not only law enforcement concerns, but the necessity to balance law enforcement needs with other legitimate considerations affecting the financial system. Achieving this balance is one of the challenges facing the Administration and Congress as we seek solutions to the problem of money laundering.

Among the key elements of anti-money laundering efforts are the reporting and recordkeeping requirements of the Bank Secrecy Act so that the trail to the money can be followed. Treasury has worked over the years to refine regulatory requirements for reporting and recordkeeping to reflect changing law enforcement needs and to enhance compliance by financial institutions.

The currency reporting system has become an essential component of the U.S. financial enforcement program against money laundering, tax evasion and other criminal activity. It is relied upon by law enforcement agencies, not just to target suspicious activity, but to support ongoing investigations, prosecutions, and forfeiture actions in a variety of ways.

The U.S. Customs Service and the Internal Revenue Service (IRS) have been delegated authority to investigate criminal violations of the Bank Secrecy Act -- IRS with respect to domestic currency reporting and Customs with respect to the reporting of international transportation of currency and monetary instruments. Reporting violations are frequently indicative of money laundering activity, carry severe criminal sanctions, and can be prosecuted without proof of the source of the money. Both Customs and IRS also have authority to investigate the crime of money laundering.

Among the most successful of international drug money laundering cases are Operation C-Chase initiated by Customs and Operation Polar Cap developed jointly by IRS, Customs, FBI, and DEA. The details of the cases are well known to the Committee, but the degree of cooperation from foreign governments in the cases should be noted. In Operation C-Chase, involving the Bank of Credit and Commerce International, Customs was able to meet with targets in France and the United Kingdom with the knowledge and assistance of those governments. The United Kingdom and France issued search warrants and seizure warrants and the United Kingdom arrested suspects in London. Similarly, in Operation Polar Cap, Uruguay arrested a suspect and later extradited Canada and Switzerland effected seizures. IRS and Customs report that there has been a marked upsurge in cooperation in money laundering cases generally as our allies come to appreciate the common nature of the money laundering threat.

Based on the success of joint efforts in Operation C-Chase, U.S., British, and French Customs have established an arrangement designated "C-Chase International." This is an informal arrangement to promote sharing of investigatory information and cooperation in all types of Customs cases with special emphasis on money laundering cases.

Through the Italian American Working Group, Customs also has created a joint operation with Italy called "Primo Paso" (First Step). U.S. Customs and Italian authorities work together to identify information about organized crime operating in Italy and the U.S. Their work is facilitated by on-line access to the currency reporting information in the Treasury Financial Database available to our Customs attache in Rome. Our Customs attaches are working to replicate the success of Primo Paso with similar operations in other European countries.

Secretary Brady has applied Treasury's years of experience in financial analysis and investigation in the creation of the Financial Crimes Enforcement Network, "FinCEN." FinCEN has been established within Treasury to provide a multi-source data access and financial analysis service to Federal, State, local and foreign law enforcement which will assist them in the investigation and prosecution of money laundering and other crimes.

FinCEN represents a fresh approach to financial analysis. For the first time, experts from law enforcement, regulatory agencies and the private sector will work together routinely to apply their collective expertise to the issue of money laundering and other financial crimes. We look forward to testifying in the future that the creation of FinCEN was a watershed event in the history of the government's war on drug money laundering.

International Cooperation

G-7 Financial Action Task Force on Money Laundering

Our most important recent initiative was the U.S. participation in the G-7 Financial Action Task Force on Money Laundering. This Task Force was convened at the direction of the 1989 G-7 Economic Summit in Paris. The heads of state and governments of the G-7 gave the group a mandate to study measures that have been taken to prevent utilization of financial institutions by money launderers and to make recommendations on how to improve international cooperation against money laundering.

The Financial Action Task Force was born of the ideas that narcotics trafficking and money laundering are inextricably linked and that money laundering is an international problem that must be addressed through international solutions.

The Task Force met under French chairmanship and consisted of sixteen members: the seven Summit participants (Canada, France, Germany, Italy, Japan, the United Kingdom and the United States), eight other industralized countries, (Australia, Austria, Belgium, Luxembourg, the Netherlands, Spain, Sweden, and Switzerland), and the European Community. The Task Force brought together over 130 experts from finance ministries, financial institution regulatory agencies, foreign affairs and justice ministries, and law enforcement agencies of the member countries.

I had the privilege of serving as the chairman of the U.S. Delegation which consisted of delegates from Treasury, including Customs and the Office of the Comptroller of the Currency, the Department of State, the Department of Justice, FBI, DEA, and the Federal Reserve Board.

After monthly meetings from September 1989 through February 1990, under the able direction of our French Chairman, the group issued an excellent report with 40 action recommendations. The report was published in the United States last week and will be a topic of discussion at the Houston Summit this summer. Treasury has provided the Committee with the report. I would like to submit the report and its annexes for the record.

These recommendations, as they are implemented by the member countries, should establish a nucleus of comprehensive programs to address money laundering and will facilitate cooperation in international investigations, prosecutions, and forfeiture actions. I think it is fair to characterize the report as the single most comprehensive, forceful international declaration on money laundering to date.

The report reflects recognition by the Task Force members that in order to wage an effective war against money laundering each member must have an effective domestic program to attack money laundering and that we must cooperate with each other in the many cases that traverse international borders through both formal and informal mechanisms. The group also recognized that financial institution secrecy laws should not stand as barriers to effective financial crimes enforcement.

Most importantly, the Task Force recommendations reflect the fact that money laundering is a complex crime that cannot be effectively attacked by conventional law enforcement methods alone. Law enforcement authorities, finance ministries, financial institution regulators, and financial institutions themselves must work together to prevent financial institutions from being used by money launderers.

With these tenets in mind, the Task Force made a number of recommendations, including the following:

- o Countries should criminalize drug money laundering and consider criminalizing other types of money laundering.

- o Countries should adopt effective seizure and forfeiture laws.

- Financial institutions should not have anonymous accounts and should be required to identify their customers when accounts are opened and when conducting transactions, in particular when performing large cash transactions.

- Financial institutions should maintain adequate records of transactions, including currency transactions, for five years, so as to be able to provide evidence in future investigations and prosecutions.

- Financial institutions should be alert to suspicious transactions and be able to report such transactions to law enforcement authorities free from liability under secrecy laws.

- Financial institutions should develop comprehensive anti-money laundering programs with employee training and audit procedures.

- Financial institution regulators should cooperate with law enforcement authorities and insure that financial institutions have adequate money laundering prevention procedures.

- Countries should provide the widest possible assistance in money laundering cases at every stage from investigation and prosecution through extradition.

While the Task Force recommendations may cause us to do some fine tuning of U.S. financial enforcement, by and large the recommendations reflect policies and programs already in place in the United States. This is not surprising given the fact that the United States has been addressing money laundering enforcement issues for many years longer than most of our allies, and our system was frequently looked to as a model.

The degree to which the Task Force was able to reach consensus on the recommendations is worth noting. Some of the recommendations, such as active participation by bank regulators and reporting of suspicious transactions, are major departures from legal and banking traditions in many of the countries.

This is not to suggest that the recommendations rubber-stamp the U.S. system. For instance, while the report has a number of recommendations dealing with large cash transactions, and takes specific note of the U.S. currency transaction reporting system, the report recommends that each government should individually consider the feasibility and utility of such a system.

The United States views routine currency reporting as one of the important components of our financial enforcement program, particularly in view of the complexity of our financial system, the number and diversity of United States financial institutions, and our geographic size. However, other countries may be able to achieve an effective enforcement program without routine reporting through programs that combine currency recordkeeping, customer identification, the availability of records to law enforcement authorities, and suspicious transaction reporting. In time, some of these countries will come to adopt routine currency reporting, as Australia has.

In the meantime, Treasury has extended an invitation to foreign government and banking officials to visit us for a demonstration of the effectiveness of our program. Treasury's Office of Financial Enforcement regularly arranges multi-day "tours" for delegations of foreign officials to view Treasury facilities at FinCEN and elsewhere and to discuss enforcement issues. This year to date, we have hosted several such delegations from various countries. In addition, Customs and IRS participate regularly in bilateral money laundering seminars and training of foreign officials.

Recognition by the Task Force member countries of the need for a united front against money laundering is a major step, but only a first step. We must keep working to encourage other countries -- large and small, developed and developing -- to embrace the Task Force recommendations and move forward to address the problem from a concerted, multilateral approach.

FATF-Related Initiatives

We shortly will have just such an opportunity to encourage other countries to endorse the recommendations. President Bush has accepted the invitation of Prime Minister Oduber of Aruba for the U.S. to participate in a conference inspired by the success of the Financial Action Task Force, focusing on money laundering in the Carribean area. On behalf of Secretary Brady, I will chair the U.S. Delegation with assistance from the Departments of Justice and State and our law enforcement and bank regulatory agencies. We hope that the countries participating will endorse the recommendations of the FATF as well as deliberate on other recommendations appropriate to addressing the money laundering problem in this region. The first organizational meeting of this Aruban Task Force took place in Washington yesterday.

A related undertaking is underway in the Organization of American States ("OAS"). On April 17 - 20, 1990, the OAS convened a Meeting of Ministers on the Illicit Use and Production of Narcotic Drugs and Psychotropic Substances and Traffic Therein. This "Alliance of the Americas Against Drug Traffic" unanimously adopted a resolution for the formation of an Inter-American Group of Experts to draft model regulations in conformity with the U.N. Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances.

The mandate of this experts group is to develop model legislation to criminalize drug money laundering to prevent the use of financial systems for money laundering, to enable authorities to identify, trace, seize and forfeit illicit proceeds, to change legal systems to ensure that bank secrecy laws do not impede effective law enforcement and mutual legal assistance, and, finally, to study the reporting of large currency transactions to national governments and to permit the sharing between governments of such information. It is expected that the OAS will soon convene this group and that Treasury will play a central role in its work.

Panama

Next, I would like to address measures taken by Panama.

Recent history dramatically demonstrated to the Panamanians the pernicious effect of money laundering on the Panamanian political, economic and social structure. With this backdrop, the Endara government has taken a number of steps that show its resolve to address drug money laundering. These steps have been taken with U.S. encouragement, but at the initiative of the Panamanian government.

In January, the Endara government entered a Mutual Cooperation Agreement on Narcotics with the United States (a so-called "Chiles" agreement required under P.L. 100-690). Under the terms of this agreement, both governments committed to take a variety of cooperative measures related to narcotic matters, including steps to combat drug money laundering. Panama also accepted an invitation to participate in the Aruban initiative.

Panama has begun to use its anti-narcotics legislation which was dormant for many years and to interpret its bank secrecy provisions in drug cases to allow access to bank records by both domestic and foreign law enforcement authorities. Following the fall of the Noriega regime, the Panamanian government froze over 200 bank accounts related to drug and drug money laundering cases based on information provided by U.S. law enforcement agencies. The accounts remain frozen to their owners and the Panamanian Attorney General has begun to share information about these accounts for use in U.S. investigations and prosecutions, including the Noriega case. These documents were important in the investigations that led to the freezing last week of a number of U.S. bank accounts last week arising out of Operation Polar Cap. This is to be contrasted with the lack of cooperation U.S. authorities received from Panama in past years in drug money laundering cases.

The Panamanian government also has taken steps to enlist its banks and bank regulators in the fight against money laundering. On February 13, 1990, the Panamanian Cabinet issued Decree No. 41, mandating that the National Banking Commission require banks to identify their customers and to record currency and certain negotiable instrument transactions in excess of $10,000. The decree gives authority to the Commission to examine banks for compliance, and provides for civil penalties and criminal fines against banks and their directors, officers and employees for failure to adhere to these requirements.

The provisions of Decree 41 and the regulations that have been issued under it appear to be a major step forward for Panama to safeguard banks against money laundering. It also represents the first time that Panamanian regulatory authorities have been actively engaged in the struggle against money laundering.

Finally, in mid-February 1990, the Endara government approached the U.S. about its desire to enter into an exchange of information agreement to facilitate the sharing of information and records, including bank records, in drug and drug-related investigations and prosecutions, including money laundering. A joint State, Treasury, and Justice team has been discussing this agreement with officials of the Panamanian government.

While I hope the Committee will understand that we cannot discuss the details of the course of these discussions, both the U.S. and Panama are intensively pursuing an agreement. We can add that we seek provisions for the sharing of currency recording information maintained in Panama under Decree 41, and consider this aspect of the discussions to be under the authority of section 4702.

In summary, the news from Panama is encouraging and reinforces the Administration's commitment to do everything possible to assist the Endara government to help stabilize democratic institutions to insure that the nightmare of the Noriega regime cannot be repeated. We want to continue to send a message of trust and friendship to the government and people of Panama.

