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United States Senate

COMMITTEE ON FINANCE
WASHINGTON, D.C. 20510

DECEMBER 12, 1983

MEMORANDUM

TO: SENATOR DOLE

FROM: GEORGE PIELER

SUBJECT: SPEECH TO NATIONAL VENTURE CAPITAL ASSOC.

ATTACHED ARE MATERIALS FOR YOUR TALK TO THE NATIONAL VENTURE CAPITAL ASSOCIATION. THE ISSUES OF PARTICULAR INTEREST TO THE GROUP ARE HIGH TECH/VENTURE CAPITAL AND CAPITAL GAINS HOLDING PERIOD, AS WELL AS TALKING POINTS ON THE DEFICIT PROBLEM, AND THE SHORT DESCRIPTION OF THE FINANCE COMMITTEE DEFICIT PACKAGE.

ATTACHMENTS

VENTURE CAPITAL/HIGH TECH

BACKGROUND

Initiatives to assist the so-called "high technology" industries address a number of purported characteristics of the industry. These characteristics include:

(1) major expenses in research and development, rather than plant and equipment;

(2) relative youth and potential for rapid expansion;

(3) alleged need for additional capital, particularly for start-up.

Special proposals to encourage research and development (R&D), and to encourage the training of individuals to work in new industries, are described below. Many proposals focus on getting venture capital into high technology industries.

HIGH TECHNOLOGY RESEARCH AND EDUCATION ACT OF 1983

A number of bills have been introduced in the 98th Congress reflecting proposals to help the high tech industry. Significant among them is S. 2165, the High Technology Research and Education Act of 1983, introduced by Senators Danforth, Chafee and Bentsen on December 18, 1983.

S. 2165, discussed more fully below, (1) makes the 25% credit for R&D expenses permanent and expands its use, but tightens the definition of R&D expenses eligible for the credit, (2) expands the limits on the type of equipment that may receive favorable tax treatment under current law for a donation of scientific equipment to post-secondary schools, and (3) excludes from income certain scholarships or fellowship grants received by graduate science students.

More important for venture capital firms, S. 2165 provides that the R&D credit will be available for qualifying start-up costs of a new corporation as well as for new research of existing corporations, and also makes the credit available for certain qualifying joint ventures. Treasury is studying these provisions, but is concerned about the potential for using joint R&D ventures as tax shelters.

TALKING POINTS ON R & D CREDIT

- One of the distinct characteristics of the so-called high technology industry is its dependence on continued research and development.

- In 1981, ERTA recognized the special needs of research oriented companies through the incremental research and development credit.

- This generous R&D credit attempts to reward the expanded research of new and growing companies; however, it has also been an attractive deduction for established companies.

- For example, some financial institutions have used the R&D credit to develop software packages for accounting purposes.

- Before the R&D credit can be made permanent, it is important to limit its scope to ensure that only significantly new and clearly risky research ventures are rewarded with the credit.

- I understand that Treasury is working with the industry to narrow the scope of the expenses qualifying for the credit, and my staff will be working closely with Treasury in this process.

INCENTIVES TO INCREASE AVAILABLE CAPITAL

1. Reduction of capital gains tax on new stock issues

S. 1666, introduced by Senator Chafee, would reduce the capital gains tax rate to a maximum of 10 percent for certain new stock issues held for 5 years or more. (The alternative minimum tax on capital gains would still apply, however.) The intended purpose of the bill is to encourage capital expansion for new growth companies.

Some members of the high tech lobby favor this approach; others, in particular the American Electronics Association, do not oppose the bill but would prefer that special incentives for the high tech industry be focused on the R&D credit, which they believe is more important.

Treasury testified about S. 1666 in September and approved the bill, fearing that it would decrease available capital for companies that did not issue new shares.

2. Stock options

Some members of the high tech lobby have argued that stock options offer the best incentive to encourage entrepreneurs to take the risks necessary to establish a high technology product or idea. Moreover, these options when exercised are a source of capital.