Section 4702

Next, I would like to turn to an integral part of our international anti-money laundering strategy, section 4702.

Under Section 4702 of the Anti-Drug Abuse Act of 1988, the Secretary of the Treasury negotiates with countries that do business in U.S. currency to require their financial institutions to keep records of large dollar currency transactions, and to share those records with U.S. law enforcement authorities upon request. The Secretary, in consultation with the Attorney General and the Director of the Office of National Drug Control

Policy (ONDCP), is to place highest priority on those countries whose financial institutions may be engaging in transactions involving the proceeds of international narcotics trafficking, particularly U.S. drug sales.

On November 18, 1990, the Secretary reports to Congress and to the President on the status of the negotiations. The President is to apply sanctions against any country that has not reached an agreement or is not negotiating in good faith unless he certifies that sanctions would not be in the national interest. Sanctions include virtually closing off access to the U.S. banking system to the financial institutions of a country.

In enacting section 4702, Congress recognized that it is essential that financial institutions adequately identify those engaging in large cash transactions, record those transactions, and make the information available to law enforcement in drug-related cases.

The Financial Action Task Force Report reached the same conclusion about the need for financial institutions to keep records of large currency transactions, to identify their customers when conducting large transactions, and to share financial institution records with foreign law enforcement authorities. In this regard, the Financial Action Task Force report should serve as a foundation for future section 4702 agreements. If properly implemented in the member countries, this will facilitate our ability to reach agreements under section 4702.

Treasury has given priority to the negotiation of these agreements. Our first accomplishment was the complex task of assessing which countries should be given highest priority for negotiation. After solicitating the views of federal law enforcement and intelligence agencies and our embassies abroad, and consulting with the Director of ONDCP and the Attorney General regarding priority countries, and careful review of all available information, we initially selected eighteen countries for negotiation of 4702 agreements. Three countries have been added to the list since our interim report to the Committee last November for a total of twenty-one. We do not regard the list as fixed, and we will adjust the list of countries as appropriate.

Next, we determined what resources would be needed to get the job done. We determined the task could be best accomplished by a multi-agency approach. So, under the direction of the Assistant Secretary for Enforcement, we have assembled a team to work on this project. The team includes four full-time international specialists detailed from IRS and Customs, an administrative officer, officials from Treasury, (Office of Financial Enforcement and General Counsel) State (International Narcotics Matters and Office of Legal Advisor), and Justice (Office of

International Affairs and the Deputy Assistant Attorney General, Criminal Division).

Treasury is working closely and meets regularly with the Departments of State and Justice to discuss our strategies for section 4702 agreements and to coordinate these initiatives with other drug and money laundering initiatives, especially any ongoing or planned Mutual Legal Assistant Treaties (MLATs) with any of the countries. I think Justice and State would agree inter-agency cooperation in this project has been excellent.

The negotiations with and approaches to the countries are at various stages. Our embassies abroad have been very helpful in making formal approaches to appropriate foreign officials and in fielding questions for Treasury that these officials pose regarding currency recordkeeping or the operation of the agreements. Over the next months, we will send negotiating delegations to many of the priority countries. Where it might facilitate the negotiating process, I intend to personally to visit my foreign counterparts.

This is a major undertaking through often uncharted waters. At this point, it is not possible to predict the course of any particular negotiation or a time when we can consider the project completed. While Treasury will report back to Congress in November on the status of negotiations, we see the process continuing beyond that time. However, our goal is clear: an international network of countries with stong anti-money laundering programs and broad colloboration among law enforcement authorities.

Several factors contribute to the uncertainty of these predictions. First, we are asking countries to adopt requirements that are often unprecendented for their financial institutions and governmental authorities. While we take the currency transaction recording and the connection between currency and drugs and drug money laundering for granted, there is an educational process to go through with many of these countries, which takes time. This is the case even for countries that are genuinely determined to have effective drug and money laundering enforcement programs.

Second, we are asking countries in most cases to amend statutory or regulatory provisions both to require currency recording and to authorize information sharing. Finally, the U.S. experience with law enforcement agreements generally is that negotiations can be protracted. For instance, as the Justice Department can attest, Mutual Legal Assistance Treaties often take a number of years to negotiate.

Let me assure the Committee that we are firmly committed to forging a network of section 4702 agreements. We are optimistic that countries will be persuaded to conclude these agreements as we help them to understand the money laundering problem and the relation of these agreements to effective enforcement programs.

I hope the Committee will understand that, because of the sensitivity of negotiations and the source of the information upon which we have based our selection of countries for negotiation, we cannot now report in more detail on the discussions or name the countries selected. We believe that to do so would be harmful to the negotiation process.

Conclusion

Our experience has taught us that we cannot make progress against drug trafficking and the international money laundering that sustains it with traditional law enforcement methods, applied within national boundaries. What is needed is painstaking, sophisticated financial analysis to uncover the tangled web of financial dealings of drug organizations, followed by determined action to deprive the organizations of their holdings. This cannot be achieved without two partnerships working together -- a partnership among financial institutions and government authorities and a partnership among nations. As money launderers know no national boundaries, countries must work together to insure that international boundaries will pose no impediments to enforcement efforts.

TREASURY NEWS

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CONTACT: OFFICE OF FINANCING
202/ 376-4350

FOR RELEASE AT 12:00 NOON

April 27, 1990

TREASURY'S 52-WEEK BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for approximately $10,000 million of 364-day Treasury bills to be dated May 10, 1990, and to mature May 9, 1991 (CUSIP No. 912794 WH 3). This issue will provide about $950 million of new cash for the Treasury, as the maturing 52-week bill is outstanding in the amount of $9,057 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, May 3, 1990.

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 May 10, 1990. In addition to the maturing 52-week bills, there are $15,680 million of maturing bills which were originally issued as 13-week and 26-week bills. The disposition of this latter amount will be announced next week. Federal Reserve Banks currently hold $1,682 million as agents for foreign and international monetary authorities, and $6,669 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 $130 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-784

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.

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

REMARKS OF
KENNETH W. GIDEON
ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

FIRST ANNUAL ADVANCED INSTITUTE ON CORPORATE TAXATION,
GEORGETOWN UNIVERSITY LAW CENTER
APRIL 30, 1990

Thank you for inviting me to speak at your first annual Advanced Institute on Corporate Taxation. I would like to discuss the loss disallowance regulations that we issued in March -- to restate our willingness to consider all reasonable alternatives to the loss disallowance rule, our openness to proposals for improvement, and our interest in comments suggesting appropriate transition rules. Given the number of misperceptions about the rule and our willingness to consider alternatives, it is worth taking a moment to explain how these regulations evolved.

First, let me emphasize that -- contrary to many comments -- the regulations are not directed solely at the so-called son-of-mirrors transactions that were promoted following the Tax Reform Act of 1986. As part of the 1986 Act, Congress repealed the General Utilities doctrine. A principal purpose for the repeal, as expressed by the legislative history, was to require the payment of a corporate-level tax when assets leave corporate solution in a transaction that results in a stepped-up basis to the new owner. In connection with the legislation, Congress by statute explicitly instructed Treasury to amend the consolidated return regulations to ensure that the purpose of General Utilities repeal could "not be circumvented" through their application.

Because the investment adjustment rules currently contained in the consolidated return regulations reflect the application of the General Utilities doctrine as it existed before the 1986 Act, the rules, if applied without modification, could be used to obtain a stepped-up basis in corporate assets without payment of a corporate level tax. Therefore, in early 1987, the Internal Revenue Service issued a notice announcing that we would amend the investment adjustment rules to "prevent recognition of losses that are attributable to [a] subsidiary's recognition of built-in gains." While this notice was viewed by many as a response to "son of mirrors" transactions, it was directed at the more general problem of the interaction of the consolidated return regulations with General Utilities repeal and contained neither a reference nor a limitation to the "son of mirrors" transaction.

The basic problem is relatively simple to illustrate: if a consolidated group acquired the stock of a subsidiary for $100 and the subsidiary had an inside basis for its assets of say $10, the group -- as required by <u>General Utilities</u> repeal -- would recognize $90 in gain on the sale of the subsidiary's assets for their fair market value of $100. However, if the consolidated return investment adjustment rules were allowed to operate without change as they did before the 1986 Act, the gain recognized on the sale would increase the group's basis in the subsidiary's stock from $100 to $190 -- even though the subsidiary held only the $100 in proceeds from the sale of its assets. If the rules continued to permit the group to recognize a $90 loss on the subsequent sale of the subsidiary's stock for $100, this loss could offset the $90 gain recognized on the sale of the subsidiary's assets -- thereby circumventing <u>General Utilities</u> repeal by effectively eliminating the corporate level tax on the sale of the assets.

As this example illustrates, the investment adjustment rules operate to increase the basis of subsidiary stock to reflect both a subsidiary's earnings and gain on the sale of the subsidiary's assets. This basis adjustment occurs even if the gain inherent in the subsidiary's assets when the subsidiary joins the group -- the so-called built-in gain -- is already reflected in the group's cost basis in the subsidiary's stock -- as it typically would be if the stock is purchased. Accordingly, when the built-in gain assets are sold, the group would receive an artificial increase to the basis of the subsidiary stock that would produce a loss when the stock is sold.

The problem can occur, however, even without the sale of built-in gain assets. The investment adjustment rules also operate to eliminate corporate level tax when a built-in gain asset -- say, an oil well or a piece of equipment -- is consumed in operations. However, it is extremely difficult to segregate investment adjustments attributable to the consumption of built-in gain assets from other operating adjustments.

Over a period of three years, our office and the IRS explored numerous approaches to resolving these problems. Let me briefly summarize the major alternatives and why we published the loss disallowance proposal.

The first method we considered was the "tracing of assets." By comparison to the method we proposed, this method would have increased gain as well as disallowed loss on the sale of subsidiary stock. Therefore it theoretically would achieve the most technically accurate results, but at an enormous administrative burden to both taxpayers and the IRS. Under a tracing system, consolidated groups would be required to appraise all of a subsidiary's assets (including the assets of any of its lower tier subsidiaries) at the time it was acquired. Thereafter, whenever a built-in gain asset was sold, investment adjustments attributable to the built-in gain would be disallowed. A separate earnings and profits mark-to-market system would be required to deal with the problem of assets that are used up in operations. Thus, it would be necessary to appraise each asset held by a subsidiary and then trace all built-in gain assets from the time the subsidiary was acquired until the assets were sold or used up, including following the assets if they were transferred in carryover basis transactions. In such a system, disputes between the IRS and taxpayers concerning appraisal of assets were likely to be both frequently recurring and costly. The IRS was understandably concerned about the difficulty of administering such a system and the degree of accuracy it would in fact achieve. Moreover, taxpayers who commented prior to issuance of the proposal overwhelmingly rejected tracing.

An alternative method would also require appraisals, but rather than tracing assets, would instead presume that all or some percentage of the subsidiary's earnings were attributable to built-in gain assets until an amount of basis adjustments equal to the built-in gain has been disallowed. Like the tracing method, this method would apply to gain as well as loss transactions. This is the basic approach recommended by the New York State Bar. However, because this approach would potentially produce non-economic results for more taxpayers than the rule we proposed, the New York State Bar also recommended that taxpayers be allowed to rebut the presumption if they could establish that not all the disallowed basis adjustments were attributable to built-in gain. This approach would effectively subject taxpayers and the IRS to tracing and require administration of two systems, because taxpayers would inevitably have to compare their results under both the presumption and tracing to determine which produced a lower tax liability.

Another method, similar in concept to the one we ultimately proposed, was a loss limitation approach. This approach, like the one we proposed, would not apply to reduce basis when subsidiary stock was sold at a gain, but would disallow loss on the sale of subsidiary stock. However, taxpayers would be able to avoid disallowance of the loss by establishing that the loss was not attributable to investment adjustments resulting from built-in gain assets. Thus, in order to take advantage of the rule, taxpayers would have to resort to tracing. Moreover, such an approach would completely disadvantage the revenue because taxpayers would be able to use basis adjustments attributable to built-in gain assets to shelter gain whenever subsidiary stock was sold at a gain, but still have the opportunity -- through tracing -- to avoid loss disallowance when it was sold at a loss.

As the foregoing catalogue makes clear, each of the alternative models that we explored presented substantial complexity and burden for both taxpayers and the IRS. Appraisals and tracing are costly for taxpayers and difficult for the IRS to audit. Arbitrary assumptions concerning amounts attributable to built-in gain would potentially produce non-economic results for more taxpayers than the loss disallowance rule. And permitting taxpayers to rebut presumptions when they are disadvantaged by the rules would both effectively require tracing, so that taxpayers could determine whether they were disadvantaged by the presumption, and assure that decisions would always be made to the disadvantage of the revenue.

Each of these alternatives would have required special rules to address such problems as fluctuating values, wasting assets, creeping acquisitions, and nonrecognition transactions. In addition, because the statutory mandate applies to all corporations, regardless of when they were acquired, a tracing regime would have imposed enormous burdens by requiring consolidated groups that acquired subsidiaries before 1987 retroactively to identify and obtain appraisals of assets held by the subsidiary at the time of acquisition.

After struggling with these approaches for some time, we settled on the pure loss disallowance rule as the most administrable course. This approach also had the virtue of being the simplest method. In most situations, the rule is beneficial to taxpayers: it requires no appraisals; it requires no tracing; and it permits investment adjustments attributable to built-in gain to be used to shelter the gain on the sale of subsidiary stock.

We realized that the rule would result in disallowance of economic losses in some cases. To provide a measure of relief, we provided for reattribution of subsidiary losses to the selling group to the extent of the disallowed loss. We are quite willing to consider additional meritorious cases for relief, particularly where it can be demonstrated -- without undue complexity -- that an economic loss in fact occurred. Accordingly, we stated in the preamble to the regulations that we are prepared to consider specific proposals for transitional relief for existing subsidiaries and suggestions for specific mechanisms that would afford relief for economic losses on an ongoing basis. I am here today to emphasize that we meant what we said there.

Although we have received some helpful comments, much of the commentary has simply been directed at opposition to the rule, without offering alternatives. General opposition to the rules we proposed, without constructive suggestions for remedies, is not of great help to us in our effort to fashion a workable rule. To take but one example, a recent submission stated that an "administratively sound and simple system" could have been developed, but did not tell which alternative that might be. In contrast, the report of the New York State Bar, which was submitted before publication of the regulations and presented the most thorough analysis of the issue we have received to date, stated:

> "We have identified no perfect or near perfect method for implementing the objectives of Notice 87-14. Nor is there a clearly preferable choice. Each of the proposals discussed herein would serve to overtax or undertax taxpayers in some circumstances, and each would involve some measure of additional complexity."

We concur. There is "no perfect or near perfect method," and progress will be made more quickly if commentators respond to this reality. We have, throughout this process, indicated our willingness to consider all fully articulated comments proposing modifications to loss disallowance, alternative approaches to the overall problem, and reasonable transition relief. We are quite willing to consider the views of taxpayers in making a choice among admittedly difficult alternatives.

Commentators should recognize that corporate level tax may be eliminated through the operations of the business as well as by dispositions of assets and that the elimination of such tax is inconsistent with General Utilities repeal. To be of greatest aid to us in the process of reviewing and modifying our proposals, comments should fully and fairly evaluate the extent to which proposed alternatives are consistent or inconsistent with the objectives articulated in the preamble to the regulations, including the ways in which the proposed amendments would apply to specific fact patterns. Comments should also address whether the sheltering of built-in gain permitted by the regulations is appropriate.

Before I close, I would like to again emphasize that we would welcome comments proposing mechanisms for transitional relief.

In closing, let me reiterate that we will consider and analyze thoughtful comments concerning approaches that would afford relief from the disallowance of economic loss. We have already received some such comments. We look forward to receiving more.

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

FOR IMMEDIATE RELEASE
April 30, 1990

Contact: Office of Financing
202/376-4350

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $8,442 million of 13-week bills and for $8,402 million of 26-week bills, both to be issued on May 3, 1990, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing August 2, 1990			:	26-week bills maturing November 1, 1990		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.88%	8.15%	98.008	:	7.99%	8.44%	95.961
High	7.91%	8.18%	98.001	:	8.05%	8.51%	95.930
Average	7.91%	8.18%	98.001	:	8.03%	8.49%	95.940

Tenders at the high discount rate for the 13-week bills were allotted 50%.
Tenders at the high discount rate for the 26-week bills were allotted 33%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 41,055	$ 41,055	:	$ 29,720	$ 29,720
New York	25,140,075	7,473,320	:	16,797,340	7,418,170
Philadelphia	20,245	20,245	:	18,050	18,050
Cleveland	45,900	45,900	:	35,370	35,370
Richmond	117,775	42,775	:	48,775	48,775
Atlanta	32,530	32,530	:	32,340	32,340
Chicago	1,727,365	277,305	:	1,620,365	485,365
St. Louis	50,785	34,285	:	27,765	27,765
Minneapolis	19,125	9,125	:	18,820	12,120
Kansas City	43,695	43,695	:	55,175	55,175
Dallas	18,425	18,425	:	19,385	19,385
San Francisco	957,140	227,140	:	876,715	123,715
Treasury	176,625	176,625	:	95,740	95,740
TOTALS	$28,390,740	$8,442,425	:	$19,675,560	$8,401,690
Type					
Competitive	$25,893,395	$5,945,080	:	$16,526,620	$5,252,750
Noncompetitive	965,345	965,345	:	735,240	735,240
Subtotal, Public	$26,858,740	$6,910,425	:	$17,261,860	$5,987,990
Federal Reserve	1,500,200	1,500,200	:	1,560,000	1,560,000
Foreign Official Institutions	31,800	31,800	:	853,700	853,700
TOTALS	$28,390,740	$8,442,425	:	$19,675,560	$8,401,690

1/ Equivalent coupon-issue yield.

NB-786

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.

May 1, 1990

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $16,800 million, to be issued May 10, 1990. This offering will provide about $1,125 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $15,680 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, May 7, 1990. The two series offered are as follows:

91-day bills (to maturity date) for approximately $8,400 million, representing an additional amount of bills dated February 8, 1990, and to mature August 9, 1990 (CUSIP No. 912794 UX 0), currently outstanding in the amount of $7,627 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $8,400 million, to be dated May 10, 1990, and to mature November 8, 1990 (CUSIP No. 912794 VH 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 May 10, 1990. In addition to the maturing 13-week and 26-week bills, there are $9,057 million of maturing 52-week bills. The disposition of this latter amount was announced last week. Tenders from Federal Reserve Banks for their own account and as agents for foreign and international monetary authorities will be accepted at the weighted average bank discount rates of accepted competitive tenders. Additional amounts of the bills may be issued to Federal Reserve Banks, as agents for foreign and international monetary authorities, to the extent that the aggregate amount of tenders for such accounts exceeds the aggregate amount of maturing bills held by them. For purposes of determining such additional amounts, foreign and international monetary authorities are considered to hold $1,547 million of the original 13-week and 26-week issues. Federal Reserve Banks currently hold $1,677 million as agents for foreign and international monetary authorities, and $6,674 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

For Release Upon Delivery
Expected at 10:00 a.m.
May 3, 1990

STATEMENT OF
HARVEY S. ROSEN
DEPUTY ASSISTANT SECRETARY (TAX ANALYSIS)
DEPARTMENT OF THE TREASURY
BEFORE THE
FINANCE COMMITTEE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to present the views of the Administration on recent trends in corporate tax receipts.

INTRODUCTION

Since its inception in 1913, the corporate income tax has generated a sizable share of total U.S. tax receipts. As the Committee has requested, my remarks today focus principally on the trend in corporate tax receipts, the importance of the corporate tax in other countries, and the effect of the Tax Reform Act of 1986 on corporate tax receipts.

HISTORY OF CORPORATE INCOME TAX RECEIPTS

In 1989, the corporate income tax produced $104 billion in revenue for the U.S. Government. The $104 billion was the most revenue ever produced by corporate taxes and represented the sixth consecutive annual increase in corporate tax receipts. In general, corporate tax receipts have increased over the past 40 years. In the 1950's, corporate tax receipts averaged $19 billion per year; in the 1960's, $26 billion per year; in the 1970's, $38 billion per year; and from 1980 to 1986, $56 billion per year. Since 1986, corporate tax receipts have averaged $94 billion per year.

The long-run increase in corporate taxes occurred even though pre-tax corporate profits as a percentage of gross national product ("GNP") fell sharply. In the mid-1950's, when corporate taxes were at their peak as a percentage of total federal tax receipts, pre-tax corporate profits were about 11 percent of GNP; by 1986, this percentage had fallen to 5.1 percent.

Although the level of federal corporate receipts rose from the mid-1950's to 1986, they fell as a percentage of total receipts. But, since 1986, the declining trend in the relative importance of the corporate tax has been reversed. From 1987 to 1989, corporate taxes accounted for an increasing share of total tax receipts. In 1989, corporate tax receipts accounted for 10.5 percent of total tax receipts, which is the highest percentage since 1980. We expect this trend to continue into the future. By 1995, we expect corporate tax receipts to account for 11.4 percent of total tax receipts.

It is important to note that the level of corporate tax receipts depends heavily on the strength of the U.S. economy. When the U.S. economy is growing, as it has been for the past 7 years, corporate profits are strong, and corporate tax receipts increase. But when the economy is in recession, corporate profits tend to fall, and corporate taxes decrease. During the 1982-1983 recession, for example, corporate taxes as a percentage of total receipts fell from 10.2 percent in 1981 to 6.2 percent in 1983. A significant portion of this decline was attributable to the fall in pre-tax corporate profits, from $202 billion in 1981 to an average of $178 billion in 1982 and 1983.

CORPORATE TAXES IN FOREIGN COUNTRIES

Because of cultural and historical differences, foreign countries have a wide variety of tax systems. For example, some countries have separate individual and corporate tax systems, similar to the U.S. tax system. Others have integrated tax systems, which generally relieve part or all of the double tax on distributed corporate earnings. These differences among tax systems make it difficult to directly compare corporate tax burdens across countries. Nonetheless, we can make some general observations.

In 1987, corporate income taxes accounted for an average of 8 percent of total tax receipts for the 22 countries in the Organization for Economic Cooperation and Development (the "OECD") for which we have data. The data pertain to corporate taxes at both the central government and local levels. Comparisons of corporate tax receipts for central governments only would be misleading because some countries have much greater corporate taxation at the local level than others.

Although U.S. corporate taxes as a percentage of total tax receipts was 8 percent in 1987, the same as the average for the 22 OECD countries, the U.S. percentage will be higher in subsequent years if current trends continue. Countries that were above the OECD average in 1987 include Japan at 23 percent, the

United Kingdom at 11 percent, and Italy at 11 percent. Countries that were below the average include Germany at 5 percent, France at 5 percent, and Switzerland at 6 percent.

In 1980, corporate income taxes also accounted for 8 percent of total tax receipts in the 22 OECD countries. Thus, there does not appear to be any general trend toward increased or decreased reliance on corporate taxes among OECD countries.

THE TAX REFORM ACT OF 1986

The Tax Reform Act of 1986 (the "1986 Act") made significant changes to the corporate tax system. These changes were expected to increase corporate tax receipts significantly. Our most recent estimates indicate that the 1986 Act will increase corporate tax receipts by $140 billion over the 1987-1991 period.

Corporate Changes in the 1986 Act

The 1986 Act adopted base-broadening measures designed to increase the overall level of corporate income taxes, even though the maximum marginal tax rate was reduced from 46 percent to 34 percent. The corporate tax base broadening was accomplished primarily by repealing the investment tax credit, limiting depreciation deductions, restricting the use of net operating losses, enacting the corporate alternative minimum tax, and adopting important changes in accounting rules, for example, by requiring uniform capitalization of certain expenditures.

The 1986 Act also made three changes that affect the taxation of corporations and their shareholders and the desirability of operating in the corporate form: (1) the relative relationship of the top individual and corporate tax rates was reversed, with corporations now subject to a higher marginal tax rate than most individuals; (2) the preference for both corporate and individual capital gains was eliminated; and (3) the so-called General Utilities doctrine was repealed.

Effect on Corporate Tax Receipts

The 1986 Act was expected to be revenue neutral. As we testified in February, for all practical purposes, the 1986 Act has been revenue neutral. Our most recent estimate indicates that the numerous positive and negative provisions of the 1986 Act sum to a total change in receipts of less than 1 percent over the 1987-1991 period.

The 1986 Act was also expected to increase corporate tax receipts and lower individual receipts as a percentage of total income tax receipts. This has also occurred. The percentage of income tax receipts accounted for by corporate taxes increased from 15 percent in 1986 to 19 percent in 1989; correspondingly, the percentage accounted for by individual taxes fell from 85 percent to 81 percent.

ECONOMIC FORECASTS IN THE 1988 BUDGET

The Reagan Administration's first budget produced after enactment of the 1986 Act was the 1988 budget. In that budget, corporate tax receipts for 1987-1989 were forecast to average $117 billion per year; actual receipts averaged only $94 billion per year.