The special treatment afforded incentive stock options (ISOs) by ERTA in 1981 responded in part to those needs; however, the high technology lobby would prefer that the ISO rules be liberalized (e.g., to exclude ISOs from minimum tax treatment). The problem with this approach is again a targeting one--ISOs are extensively used by all industries to provide tax-favored compensation to key executives. Since ISOs are so popular, an attempt to limit any new uses of ISOs to one industry would likely be resisted.

Capital Gains Holding Period

S. 13--the Capital Gains Tax Act of 1983

- Shortens the holding period for long-term capital gains to six months;
- Original Co-sponsors are Senators Dole, Long, Danforth, Bentsen, Baker, Wallop, Symms, Jepsen, and D'Amato;
- The bill has strong bipartisan support in the Senate and is supported by the Administration.

Previous Votes on Shortening the Holding Period

Senate:

- Approved 77-17, as amendment to debt ceiling bill, August, 1982;
- Approved as part of TEFRA, July, 1982, (removed in TEFRA conference);

House

- Included in Administration supported version of ERTA approved 238-195, July 29, 1981, (removed in ERTA conference).

Current Legislative Prospects

- The bill is officially estimated to lose over $200 million annually, but many supporters believe the change will raise revenues, as well as increasing capital market efficiency.
- A shorter holding period will raise revenues if significantly greater numbers of "gain" transactions are consummated, even at a lower tax rate. Taxing 20 percent of something, is better than taxing 50 percent of nothing.
- Some House members may need to be persuaded of the value of this measure.
- As mutual funds begin to offer more "exotic" types of investments, including short-term trading in stocks, options, and commodities, the benefits of shortening the holding period will be available to lower income individuals. Thus, the bill should not be viewed as just helping the well-off.

- As part of a possible deficit-reduction package, the Finance Committee is currently considering a proposal to reduce the holding period for long-term capital gains to 6 months effective for assets purchased after November 1, 1983.

- To make this change revenue neutral, the limit on the deductibility of capital losses against ordinary income would be reduced from $3,000 to $1,000, effective for calendar year 1983 and subsequent years. The special rule for pre-1970 losses would be repealed.

Talking Points

Capital Gains Holding Period

- Shortening the capital gains holding period will reduce effective capital gains tax rates, and should therefore increase incentives to invest. Indeed, based on past experience with capital gains rate reductions, tax receipts might very well increase.

- Among other major industrialized countries, most have no capital gains holding period or a shorter holding period. This should be of concern to Congress, since, according to studies conducted by Price Waterhouse and the New York Stock Exchange, high effective capital gains rates are associated with low personal savings rates.

- A shorter holding period would encourage equity financing and help broaden our economy's equity base, needed to alleviate the serious balance sheet problems of many American corporations.

- A long holding period restricts the mobility of capital, making it more difficult for small and new companies to obtain funds needed for growth and expansion.

TALKING POINTS ON REDUCING THE DEFICIT NOW

- In its midyear budget review, the Reagan Administration estimated that the Federal budget deficit would be roughly $200 billion for each of the next 6 years.

- Over that 6-year period, unless something is changed these deficits will cumulate to $1.2 trillion--just about doubling the national debt.

- Without action on the deficit, deficits for each of the next 6 years will exceed 4 percent of our Gross National Product--that is a postwar record previously matched only in 1976.

- Assuming a $200 billion deficit has to be financed at a 10 percent interest rate--a reasonable assumption given prevailing conditions--the interest alone on a deficit of this size amounts to $20 billion. That is enough to finance all of the Medicaid program at current funding--it is 2-1/2 times the cost of the AFDC program, or of the SSI program--it is over four times the cost of General Revenue Sharing.

- Over the next 5 years financing costs for the interest on this additional debt would amount to $100 billion.

- In addition, if nothing is done to prevent this $1.2 trillion addition to the national debt, interest payments on this additional debt alone would amount to $100 billion a year after 1988. That is nearly double the present cost of interest on the national debt, and is equal to over 20 percent of all the personal tax revenue we expect to collect in 1988.