The Reagan Administration was not alone in overestimating corporate tax receipts after the 1986 Act. In its first budget after the 1986 Act, the Congressional Budget Office also overestimated corporate tax receipts by an average of $21 billion per year for the 1987-1989 period. Table 1 shows actual corporate tax receipts for the 1987-1989 period, and compares them with the Administration and CBO forecasts made for the 1988 budget.

The question then arises: why were corporate tax receipts between $20 billion and $25 billion lower than forecast after the 1986 Act was enacted? Our analysis of the effect of the 1986 Act on corporate tax receipts today is both preliminary and incomplete. It is always difficult to distinguish quantitatively between the effects of changes in the tax law and other economic factors, but in this case we face special difficulties. Many of the important and fundamental provisions of the 1986 Act were phased-in over time and did not become fully effective until 1988. Large corporations, following their conventional practice, typically did not file their 1988 tax returns until mid-September 1989. The most recent detailed data on corporate tax payments are for 1987. Hence, detailed data even for the first year in which the 1986 Act became fully effective cannot yet be analyzed.

Until more detailed data become available, our judgments and observations must remain tentative. We do have aggregate data through 1989 for tax receipts and corporate profits, although the most recent profits data may be revised.

The Main Explanation - Lower Corporate Profits

We believe that the primary reason why corporate tax receipts were lower than expected in the FY 1988 budget is that pre-tax corporate profits came in below expectations. It is worth noting that although the Administration 1988 budget overestimated book value profits, it was conservative in its forecast of economic growth in 1987-89. Specifically, real GNP was estimated to grow at 3 percent per year during the period, significantly below the actual 3.7 percent. In the 1988 budget, pre-tax corporate profits were projected to average $342 billion per year over the 1987-1989 period; actual pre-tax corporate profits averaged $287 billion per year over this period. The overestimate of $55 billion in average annual corporate profits resulted in an average annual overestimate of between $15 billion and $20 billion in corporate tax receipts.

Wages and Salaries. An important reason for the overestimate of corporate profits appears to be that actual wages and salaries were higher than expected. Because wages and salaries are deductible expenses for corporations, higher wages and salaries reduce corporate profits.

The 1988 budget projected that wages and salaries would average $2,376 billion per year over the 1987-1989 period. Actual wages and salaries for this period averaged $58 billion more per year than forecast. Although the economy was stronger than expected during 1987-1989, wages and salaries as a percentage of GNP were also higher than expected during this period.

Higher wages and salaries would also have the effect of raising the taxable income of individuals. The higher-than-expected level of wages and salaries is reflected in higher-than-expected individual income tax receipts. In the 1988 budget, individual income tax receipts for the 1987-1989 period were forecast to average $391 billion per year. Actual income tax receipts for this period averaged $413 billion per year. Similarly, in the 1988 budget, individual income tax receipts for the 1990-1992 period were forecast to average $488 billion per year. In the 1991 budget, individual taxes for the period were forecast to average $526 billion per year.

Interest Rates. Higher-than-expected interest rates also appear to have been a factor in the overestimate of corporate profits. Nonfinancial corporations are large net borrowers, so that higher interest rates result in higher interest payments and, thus, lower profits. Financial corporations are large net lenders, but because they generally lend long-term and borrow short-term, their profits also suffer with higher interest rates. Actual interest rates for 1987-1989 were generally between 1.5 and 2 percentage points higher than interest rates forecast in the 1988 budget. Similarly, interest rate forecasts in the 1991 budget for the 1990-1992 period are between 1.5 and 2 percentage points higher than interest rate forecasts in the 1988 budget for the same period.

Other Explanations

Although lower-than-expected corporate profits explain much of the underestimate in corporate tax receipts from the 1988 budget, corporate profits do not explain all of it. Our analysis shows that even if actual corporate profits had reached the levels forecast in the 1988 budget, corporate tax receipts would still not reach the levels forecast in the 1988 budget. Several other factors may account for the overestimate in corporate tax receipts.

S Corporations. The changes in the top marginal tax rates in the 1986 Act caused some taxpayers to prefer the S corporation form over the corporate form. An S corporation is treated as a corporation for most legal considerations, but it is treated as a "passthrough" entity for tax purposes. That is, net income (or loss) from an S corporation flows through and is taxed directly to shareholders with no corporate-level tax. In order to elect this passthrough treatment, a corporation must satisfy certain requirements. For example, the number of shareholders cannot exceed 35, and shareholders must be individuals (other than nonresident aliens) and certain estates and trusts. In addition, an S corporation can have only one class of stock.

The preliminary evidence on S corporations clearly indicates a surge in S corporation activity. Filings of the form required to elect S corporation status increased 67 percent between 1986 and 1987, from 346,000 to 578,000. Since then, the number of filings has receded somewhat, but the 435,000 filings in 1989 remain well above levels before the 1986 Act.

More importantly for tax receipts, income earned by S corporations also appears to be rising considerably since 1986. Net income from S corporations reported on individual returns for 1987 more than doubled, rising by about $12 billion. Advance information on 1988 returns suggests that substantial growth in net income has continued. Although no explicit prediction was made about the use of S corporations, the increased use of S corporations may be well beyond what was implicitly predicted at the time the forecast was made.

S corporation profits are accounted for and forecast as part of corporate profits. Thus, other things being the same, higher-than-expected use of S corporations would not affect the measurement of corporate profits. S corporation profits, however, are not taxed at the corporate level, but rather, are taxed at the individual level. Thus, for a given corporate profits forecast, if S corporation profits are higher than forecast, corporate tax receipts will be lower than forecast. In addition, individual receipts will be greater than forecast. As we have already discussed, individual receipts have been greater than forecast.

Federal Reserve Earnings. Higher-than-expected interest rates contributed to a shift in corporate profits from the taxed sector to the nontaxed sector. The earnings of the Federal Reserve System (the "Fed") are reported as part of corporate profits. Fed earnings come primarily from the interest earned on the Treasury securities held by the Fed. Fed earnings have been higher than forecast, in part because interest rates have been higher than forecast in the 1988 budget. Thus, for a given forecast of corporate profits, higher interest rates would cause Fed earnings to account for a greater share of corporate profits than had been forecast. But because Fed earnings are not taxed, corporate tax receipts would fall short of their forecast levels. (After paying its operating expenses, the Fed turns all excess earnings over to the Treasury.) Thus, even if corporate profits had been at levels forecast by the 1988 budget, corporate tax receipts would have been several billion less than the forecast level because of higher than expected Fed earnings.

Possible Explanations

We believe the above reasons are the most compelling, but we cannot rule out two other possible explanations. There is currently no evidence that these factors contributed substantially to the underforecast of corporate tax receipts.

Increased Leveraged Buyouts. Although leveraged buyout ("LBO") activity increased significantly during the 1980's, the effect of LBOs on corporate profits is unclear. Because all LBOs are to some extent financed by debt, increased LBO activity is generally expected to result in higher corporate interest payments, which in turn, lower corporate profits. But the evidence suggests that LBOs had little impact on total corporate interest payments. In addition, to the extent that the acquired firms are managed more efficiently, LBOs may increase corporate profits and corporate receipts.

I should also add that increased LBO activity may increase individual income tax receipts. For example, a portion of capital gains generated by LBOs goes into the individual income tax base, as does interest received by taxable investors.

Shift from C Corporations to Partnerships. As discussed earlier, the 1986 Act made the top corporate tax rate higher than the top individual tax rate. It was expected that this change in relative top tax rates would lead to greater use of the partnership form, which provides income that is taxed at the individual level, and lesser use of the corporate form. Preliminary evidence is mixed, perhaps because the 1986 Act's limitations on passive activity losses and 1987 legislation on publicly traded partnerships tended to discourage partnership activity. If the use of partnerships has increased, personal income would increase and corporate profits decline.

CONCLUSION

In summary, I would characterize recent trends in corporate tax receipts as follows:

-- Corporate tax receipts forecasts made by both the Treasury and the Congressional Budget Office following the enactment of the 1986 Act exceeded actual corporate tax receipts by between $20 billion and $25 billion per year for the 1987-1989 period.

-- The Tax Reform Act of 1986 reversed a long-term decline in the relative importance of corporate taxes in producing revenues for the U.S. Government. The share of total taxes paid by corporations has been steadily rising since 1986. This trend is expected to continue throughout most of the budget period.

-- The 1986 Act has been revenue neutral because individual tax receipts are higher than expected.

-- Lower than expected corporate profits explain much of the underestimate in corporate tax receipts.

In short, the 1986 Act was revenue neutral and significantly increased corporate tax receipts both in absolute terms and as a proportion of all income tax receipts.

This concludes my prepared remarks. I would be happy to answer any questions of the Committee. Thank you.

TABLE 1

CORPORATE RECEIPTS FORECASTS

THE REAGAN ADMINISTRATION'S FY 1988 BUDGET VS. ACTUALS

	Fiscal Years ($ Billions)		
	1987	1988	1989
1988 Budget	105	117	129
Actual	84	95	104
Overestimate in FY 1988 Budget	21	22	25

THE CONGRESSIONAL BUDGET OFFICE'S FY 1988 BUDGET VS. ACTUALS

	Fiscal Years ($ Billions)		
	1987	1988	1989
1988 Budget	101	119	126
Actual	84	95	104
Overestimate in FY 1988 Forecast	17	24	22

Department of The Treasury
Office of Tax Analysis

TREASURY NEWS

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

FOR RELEASE WHEN AUTHORIZED AT PRESS CONFERENCE
May 2, 1990

CONTACT: Office of Financing
202/376-4350

TREASURY MAY QUARTERLY FINANCING

The Treasury will raise about $12,375 million of new cash and refund $18,130 million of securities maturing May 15, 1990, by issuing $10,500 million of 3-year notes, $10,000 million of 10-year notes, and $10,000 million of 30-year bonds. The $18,130 million of maturing securities are those held by the public, including $2,268 million held, as of today, by Federal Reserve Banks as agents for foreign and international monetary authorities.

The three issues totaling $30,500 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, for their own accounts, hold $2,102 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.

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

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-789

HIGHLIGHTS OF TREASURY OFFERINGS TO THE PUBLIC
MAY 1990 QUARTERLY FINANCING

May 2, 1990

Amount Offered to the Public	$10,500 million	$10,000 million	$10,000 million
Description of Security:			
Term and type of security	3-year notes	10-year notes	30-year bonds
Series and CUSIP designation	Series T-1993 (CUSIP No. 912827 YV 8)	Series B-2000 (CUSIP No. 912827 YW 6)	Bonds of 2020 (CUSIP No. 912810 EF 1)
CUSIP Nos. for STRIPS Components	Not applicable	Listed in Attachment A of offering circular	Listed in Attachment A of offering circular
Issue date	May 15, 1990	May 15, 1990	May 15, 1990
Maturity date	May 15, 1993	May 15, 2000	May 15, 2020
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	November 15 and May 15	November 15 and May 15	November 15 and May 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
Deposit guarantee by designated institutions	Acceptable	Acceptable	Acceptable
Key Dates:			
Receipt of tenders	Tuesday, May 8, 1990, prior to 1:00 p.m., EDST	Wednesday, May 9, 1990, prior to 1:00 p.m., EDST	Thursday, May 10, 1990, prior to 1:00 p.m., EDST
Settlement (final payment due from institutions):			
a) funds immediately available to the Treasury	Tuesday, May 15, 1990	Tuesday, May 15, 1990	Tuesday, May 15, 1990
b) readily-collectible check	Friday, May 11, 1990	Friday, May 11, 1990	Friday, May 11, 1990

TREASURY NEWS

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FOR IMMEDIATE RELEASE
MAY 3, 1990

CONTACT: OFFICE OF FINANCING
202/376-4350

RESULTS OF TREASURY'S 52-WEEK BILL AUCTION

Tenders for $10,036 million of 52-week bills to be issued May 10, 1990, and to mature May 9, 1991, were accepted today. The details are as follows:

RANGE OF ACCEPTED COMPETITIVE BIDS:

	Discount Rate	Investment Rate (Equivalent Coupon-Issue Yield)	Price
Low -	8.04%	8.68%	91.871
High -	8.05%	8.70%	91.861
Average -	8.05%	8.70%	91.861

Tenders at the high discount rate were allotted 93%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted
Boston	$ 43,995	$ 43,995
New York	27,190,820	9,184,900
Philadelphia	22,770	22,770
Cleveland	46,045	46,045
Richmond	41,320	41,320
Atlanta	25,800	25,800
Chicago	1,688,490	62,090
St. Louis	22,405	18,405
Minneapolis	11,110	11,040
Kansas City	57,055	55,225
Dallas	25,325	15,325
San Francisco	851,265	127,065
Treasury	381,760	381,760
TOTALS	$30,408,160	$10,035,740
Type		
Competitive	$26,710,435	$ 6,338,015
Noncompetitive	1,067,725	1,067,725
Subtotal, Public	$27,778,160	$ 7,405,740
Federal Reserve	2,500,000	2,500,000
Foreign Official Institutions	130,000	130,000
TOTALS	$30,408,160	$10,035,740

An additional $70,000 thousand of the bills will be issued to foreign official institutions for new cash.

NB-790

TALKING POINTS
FOR THE
FINANCING PRESS CONFERENCE

May 2, 1990

Today we are announcing the terms of our regular May quarterly refunding. I will also discuss the Treasury's financing requirements for the balance of the current calendar quarter and our estimated cash needs for the July-September 1990 quarter.

1. We are offering $30.50 billion of notes and bonds to refund $18.1 billion of privately-held notes and bonds maturing on May 15 and to raise approximately $12.4 billion of cash. The three securities are:

-- First, a 3-year note in the amount of $10.50 billion maturing on May 15, 1993. This note is scheduled to be auctioned on a yield basis on Tuesday, May 8. The minimum denomination will be $5,000.

-- Second, a 10-year note in the amount of $10.00 billion maturing on May 15, 2000. This note is scheduled to be auctioned on a yield basis on Wednesday, May 9. The minimum denomination will be $1,000.

-- Third, a 30-year bond maturing May 15, 2020 in the amount of $10.00 billion. This bond is scheduled to be auctioned on a yield basis on Thursday, May 10. The minimum denomination will be $1,000.

We will accept noncompetitive tenders up to $1,000,000 for each of these issues.

2. For the current April-June quarter, we estimate a net market borrowing need of $12.6 billion, assuming a $30 billion cash balance at the end of June. We may want to have a higher balance, depending upon our assessment of cash needs at the time.

Including this refunding, we will have raised $2.6 billion of the $12.6 billion in marketable borrowing needed this April-June quarter. This net borrowing was accomplished by borrowing $27.8 billion and paying down $25.2 billion as follows:

-- $2.5 billion of cash from the 2- and 4-year notes which settled April 2;

-- $2.8 billion of cash from the 7-year note that settled April 16;

-- $1.5 billion of cash from the 2-year note which settled April 30;

-- $6.9 billion of cash in regular weekly bills, including the bills announced yesterday;

-- $1.7 billion of cash in 52-week bills;

-- $25.2 billion paydown in cash management bills; and

-- $12.4 billion of cash from the refunding issues announced today.

The $10.0 billion to be raised in the rest of the April-June quarter could be accomplished through sales of regular 13-, 26-, and 52-week bills, a 2-year note in May and a 5-year 2-month note in early June. Cash management bills may be necessary to cover the low points in the cash balance.

3. The $12.6 billion net Treasury borrowing requirement for the April-June quarter includes Treasury borrowing to finance Federal Financing Bank lending to the Resolution Trust Corporation. On April 12 the Oversight Board of the RTC announced that RTC is authorized to borrow a maximum of $42.7 billion net from FFB in the April-June period.

4. We estimate Treasury net market borrowing needs to be in the range of $30 to $35 billion for the July-September quarter, assuming a $30 billion cash balance on September 30. The Treasury's July-September borrowing estimate does not include any allowance for FFB lending to RTC. Treasury plans to update its market borrowing estimate for the July-September quarter as soon as the Oversight Board has reviewed and approved the RTC's working capital budget for that period.

5. We anticipate that the next auction of REFCORP bonds will be announced on July 3 for auction July 10 and settlement July 17.

6. The notes and bonds announced today will be eligible for conversion to STRIPS (Separate Trading of Registered Interest and Principal of Securities) and, accordingly, may be divided into separate interest and principal components.

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PUBLIC DEBT NEWS

Department of the Treasury • Bureau of the Public Debt • Washington, DC 20239

FOR RELEASE AT 3:OO PM
May 4, 1990

Contact: Peter Hollenbach
(202) 376-4302

PUBLIC DEBT ANNOUNCES ACTIVITY FOR SECURITIES IN THE STRIPS PROGRAM FOR APRIL 1990

Treasury's Bureau of the Public Debt announced activity figures for the month of April 1990, of securities within the Separate Trading of Registered Interest and Principal of Securities program, (STRIPS).

	Dollar Amounts in Thousands
Principal Outstanding (Eligible Securities)	$408,865,583
Held in Unstripped Form	$310,745,253
Held in Stripped Form	$98,120,330
Reconstituted in April	$2,074,720

The accompanying table gives a breakdown of STRIPS activity by individual loan description. The balances in this table are subject to audit and subsequent revision. 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, APRIL 30, 1990
(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	$5,264,954	$1,393,600	-0-
11-1/4% Note A-1995	2/15/95	6,933,861	6,413,381	520,480	$12,000
11-1/4% Note B-1995	5/15/95	7,127,086	5,666,286	1,460,800	-0-
10-1/2% Note C-1995	8/15/95	7,955,901	7,321,101	634,800	10,000
9-1/2% Note D-1995	11/15/95	7,318,550	6,481,350	837,200	10,000
8-7/8% Note A-1996	2/15/96	8,575,199	8,322,399	252,800	-0-
7-3/8% Note C-1996	5/15/96	20,085,643	19,864,843	220,800	-0-
7-1/4% Note D-1996	11/15/96	20,258,810	19,958,810	300,000	-0-
8-1/2% Note A-1997	5/15/97	9,921,237	9,852,037	69,200	-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	9,792,329	16,000	-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	11,214,646	128,000	-0-
8-7/8% Note D-1998	11/15/98	9,902,875	9,896,475	6,400	-0-
8-7/8% Note A-1999	2/15/99	9,719,628	9,716,428	3,200	-0-
9-1/8% Note B-1999	5/15/99	10,047,103	9,178,303	868,800	-0-
8% Note C-1999	8/15/99	10,163,644	10,081,644	82,000	-0-
7-7/8% Note D-1999	11/15/99	10,773,960	10,769,160	4,800	-0-
8-1/2% Note A-2000	2/15/00	10,673,033	10,673,033	-0-	-0-
11-5/8% Bond 2004	11/15/04	8,301,806	3,804,206	4,497,600	75,200
12% Bond 2005	5/15/05	4,260,758	1,882,708	2,378,050	-0-
10-3/4% Bond 2005	8/15/05	9,269,713	8,295,313	974,400	26,400
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	1,861,584	4,144,000	48,800
11-1/4% Bond 2015	2/15/15	12,667,799	2,631,159	10,036,640	397,280
10-5/8% Bond 2015	8/15/15	7,149,916	1,735,516	5,414,400	100,160
9-7/8% Bond 2015	11/15/15	6,899,859	2,223,059	4,676,800	-0-
9-1/4% Bond 2016	2/15/16	7,266,854	6,330,054	936,800	204,000
7-1/4% Bond 2016	5/15/16	18,823,551	16,766,751	2,056,800	74,400
7-1/2% Bond 2016	11/15/16	18,864,448	10,929,648	7,934,800	267,440
8-3/4% Bond 2017	5/15/17	18,194,169	7,241,369	10,952,800	-0-
8-7/8% Bond 2017	8/15/17	14,016,858	9,168,858	4,848,000	59,200
9-1/8% Bond 2018	5/15/18	8,708,639	3,687,839	5,020,800	-0-
9% Bond 2018	11/15/18	9,032,870	2,019,470	7,013,400	29,200
8-7/8% Bond 2019	2/15/19	19,250,793	7,287,593	11,963,200	369,600
8-1/8% Bond 2019	8/15/19	20,213,832	13,664,712	6,549,120	391,040
8-1/2% Bond 2020	2/15/20	10,228,868	8,335,668	1,893,200	-0-
Total		408,865,583	310,745,253	98,120,330	2,074,720

[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 942-644

May 6, 1990

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 May 6, 1990, in Washington, for an exchange of views on current global economic and financial issues. The Managing Director of the IMF participated in the discussions on recent economic developments in the Group of Seven.

The Ministers and Governors reviewed developments in their economies and in global financial markets since their meeting of April 7. They noted with satisfaction the recent stability in exchange markets and continued growth in industrial countries. However, they agreed that price pressures warrant continued vigilance. They also noted the yen had stabilized since their meeting in Paris, but remained of the view that the present level may have undesirable consequences for the global adjustment process. They discussed recent developments towards German economic and monetary union. They agreed that this process would contribute to improved non-inflationary global growth and to a reduction of external imbalances. This process would also contribute to positive economic developments in Eastern Europe which at the same time are supported by the international community.

They agreed to keep economic and monetary developments under review and reaffirmed their commitment to economic policy coordination, including cooperation on exchange markets.

The Ministers and Governors underscored their determination to resist protectionism. They emphasized that a successful conclusion of the Uruguay Round is essential for promoting an open and growing world economy.

The Ministers and Governors expressed their continued strong support for the strengthened debt strategy, and were encouraged by the substantial progress which has been achieved, including the commercial bank accords with six heavily indebted countries. They reaffirmed their support for the case-by-case approach and for the guidelines governing Fund and Bank financial support for debt and debt service reduction. They reemphasized the central importance of sustained debtor reforms and urged a stronger emphasis in Fund and Bank programs on measures to attract new investment and a return of flight capital as new sources of finance for debtor nations.

The Ministers and Governors also discussed the Ninth General Review of Quotas of the International Monetary Fund. They agreed that a 50 percent increase in IMF quotas would provide the Fund with the resources to fulfill its central responsibilities in the world economy. They also agreed on the need for strengthening the IMF arrears strategy as an integral part of the quota review.

TREASURY NEWS

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

TEXT AS PREPARED
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**Remarks by
Secretary of the Treasury
Nicholas F. Brady
at the Morning Session of
The Interim Committee
Washington, D.C.
May 7, 1990**

The World Economic Outlook, the Ninth General Review of Quotas and the Strengthening of the IMF Arrears Strategy

The global economic expansion, now into its eighth year, continues at a moderate and sustainable pace. The industrial countries are expected to maintain average growth of about 3 percent per year through 1991, supporting improved developing country growth and continued healthy expansion of world trade. Substantial progress has been made in reducing some of the largest industrial country external imbalances. Price pressures warrant continued vigilance. With the passing of some temporary factors, however, they should remain under control.

The generally favorable global economic picture owes much to sound economic policies and the effective international coordination of these policies. We have built our strategy around the goals of a prudent and coordinated approach to fiscal and monetary policy, and measures to increase economic efficiency and maintain financial market stability.

We have made significant progress toward these goals. Nevertheless, we have some important unfinished business. External imbalances still remain too high. We are committed to achieving substantial further reductions, and to implementing the domestic policies necessary to help bring this about. For the United States, this means maintaining export-led growth and boosting national savings. I recognize there are concerns about the need for continued reductions in the U.S. federal budget deficit. Let me assure you that the President remains fully committed to deficit reduction, and we will work closely with the Congress to make further progress. In addition, we have proposed measures to strengthen our private saving and investment performance.

NB-791

Of course, in an interdependent global economy, sustained global growth and a reduction of external imbalances require appropriate policies in other countries. In the surplus countries, economic growth needs to be led by domestic investment and consumption to address their own saving/investment imbalances and to encourage continued import growth. In many countries, there is ample scope for additional measures to remove structural impediments to growth and adjustment.

Recent developments in Eastern Europe pose great new challenges and opportunities for the 1990s. Unification of the Federal Republic of Germany and the German Democratic Republic, for example, will have fundamental economic consequences of great interest both within and outside Europe. We believe that reunification would contribute to improved non-inflationary global growth and to a reduction in external imbalances.

The Ninth General Review of Quotas

Let me turn now to the Ninth General Review of Quotas.

The United States is a strong supporter of the IMF and its central role as a monetary institution in the world economy. The Fund remains pivotal to the international debt strategy and it will be at the center of international efforts to help Eastern European countries restructure their economies toward free markets. We firmly believe that the IMF must have adequate resources and that it must safeguard its financial integrity in order to continue to fulfill its critical responsibilities in the world economy.

At our last meeting in September, we pledged to work to complete the Ninth General Review as a matter of priority. The United States has worked actively since that time to bring the quota review to conclusion, and significant progress has been made in resolving and narrowing differences on a broad range of issues. Today, we are on the verge of successfully completing the quota review. Against this background, let me turn to the handful of issues that remain outstanding.

A central issue in the negotiations has been the overall size of the quota increase. In recent weeks, a consensus has appeared to emerge for up to a 50 percent increase in the size of the Fund. Though the United States has supported a smaller increase, this is a compromise that can command the support of the United States in the context of a satisfactory resolution of other issues. A 50 percent increase, coupled with the Fund's existing uncommitted liquid resources -- presently $35 billion--will allow the IMF to discharge its systemic responsibilities over the coming years.