- All of this additional debt, and the interest we pay on it, has to be paid for in some way--in higher interest premiums or inflation, in higher taxes, or more severe spending cuts. The longer we wait, the higher the cost of deficit reduction will be.

- Lowering outyear deficits now should help bring down interest rates; that can stimulate investment to keep recovery going. That means a stronger economy in the outyears when further spending reductions and tax increases we enact now would be coming in place. But absent such a boost to the economy, the economy may be too stagnant in those outyears to sustain a sudden restraint on fiscal policy--which means we would be compounding the problem and risking a downward economic spiral.

- Interest rates that are kept high by the size of anticipated deficits matter not just for government finance and the taxpayer--they matter for the homebuyer, who has seen rates creep back up to the 13+ percent range, and for the small businessman or entrepeneur trying to get started. High interest rates can cut short a promising economic future for everyone.

- The $1.2 trillion increase in the national debt over the next six years will add $5,217.39 in new debt for each man, woman and child now living in the U.S. This would come on top of the over $6,000 debt per capita already outstanding.

- Escalating deficits leading to higher interest rates do not just pose the threat of mortgaging our future. Higher interest rates mean lower capital formation and less long-term growth; more pressure for raising domestic barriers to free trade; and bad news for our basic industries, because the need for upgrading heavy plant and equipment means those industries are very sensitive to interest costs.

- In addition, the stronger dollar that tends to result from higher U.S. interest rates makes it more difficult for American companies to compete with low-cost imports and to secure a foothold in overseas markets.

- High deficits and interest rates retard capital formation and pose a real risk of 'disinvestment' in the United States, implying a much more fragile American economy. A low-growth path could condemn many citizens to poverty who might ottherwise be able to find productive and useful employment.

TALKING POINTS ON DEFICITS

- As Martin Feldstein, President Reagan's chief economic adviser, has said, if we don't do anything about controlling this deficit now, it will cost one-fifth of all personal income taxes collected by the Federal Government just to service the interest costs of the $1 trillion of new debt accumulated over the next five years.

- If we wait just one year to do something about controlling the increase in the deficit, it will require deeper spending cuts and higher tax increases.

  For every dollar in spending cuts needed this year, it will require 1.10 next year.

  For every dollar we raise taxes this year to accomodate the deficit, we will have to raise them $1.10 next year.

- Since 1981, we have brought about spending cuts amounting to $1Ø9 billion for the 1983, 1984 and 1985 budget years.

  But over the same period of time, we have seen the budget deficit increase by $91 billion.

  That means that the deficit has wiped out 83 percent of all the savings we have realized through our reductions in Federal spending.

November 29, 1983

BASIC COMPONENTS OF PROPOSED FINANCE COMMITTEE DEFICIT REDUCTION PACKAGE

Overview

- The Finance Committee has aimed for $150 billion in total deficit reduction over the next 4 fiscal years, with most of the savings coming in fiscal years 1985 through 1987.

- The package will have at least one dollar in guaranteed spending cuts for each dollar of revenue increases.

- The Finance Committee will undertake to enact one-half of the spending reductions, and look to the other Senate Committees to produce an equivalent amount of savings.

- Any new revenue increases (other than pure loophole closers) will be expressly contingent on a certification that spending cuts have been achieved and will be triggered off if Congress later reneges on these spending cuts.

I. Spending Reduction Proposals Within the Jurisdiction of the Senate Finance Committee

The total package, including provisions totalling $5.3 billion in savings incorporated in the Reconciliation Act of 1983 as reported by the Budget Committee, would result in a savings of $38 billion over 4 years. The majority of the proposals would have an effective date of January 1, 1985.

- Rounding of Social Security COLA. Proposal modifies the COLA paid in 1985, 1986 and 1987 by rounding the increase to the next lower whole percentage amount.