The IMF's Articles of Agreement provide for a five-year quota review period to ensure that the Fund's resources are adequate. Given the historically high level of resources at this time in the quota review, as well as the prospective quota increase, the IMF's resources should suffice to meet the challenges of the first half of this decade. Furthermore, the United States has shown in the past that if a demonstrated need for an increase in IMF resources emerges sooner than anticipated, we stand ready to consider the need for earlier action. In these circumstances, we believe that the next quota review should run through 1995.

<u>Strengthening the IMF Arrears Strategy</u>

Let me now turn to the need for strengthening the IMF arrears strategy in the context of the quota review.

Arrears to the IMF have grown significantly in recent years, despite the adoption of numerous measures. They now total $4 billion from 11 members, an amount roughly twice the level of the IMF's reserves. These arrears pose a fundamental challenge to the IMF's financial integrity and its central role in the world economy. The IMF must strengthen its policies on arrears, as an integral part of the quota review, in order to preserve its role as an anchor for the international monetary system and ensure that increased capital is used effectively.

Over the past months, the Executive Board has worked hard to develop a comprehensive approach to arrears. This effort has borne fruit. I am pleased that broad support has emerged for the key elements of a strengthened approach. These elements should combine a mix of incentives to reward sound economic performance and disincentives to the accumulation of arrears. We must implement both aspects in full.

In this regard, I support the proposal to use the IMF's Enhanced Structural Adjustment Facility (ESAF) to provide financing to low-income arrears countries, performing under extended Fund-monitored arrangements, to eliminate their overdue obligations. Also, the proposal for a contingent and limited mobilization of 3 million ounces of IMF gold, to provide additional security to ESAF creditors for such lending, is fair and reasonable.

The United States also supports the proposed amendment to the IMF Articles of Agreement authorizing the possible suspension of the voting rights and representation privileges of certain members with arrears. The quota increase should only become effective when this amendment has been ratified and adopted by the necessary majority.

TREASURY NEWS

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

CONTACT: Office of Financing
202/376-4350

FOR IMMEDIATE RELEASE
May 7, 1990

RESULTS OF TREASURY'S WEEKLY BILL AUCTIONS

Tenders for $8,408 million of 13-week bills and for $8,405 million of 26-week bills, both to be issued on May 10, 1990, were accepted today.

RANGE OF ACCEPTED COMPETITIVE BIDS:	13-week bills maturing August 9, 1990			:	26-week bills maturing November 8, 1990		
	Discount Rate	Investment Rate 1/	Price	:	Discount Rate	Investment Rate 1/	Price
Low	7.77%	8.04%	98.036	:	7.81%	8.24%	96.052
High	7.80%	8.07%	98.028	:	7.84%	8.28%	96.036
Average	7.79%	8.06%	98.031	:	7.84%	8.28%	96.036

Tenders at the high discount rate for the 13-week bills were allotted 11%.
Tenders at the high discount rate for the 26-week bills were allotted 76%.

TENDERS RECEIVED AND ACCEPTED
(In Thousands)

Location	Received	Accepted	:	Received	Accepted
Boston	$ 57,345	$ 57,345	:	$ 51,320	$ 51,320
New York	20,913,365	6,965,390	:	22,641,890	7,207,535
Philadelphia	17,265	17,265	:	15,285	15,285
Cleveland	53,850	53,850	:	54,720	54,720
Richmond	57,370	57,370	:	58,850	48,350
Atlanta	32,610	30,800	:	33,800	32,790
Chicago	1,867,155	236,145	:	1,654,315	192,035
St. Louis	36,010	17,110	:	26,535	18,535
Minneapolis	21,310	12,410	:	17,920	12,680
Kansas City	38,850	38,850	:	64,590	61,250
Dallas	37,225	27,775	:	39,940	29,940
San Francisco	789,050	198,800	:	938,925	122,925
Treasury	694,475	694,475	:	557,725	557,725
TOTALS	$24,615,880	$8,407,585	:	$26,155,815	$8,405,090
Type					
Competitive	$20,875,060	$4,666,765	:	$21,674,670	$3,923,945
Noncompetitive	1,543,205	1,543,205	:	1,302,345	1,302,345
Subtotal, Public	$22,418,265	$6,209,970	:	$22,977,015	$5,226,290
Federal Reserve	2,073,815	2,073,815	:	2,100,000	2,100,000
Foreign Official Institutions	123,800	123,800	:	1,078,800	1,078,800
TOTALS	$24,615,880	$8,407,585	:	$26,155,815	$8,405,090

1/ Equivalent coupon-issue yield.

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TREASURY NEWS

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

STATEMENT BY
JOHN M. NIEHUSS
SENIOR DEPUTY ASSISTANT SECRETARY
FOR INTERNATIONAL ECONOMIC POLICY
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON INTERNATIONAL DEVELOPMENT,
FINANCE, TRADE AND MONETARY POLICY
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES
MAY 8, 1990

Mr. Chairman and Members of the Committee:

I am here at your invitation to testify on World Bank lending to China.

In March, Assistant Secretary Dallara testified before this Committee on the Administration's request for authorization to participate in the ninth replenishment of the resources of the International Development Association (IDA). In response to statements and questions from you, Mr. Chairman, and Congresswoman Pelosi, Assistant Secretary Dallara presented the Administration's position on World Bank lending to China. My testimony today elaborates on that position.

Basic Objectives of U.S. Policy

The U.S. policy toward World Bank lending to China should be seen in the context of the Administration's broader policy toward China. The elements of this policy were set forth in the February 7, 1990, testimony of Acting Secretary of State Eagleburger before the Senate Foreign Relations Committee. In that testimony, Acting Secretary of State Eagleburger stated:

> The challenge was to make clear American revulsion at and condemnation of the bloodshed at Tiananmen, yet express it in a way that would maintain, to the extent possible, our ability to influence events within China and encourage a return to reforms of the economy and society. The Administration has, therefore, sought to demonstrate its repugnance for the actions taken by the Beijing government while preserving the framework of our relationship with the Chinese people -- links wisely forged in a spirit of bipartisan consensus in the 1970s and 1980s.

He went on to note that:

> In short, we seek to soften the blow to the Chinese people brought about by the crisis in China...Indeed, the forces favoring reform have not disappeared. We owe them an approach that strengthens their hand, not the hand of those who would welcome isolation.

Evolution of U.S. Policy

With these basic policy objectives in mind, I would like to begin my testimony with a brief chronology summarizing the evolution of the Administration's policy toward World Bank lending to China. The key events are as follows:

June 3-4, 1989 - Tiananmen Square

June 20, 1989 - President Bush announced that the Administration would seek to postpone consideration of all new loans to China by international financial institutions.

July 14, 1989 - The heads of state and government of the G-7 (the U.S., Japan, Federal Republic of Germany, Britain, France, Canada, and Italy) met in Paris for the annual Economic Summit and agreed that "in view of current economic uncertainties, the examination of new loans by the World Bank be postponed."

December, 19, 1989 - Section 604 (b) of the International Development and Finance Act of 1989 expressed the sense of Congress that the U.S. should oppose loans to China in accordance with Section 701 (f) of the International Financial Institutions Act. (This provision instructs the U.S. to oppose loans to countries engaging in a pattern of human rights violations unless the loans are directed to programs which serve the basic human needs of citizens of the country.)

January 10, 1990 - The State Department announced that the U.S. was considering supporting a limited resumption of lending to China for humanitarian reasons.

February 7, 1990 - Acting Secretary of State Eagleburger testified before the Congress that "in light of our belief that we should avoid actions which harm the Chinese people... the United States would be prepared, on a case-by-case basis, to have the World Bank consider earthquake aid and other basic human needs loans to China."

February 8, 1990 - The U.S. supported a $30 million IDA credit for an earthquake reconstruction project.

February 27,1990 - The U.S. supported a $60 million IDA credit, the Jiangxi Agricultural Development Project.

March 27, 1990 - The U.S. supported a $50 million IDA Vocational and Technical Education credit.

World Bank Loans Pending as of June 1989

Prior to June 1989, the World Bank and IDA had approved loans and credits totalling $8.6 billion to China. The Bank and IDA have approved commitments of slightly less than an annual average of $1.5 billion in the last three World Bank fiscal years (July 1 - June 30). At the time of the June 4, 1989, events of Tiananmen Square, there were seven loans and credits totalling $786 million scheduled for World Bank Board consideration by June 30, 1989, the end of World Bank fiscal year 1989. At that time, the World Bank had over 40 projects totalling about $7 billion dollars in the pipeline.

Administration Policy

Since June, 1989, the Administration has kept the issue of World Bank lending to China under constant review. With its support of the earthquake reconstruction credit in early February, 1990, the Administration formally modified its position on lending to China for humanitarian reasons, consistent with the sense of Congress expressed in the International Finance and Development Act of 1989. At the time, the Administration decided that the United States should continue to oppose a general resumption of World Bank lending to China. However, it also concluded that, on a case-by-case basis, it would not oppose lending which clearly meets basic human needs (BHN).

Two important considerations were involved in the U.S. position to support a limited resumption of lending to China. First, Congress had expressed its sense that the United States should use its voice and vote in the World Bank on loans to China, in accordance with Section 701 (f) of the International Financial Institutions Act. Support for loans which meet basic human needs is consistent with Section 701 (f), the human rights legislation. We concluded that it was justified on humanitarian grounds to support lending to China which would help the poorest segments of the population in such areas as housing, education, health, and rural development.

The second consideration was the position of our G-7 allies with whom we developed the July 1989 consensus in Paris. Within the G-7, there has been a broad consensus on limiting World Bank lending to China. However, with the passage of time, there has been increasingly strong pressure on World Bank members and management to resume lending to China. There also has been growing pressure from some of our major allies to resume some lending to China.

We believe that it is essential that the G-7 consensus remain intact in order to effectively limit future actions of the Bank with respect to lending for China. This consensus was, and is, important since the United States does not have sufficient voting power alone to block World Bank loans. We want to be sure that there is not a return to "business as usual" at this time. Thus, we worked closely with our G-7 allies, to develop a new consensus to support a gradual resumption of lending which meets basic human needs, but which stopped far short of a complete resumption of lending to China. While our G-7 allies have been willing to restrict a resumption of lending to basic human needs loans, they have pointed out that they do not have legislation similar to U.S. laws on human rights which limit lending to projects which meet the BHN criterion.

Approved Loans

Since early February three loans have come to the Board for consideration. The U.S. supported all three because they clearly met the basic human needs criteria. These three loans are the only IDA commitments approved for China since last May and total $140 million.

On February 8, 1990, we supported a $30 million IDA credit, the North China Earthquake Reconstruction Project. A serious earthquake hit two northern provinces on October 18, 1989, causing widespread damage. The credit provides assistance to rebuild housing, schools, clinics, community facilities and some basic infrastructure -- bridges, power and telecommunications.

On February 27, we supported a $60 million IDA credit, the Jiangxi Agricultural Development Project. This project will support small farmers' efforts to diversify their agricultural activities. On March 27, we supported a $50 million IDA Vocational and Technical Education credit. The credit will help the State Education Commission and provincial and municipal governments to improve vocational and technical education. These two loans had been scheduled for Board consideration in June 1989, but were postponed.

World Bank Country Review

Any time that there is a significant interruption in Bank lending to a country or potentially significant changes in economic policy, we believe that there should be a thorough review of the country's economic situation and policies. There was no lending from June 1989 to February 1990. The Bank is preparing a Country Economic Memorandum, which will be distributed shortly. It will serve as the basis for a full review on May 29, by the Executive Board of: the current economic situation, policies, and prospects in China; China's commitment to economic reform; its creditworthiness; China's ability to implement projects effectively; and the Bank's lending strategy. We expect the discussion to include an assessment of the adequacy of macroeconomic and sectoral policies as a basis for effective use of Bank and IDA funds, identification of the economic policies that have changed since last June, and the areas in need of reform.

We have some questions as to whether significant lending to China is appropriate based on the current economic situation and policies. We have concerns about China's creditworthiness, its commitment to economic reform, and its ability to effectively implement projects. Accordingly, we will be analyzing very carefully the Bank report, as well as information from our Embassy in China and other sources.

G-7 Coordination

It has taken a great deal of time and effort on the part of the U.S. Government working closely with our allies to arrive at a consensus to limit World Bank lending to China. This has involved communications and meetings with representatives from national capitals as well as intensive coordination with their Executive Directors based at the Bank in Washington. As Assistant Secretary Dallara mentioned to you on March 28, we have made very clear to the Bank that the "lending program should be one that is modest, moderately paced, and limited in the foreseeable future strictly to basic human needs". To date, we have worked successfully with other countries to ensure that World Bank lending to China conforms to this program. We will continue to work with our allies to sustain the consensus on lending to China.

Conclusion

We fully share Congressional concerns regarding China's human rights situation. We continue to oppose a general resumption of World Bank lending to China. On a case-by-case basis, we will support lending which, after careful analysis, clearly meets the basic human needs criteria in order to avoid penalizing the Chinese people just because their government follows repressive practices. We believe that this policy is consistent with the basic objectives set forth by Acting Secretary Eagleburger in his February testimony. It expresses our condemnation of the policies of the Chinese government, but does so in a way that helps soften the blow to the Chinese people brought about by the crisis in China.

Supporting BHN projects is an expression of humanitarian concern for the welfare of the poorest and most vulnerable people in China. This approach is consistent with existing human rights legislation and past U.S. Government practices in other human rights problem countries.

TREASURY NEWS

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FOR RELEASE ON DELIVERY
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Statement of
The Honorable Robert R. Glauber
Under Secretary of the Treasury for Finance
Before the
U.S. Senate Committee on
Agriculture, Nutrition, and Forestry

May 8, 1990

Chairman Leahy, Senator Lugar, and Members of the Committee:

Thank you for this opportunity to discuss the Administration's views on regulatory fragmentation and related issues in the securities and futures markets. We believe the time has come to reform the disjointed regulation of the markets governing stocks, stock options, and stock index futures.

We also believe that if steps are not taken to correct the problem now, we are more likely to see minor events trigger major market disruptions like the breaks in October of 1987 and October of 1989 -- and the appropriate regulatory tools will not be in place to help contain the risk to this country's financial system. Finally, a failure to act will impede innovation; drive new financial instruments to overseas markets; and thwart enforcement of intermarket abuses.

As Secretary Brady has said many times, any reform must be based upon the fact that the markets for stocks, stock options, and stock index futures are really "one market." The financial community already recognizes this fact, as do regulators in other countries. The question is whether our regulatory structure needs change in order to recognize this fact as well -- whether one market requires one regulator, and whether this will result in progress on key intermarket issues that will reduce the likelihood and risk of major market disruptions.

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We believe the answer to all these questions is yes. As a result, the Administration will submit proposed legislation this week. Before outlining this proposal, however, let me explain why the Administration has come to this position.

The Onset of Major Market Disruptions

As this Committee knows, stock index futures began trading on futures exchanges less than ten years ago. These instruments have proved to be one of our financial system's most innovative new developments, and we believe their use has helped keep our cost of capital lower than it otherwise would be. They have also permitted institutional traders to engage in more effective asset allocation techniques and have provided a more flexible mechanism to enter and exit the stock market.

Nevertheless, the interaction of these new instruments with stocks and stock options has been an important contributor to major market disruptions -- periods when the markets disconnect with prices spiraling down. These major market disruptions are not episodes of markets adjusting to fundamental changes in value or responding to major news events. They are periods when the markets break down, as history has shown us.

In the 52 years between 1930 and 1982 (the year stock index futures began trading) the Dow Jones Industrial Average declined by more than 6 percent on only three occasions: when the Germans took the Netherlands in May of 1940 (6.8 percent); when they encircled the Allied forces at Dunkirk just days later in the same month (6.8 percent); and when President Eisenhower suffered a heart attack in September of 1955 (6.5 percent). As the futures markets have grown, such massive one-day selloffs have occurred four times in the last three years:

October 19, 1987 -- 22.6 percent
October 26, 1987 -- 8.0 percent
January 8, 1988 -- 6.9 percent
October 13, 1989 -- 6.9 percent

Not one of these days corresponded with any major news events like the ones before 1982. But they all shared the characteristic of enormous selling pressure from the stock index futures markets.

Again, these were not merely days of "excessive price fluctuations" or "increased volatility." Beginning with the Report of the Presidential Task Force on Market Mechanisms, chaired by Secretary Brady, we have consistently recognized that there is no compelling evidence that average stock market volatility has increased over the past 25 years. But that is completely beside the point.

The problem is not an increase in average price volatility, but the infrequent episodes of violent disruptions when the markets cease to function correctly. During these episodes, pricing relationships between stocks and futures break down; markets in particular instruments experience difficulties in staying open; serious supply-demand imbalances develop; and very large market moves occur in the absence of underlying fundamental information.

It is the increased potential for and consequences of these major market disruptions that lead us to urge prompt regulatory reform.

Systemic Risk and Erosion of Investor Confidence

The most disturbing consequence is the risk these major market disruptions pose to the entire financial system, especially through the clearance and settlement process. For example, after the October 1987 break, the clearance and settlement system fell over 6 hours behind its normal payment times, with futures clearinghouses owing over $1.5 billion to investment houses. Had these funds been missing for any significantly longer time, it would have unleashed a chain reaction of events where other payments to other creditors would not have been made. The Presidential Task Force concluded that the prospect of clearinghouse failures reduced the willingness of lenders to finance market participants, leading to "a crisis of confidence [that] raised the spectre of a full-scale financial system breakdown."

Obviously, we must take appropriate steps to reduce this very real risk of systemic breakdown.

Moreover, we need to address another consequence of these major market disruptions -- their contribution to the erosion of investor confidence and capital formation:

- Initial Public Offerings (IPOs) have plummeted since the 1987 market break. After peaking at $18 billion in 1986, IPOs raised only about $6 billion a year in 1988 and 1989.

- Equity offerings as a percentage of new funds raised domestically has fallen off dramatically. In the early 1980s, equity accounted for about 30-50 percent of all public new issues, but the share dwindled to only 10 percent in 1989.

- The percentage of stock outstanding held by individuals has declined from 84 percent in 1965 to 55 percent in 1989.

- Trading volume in options, futures, and stocks is off substantially from levels that prevailed before the October 1987 market break.

To bring investors back into our markets to stay, we must renew their confidence that market mechanisms are operating efficiently and that they are still a safe place to invest.

Regulatory Fragmentation

The fundamental impediment to reducing the likelihood of major market disruptions -- and its consequences to the system and to investors -- is regulatory fragmentation. One regulator for the "one market" would have much more flexibility to coordinate the key intermarket mechanisms that disconnect to create or exacerbate major market disruptions. These include the following.

Clearance and Settlement. I have already described the systemic risks posed by potential breakdowns in the clearance and settlement systems. This continues to be what Secretary Brady has described as the weakest link in the financial system. The problem is the fragmentation of clearing systems among the stock, stock options, and stock index futures markets. While legislation is pending in both the Senate and House to help address these systems, there is little doubt that a single regulator could help accelerate the coordination process.

Unharmonized Margins. While there is federal oversight of margins in the stock and stock options markets, there is virtually none in the stock index futures markets. The result is a tremendous disparity among margin levels in the three markets, with futures margins often dipping to dangerously low levels. The fact is that futures traders can control so great an amount of stock with so little of their own money that relatively small amounts of capital can concentrate enormous selling pressure on the stock market -- great enough to cause a major market disruption that could punch a hole in the fabric of the financial system.

For example, just prior to the October 13, 1989 break, a professional trader in the futures market with $50,000 in cash could control almost $2,000,000 in stock, which is nearly 10 times more than the $200,000 that a professional trader in the stock market can control with the same amount of cash. Many observers were astounded that, while stock index futures margins were increased temporarily in the wake of the October 1987 break, they were actually lower in October of 1989 than they were in October of 1987.

The result is that during market downdrafts, when the system is most in need of liquidity, futures exchanges are forced to restrict liquidity through margin calls because margins have been set so low. This is precisely the opposite of what should occur: during emergencies it is critical to pump liquidity into the system.

Thus, low futures margins create a direct prudential risk not merely to the futures markets, but to the financial system as a whole. However, since these margins are set by the futures industry, with no day-to-day regulatory oversight, there is no way to harmonize margins between futures and stocks to protect the public. This exposure to systemic risk requires federal oversight of margin-setting for stock index futures, and the oversight should come from one regulator that can ensure harmonized margins among linked markets.

Evasion of Short Selling Restrictions. For over 50 years the securities laws have restricted bear raiders like the 1920s' Jessie Livermore from selling short in declining markets. The purpose of these restrictions is to prevent "gunning" the market, which drives down the market and confuses the small investor. However, a concerted selling effort in the futures market can completely undermine the short selling restriction -- and in fact, because of low futures margins, can accelerate the stock market downdraft. Again, it is critical to harmonize these intermarket rules to prevent manipulators from using one market to evade restrictions in another market.

Uncoordinated Circuit Breakers. Some progress has been made to coordinate circuit breakers in stock and stock index futures markets, and discussions are continuing within the President's Working Group on Financial Markets. Nevertheless, more can be done, and fundamental disagreements continue to exist between markets and their regulators over the appropriate kinds of circuit breakers.

In short, fragmented regulation has impeded progress on the coordination of these fundamental intermarket mechanisms. We believe one regulator with appropriate authority could accelerate progress substantially towards the harmonized regulation we need to address the problem of major market disruptions.

Barriers to Innovation

Apart from major market disruptions, regulatory fragmentation is now creating a serious impediment to innovation. This was not always true -- in the past, fragmented regulation sometimes promoted innovation. Competition between Chicago and New York markets spurred new product development, while the practices of different regulators often promoted diversity, experimentation, and creativity.

But regulatory competition also begets jurisdictional squabbles, which can strangle innovation. New products are not merely stifled; they quickly move to overseas markets.

This is particularly true with respect to the so-called "exclusivity" clause of the Commodity Exchange Act (CEA). As a result of regulatory disputes, the courts currently interpret this provision to require that any financial instrument with any degree of "futurity" must be traded on a futures exchange. But certain of the new "hybrid" products are simply not amenable to trading in this manner. The result has been protracted litigation over what constitutes a "future"; an inability to trade in the U.S. markets most suited to the product; and the shifting of business to more hospitable overseas markets. This is precisely what happened to Index Participation Certificates, which now trade in Toronto rather than the United States.

My point is this: with the globalization of financial markets, other countries have provided us all the regulatory competition we need. We can no longer afford jurisdictional conflicts that stifle innovation at home and drive important business overseas.

Enforcement and Globalization

The other problems created by regulatory fragmentation involve intermarket enforcement and globalization.

Ineffective Intermarket Enforcement. With two different regulators, it becomes extremely difficult to prevent manipulation and fraud in transactions between the stock and futures markets. The situation is similar to state troopers who are forced to stop at the state line when chasing lawbreakers. In particular, it is extremely difficult to detect intermarket "frontrunning," where a trader trades ahead of his client in one market knowing that the client's trade will drive a linked market in a particular direction. In fact, at this time there is not even a universally accepted definition of illegal frontrunning in the cross-market context.

The plain fact is that with our current system it is simply too easy for intermarket abuses to slip through the cracks because of the dispersion of regulatory responsibility. Integrated regulation would enhance surveillance, facilitate intermarket rulemaking, and promote accountability.

Globalization. The clear trend toward globalization of financial markets has now been recognized. I have already discussed how this overseas competition requires the United

States take the steps necessary to foster domestic innovation. But it also requires viewing interrelated domestic markets in a global context and speaking with one voice to our foreign counterparts.

Secretary Brady, testifying before the Senate Banking Committee last October, described the growing interdependence of the world's financial markets and supported the idea of identifying particular issues where an international and intermarket approach would be useful. Integrating "one market" regulation in the U.S. would obviously facilitate the process. In addition, integrated regulation would enable us to deal more effectively with foreign governments by speaking in a unified and consistent way.

Indeed, every other country with major trading in stocks and stock index futures has a single regulator to make sure its financial system as a whole is protected. Japan, the United Kingdom, and France, which together with the United States account for 90 percent of global futures trading, recognize the "one market" reality -- each country assures that regulation of stocks, options, and futures is coordinated by a single regulator. Yet here in the United States, by reason of historical accident, the Securities and Exchange Commission (SEC) regulates stocks and stock options, while the Commodity Futures Trading Commission (CFTC) regulates stock index futures.

Recommended Solutions

Before outlining the Administration's proposal, let me emphasize the importance of avoiding an approach that will stifle innovation. This is the effort to ban or drastically curtail program trading. We believe that this blunt approach of government intervention is simply the wrong way to address these problems. Rather than trying to restrict particular trading strategies, it is much more productive to focus on inconsistent intermarket regulation.

Again, to do this we must recognize that what we now have is a single market with uncoordinated and even conflicting regulation. That may have created benefits in the past when markets were less connected and overseas competition was minimal. But now it creates substantial problems, as I have just described.

The solution is not complicated. We do not need more regulation. But we do need more unified regulation as the umbrella under which specific intermarket issues can be much more easily resolved. The result will be more streamlined and efficient regulation.