  FY 1984-87: $5.1 billion

- Modify timing and rate of increase in Part B Premium. The premium would be permitted to increase each year until it reached 35% by 1990. (Modification of 1983 Administration proposal)

  FY 1984-87: $2.9 billion

- Delay In Initial Eligibility for Medicare Entitlements. Delays eligibility for both Parts A and B of Medicare to the first day of the month following the month of the individual's 65th birthday. (1983 Administration proposal)

FY 1984-87: $1.0 billion

- Restructure Medicare Cost Sharing/Apply Co-Pays to Hospital Days and Provide Unlimited Hospital Days. Modifies cost sharing on hospital stays and nursing home stays and provides catastrophic protection under Part A of Medicare. (Modification of 1983 Administration proposal)

  FY 1984-87: $1.6 billion

- Modification of Working Aged Provision. Modifies 1982 provision which made Medicare benefits secondary to benefits under employer group health plans. (Strongly supported by OMB and HHS)

  FY 1984-87: $1.2 billion

- Participating Physician Program. Freezes certain physician fees for 2 years and creates incentives for physicians to take assignment. (Modification of 1983 Administration proposal)

  FY 1984-87: $2.2 billion

- Limit Increase in Hospital Costs Per Case. Limits increases in hospital costs per case to the increase in the hospital market basket price index. (Modification of 1983 Administration proposal)

  FY 1984-87: $2.9 billion

- Fee Schedule for Clinical Laboratory Services. Establishes fee schedule for payment to all laboratories for services provided to Medicare patients.

  FY1984-87: $0.9 billion

- Extend Reduction in Federal Payments. Extends the existing reduction in Federal Medicaid payments to States for 2 years. (Modification of 1983 Administration proposal)

  FY 1984-87: $1.0 billion

- Debt Service. The reduced outlays and increased revenues would decrease interest on the Federal debt by $13.9 billion over FY 1984-87.

II. Revenue Provisions

The total package, including provisions totalling $21.1 billion incorporated in the Omnibus Reconciliation Act of 1983 as reported by the Budget Committee, would increase revenues by $72.8 billion over 4 years.

A. Contingent Revenue Increases

The following revenue provisions, totalling $59.8 billion over 4 years, would take effect on January 1, 1985 only upon verification that the required reductions in Federal outlays have, in fact, been achieved:

- Energy Tax. A two and one-half percent tax would be imposed on the sale of sources of energy consumed in the United States.

  The President's 1984 budget included a $5 per barrel excise tax on domestic and imported oil.

  FY 1984-87: $20.9 billion

- High Income Individual Surchage. A surcharge of two and one-half percent would be imposed on income above approximately $60,000 for joint returns ($42,000 for single returns).

  The President's 1984 budget included a surcharge on individuals approximately equivalent to one percent of taxable income.

  FY 1984-87: $5.1 billion

- Tax on Corporate Economic Income. A two and one-half percent tax would be imposed on the economic income (over $100,000) of corporations.

  The President's 1984 budget included a surcharge on corporations of approximately one percent of taxable income.

  FY 1984-87: $14.5 billion

- Rounding Down of Indexing. Indexing of brackets, exemptions, and the zero bracket amount would be computed with reference to the Consumer Price Index rounded down to the next lower full percentage point. This proposal would be consistent with the modification of Social Security COLA's.

  FY 1984-87: $5.6 billion

- Zero-Bracket Amount (ZBA) Increased. The ZBA (formerly the "standard deduction") would be increased by $100 ($200 for joint returns) in 1985. Heads of households would be given a ZBA halfway between simple and married taxpayers, with a new rate schedule.

FY 1984-87: $7.4 billion

B. Treasury-Supported Revenue Reforms.

The deficit reduction package would include proposals, totalling $13 billion, supported by Treasury testimony to the Finance Committee limiting tax shelters and accounting abuses and reforming the taxation of corporations.

FY 1984-87: $13.0 billion

III. Summary

	Fiscal Years 1984-1987
Spending Restraint Already Agreed to by the Finance Committee	5.3
Spending Restraint Proposals Within Finance Committee Jurisdiction Contained in Proposed Package	32.7
Spending Restraint Requirements Within the Jurisdiction of Other Committees	37.5
Revenue Increase Already Agreed to by the Finance Committee	21.1
Revenue Increase Proposals in Proposed Package	51.7
TOTAL	148.3