Unifying regulation could involve the more substantial action of merging the SEC and the CFTC, as some members of Congress have suggested. Another approach would shift the regulation of all financial futures from the CFTC to the SEC. However, both of these proposals involve major regulatory changes that are more than is necessary to address the problems we believe require immediate correction.

Instead, the Administration supports a less sweeping approach that would only unify regulation of the "one market" of stocks, stock options, and stock index futures under the SEC, the agency with the greatest expertise in the combination of these products. The proposal the Administration will submit will:

-- Shift regulatory authority for stock index futures to the SEC, but in a manner that minimizes the disruption to the current operation of the markets in these instruments;

-- Provide the SEC with oversight authority over the futures exchanges' ability to set margins, which would be similar to its current oversight authority over margin-setting by the options exchanges (there would be no pre-set minimum margins established by statute);

-- Modify the "exclusivity clause" of the Commodity Exchange Act in order to end pointless litigation and remove barriers to innovation that are driving new products to foreign markets;

-- Enhance enforcement authority, especially on an intermarket basis;

-- Provide for appropriate transition; and

-- Mandate reports within eighteen months on any additional modifications that are necessary for the efficient regulation of the "one market" of stocks, stock options, and stock index futures.

The Administration believes that this is the most appropriate approach for addressing regulatory fragmentation with the least disturbance to and best protection for the futures markets. Moreover, it would have no effect on the agricultural community, since stock index futures have no relation to agricultural products or agricultural futures.

The proposal would also minimize the effect on the CFTC, because stock index futures represent less than 10 percent of the futures volume under CFTC jurisdiction. Indeed, the CFTC will be able to concentrate its considerable expertise on the more traditional agricultural and financial futures products that have long been the core of its jurisdiction.

Conclusion

In conclusion, the benefits of unified regulation are substantial. While we embrace this approach, I want to emphasize our belief that today's problems do not come from the regulators themselves. Both the CFTC and the SEC are doing a good job under difficult circumstances -- administering a scheme of regulation that simply is not designed for the unified marketplace they are expected to regulate. We believe the answer is a coherent regulatory structure that can deal effectively with unified markets. Resolving regulatory fragmentation will reduce systemic risk and promote investor confidence, which are keys to our long-term competitiveness.

Moreover, led by Chairman Gramm, I believe the CFTC will continue its outstanding job of ensuring the integrity and safety and soundness of the markets it regulates. I urge the Senate to speedily confirm Chairman Gramm for another term, so that the CFTC will have the leadership necessary to address these matters successfully.

Mr. Chairman, that concludes my testimony. I would be pleased to answer any questions the Committee may have.

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TEXT AS PREPARED
FOR IMMEDIATE RELEASE

Remarks by
Secretary of the Treasury
Nicholas F. Brady
at the Afternoon Session of
The Interim Committee
Washington, D.C.
May 7, 1990

The International Debt Strategy

The strengthened debt strategy is now well accepted. Six nations have reached new agreements with commercial banks -- representing nearly half of the commercial bank debt of the major debtor nations -- and others have moved ahead with new reform efforts.

The approach we launched last spring deserves our continued strong support. It is clearly moving us in the right direction. Debtor nations are gaining benefits from the combination of economic reforms, debt and debt service reduction by commercial banks, and new financial support from the international financial institutions.

Sound economic programs are the order of the day, and investment and repatriation of flight capital should follow. The strategy has encouraged many indebted countries to focus on medium-term reform programs in order to obtain financial support for debt and debt service reduction. The Government of Mexico, which has had a strong record of implementing economic reform, has pressed forward with measures to reduce the size of the public sector and to liberalize its foreign investment regime. The Government of Venezuela has launched the most comprehensive economic adjustment program in its history. These countries provide examples of the kind of financing packages available with strong reform programs.

One area that needs to be emphasized by both debtor nations and the international financial institutions is the need to attract new foreign investment and encourage the return of flight capital. The ability to compete effectively for foreign private capital, and to tap the capital of debtor nationals held overseas, is taking on increasing importance as global investment needs grow. Therefore, both the IMF and the World Bank need to work closely with debtor nations to incorporate in their reform

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programs specific measures to open investment regimes and to encourage flight capital to return home for productive use.

The debt strategy has proven to be both resilient and flexible. It has been able to respond to specific country circumstances, including differences in individual debt situations and financing needs. To meet these differing situations, the bank packages which have been negotiated have varied substantially in the instruments used. For example, Mexico's package focused on debt and debt service reduction through collateralized par and discount bonds, plus new money. The Philippine package focused on cash buybacks and new lending. Costa Rica's package included buybacks, interest reduction and arrangements for resolving arrears problems.

We believe that the guidelines for IMF and World Bank support under the debt strategy remain sound. Although some would call for a more active role by the IMF and World Bank in fashioning agreements between debtor countries and their banks to assure that financing needs are met, the voluntary market-based strategy has worked well.

Both commercial banks and the official community have a common interest in supporting stronger growth and productive development in debtor economies. That is the fundamental aim of the debt strategy. And that is our continuing challenge.

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STATEMENT OF
SECRETARY OF THE TREASURY
NICHOLAS F. BRADY
AT THE MORNING SESSION
OF THE DEVELOPMENT COMMITTEE
OF THE WORLD BANK AND
THE INTERNATIONAL MONETARY FUND
WASHINGTON, D.C.
MAY 8, 1990

This morning, I want to review three topics:

1) progress under the strengthened debt strategy, including the importance of foreign investment and the return of flight capital;

2) the role of the private sector in development; and

3) the treatment of environmental issues within the World Bank.

The Strengthened Debt Strategy

I welcome the progress that has been made under the strengthened debt strategy. Six heavily-indebted countries have reached agreements with the commercial banks. The international institutions, creditor governments and commercial banks have all contributed to support debtor reform efforts under the new approach.

Debtor countries, are already gaining benefits. Debt burdens have been reduced, flight capital is returning and investor confidence is growing. However, to ensure that these benefits are lasting, reform efforts must be sustained. Policies for promoting foreign investment and capital repatriation, privatizing public enterprises, and developing competitive economies are an essential part of these reforms.

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Debtors need to liberalize regulations relating to investment and create efficient domestic capital markets in order to develop competitive economies and attract foreign capital. The international financial institutions should complement those efforts and assume a more active role in the reform of investment regimes. They should, for example, develop investment sector loans and incorporate measures to liberalize direct investment policies in both structural and sectoral adjustment loans. Debt/equity swap programs can also be an important element of adjustment programs while also contributing to overall debt reduction.

The Role of the Private Sector

A related and broader issue is the importance of enhancing the contribution of the private sector to development. Developing countries have begun to recognize that a dynamic private sector is the key to sustainable development and economic well-being. The United States welcomes this change and is working through many channels to support and encourage it.

The World Bank Group is well positioned to promote private sector growth in its borrowing members. The Bank, should pay greater attention to the role of the private sector in the development process.

Since the World Bank is a key source of adjustment lending, it is able to help developing countries implement needed macroeconomic, structural and institutional changes. The Bank should give higher priority to private sector development and institutionalize this priority across the entire range of Bank operations. Failure to stimulate private sector growth and mobilize private capital could undermine sustainable growth.

We will be discussing this issue this afternoon. However, given its critical importance, and the presence of other issues on the afternoon agenda, I suggest that the Committee revisit the issue of private sector development, including the mobilization of private capital, as a primary topic of discussion at the next meeting in September.

The Environment

I would like to conclude with a few remarks on the environment. This is an issue of great importance to the United States. At last September's annual meeting of the World Bank, President Bush called for more emphasis on the environment in national policy making, especially in promoting energy efficiency and conservation and greater protection of tropical forests. With respect to the World Bank, the United States has sought to promote the integration of environmental considerations into its lending programs and has encouraged the use of environmental impact assessments and environmental action plans.

The United States has supported the use of debt-for-nature swaps to help preserve forests and wetlands. In the recent past, such swaps have been signed in a number of countries. While the dollar amounts involved in these swaps have been small, an important principle has been established. We believe this mechanism can be used more innovatively and encourage the World Bank to play a more active role in facilitating swaps. For example, a portion of either project or sector loans could be used by the Bank to help finance debt-for-nature swaps.

An environmental report has been prepared by the Bank for our meeting today. However, it focuses on the proposed Green Fund and does not address a number of important issues relating to the Bank's existing environmental programs as was requested at the meeting of this Committee last September. Significant progress has been made by the Bank in the environmental area, but a great deal more needs to be done. We suggest that the information requested last Fall be provided to the Committee for our next meeting in September so that the Bank's progress can be reviewed, and further progress encouraged.

TREASURY NEWS

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

FOR IMMEDIATE RELEASE
May 8, 1990

CONTACT: LARRY BATDORF
(202) 566-2041

UNITED STATES AND BULGARIA TO NEGOTIATE A NEW INCOME TAX TREATY

The Treasury Department announced today that negotiations of a new income tax treaty between the United States and Bulgaria will begin during the week of May 21 in Washington, D.C. There is no income tax treaty now in effect between the two countries.

The negotiations will take into account the model income tax treaties published by the Organization for Economic Cooperation and Development, the United Nations, and the U.S. Treasury Department, as well as tax treaties recently concluded by the two countries with other countries, and recent changes in their respective income tax laws.

Income tax treaties provide rules for the taxation of income derived in one of the countries (the "source" country) by residents of the other. They establish when the source country may tax various classes of income and specify maximum rates of tax at source on certain items, such as dividends, interest and royalties. They also provide for administrative cooperation between the tax authorities of the two countries and guarantee nondiscriminatory taxation. Treaty benefits are limited to residents of the two countries.

Persons wishing to offer comments or suggestions on the negotiations are invited to write to Philip D. Morrison, International Tax Counsel, Treasury Department, Washington, D.C. 20220.

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NB-797

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

FOR IMMEDIATE RELEASE
May 8, 1990

CONTACT: Office of Financing
202/376-4350

RESULTS OF AUCTION OF 3-YEAR NOTES

The Department of the Treasury has accepted $10,574 million of $37,327 million of tenders received from the public for the 3-year notes, Series T-1993, auctioned today. The notes will be issued May 15, 1990, and mature May 15, 1993.

The interest rate on the notes will be 8-5/8%. The range of accepted competitive bids, and the corresponding prices at the 8-5/8% rate are as follows:

	Yield	Price
Low	8.73%*	99.728
High	8.75%	99.676
Average	8.74%	99.702

*Excepting $10,000 at lower yields.

Tenders at the high yield were allotted 13%.

TENDERS RECEIVED AND ACCEPTED (In Thousands)

Location	Received	Accepted
Boston	$ 85,830	$ 85,770
New York	33,902,715	9,097,475
Philadelphia	50,970	50,690
Cleveland	152,300	152,300
Richmond	115,090	104,470
Atlanta	89,865	88,345
Chicago	1,542,470	306,845
St. Louis	131,795	109,050
Minneapolis	86,940	69,525
Kansas City	197,360	196,190
Dallas	65,115	60,050
San Francisco	791,570	138,410
Treasury	115,020	115,020
Totals	$37,327,040	$10,574,140

The $10,574 million of accepted tenders includes $2,448 million of noncompetitive tenders and $8,126 million of competitive tenders from the public.

In addition to the $10,574 million of tenders accepted in the auction process, $770 million of tenders was awarded at the average price to Federal Reserve Banks as agents for foreign and international monetary authorities. An additional $1,702 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

CONTACT: Office of Financing
202/376-4350

FOR RELEASE AT 4:00 P.M.
May 8, 1990

TREASURY'S WEEKLY BILL OFFERING

The Department of the Treasury, by this public notice, invites tenders for two series of Treasury bills totaling approximately $16,800 million, to be issued May 17, 1990. This offering will provide about $1,100 million of new cash for the Treasury, as the maturing bills are outstanding in the amount of $15,710 million. Tenders will be received at Federal Reserve Banks and Branches and at the Bureau of the Public Debt, Washington, D. C. 20239, prior to 1:00 p.m., Eastern Daylight Saving time, Monday, May 14, 1990. The two series offered are as follows:

91-day bills (to maturity date) for approximately $8,400 million, representing an additional amount of bills dated February 15, 1990, and to mature August 16, 1990 (CUSIP No. 912794 UY 8), currently outstanding in the amount of $7,695 million, the additional and original bills to be freely interchangeable.

182-day bills for approximately $8,400 million, to be dated May 17, 1990, and to mature November 15, 1990 (CUSIP No. 912794 VJ 0).

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

The bills will be issued for cash and in exchange for Treasury bills maturing May 17, 1990. 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 $930 million as agents for foreign and international monetary authorities, and $4,409 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-799

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.

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