[JOINT COMMITTEE PRINT]

DESCRIPTION OF TAX BILLS
(H.R. 617, H.R. 2402, H.R. 4917, H.R. 5985, and H.R. 6218)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS

ON JULY 12, 1982

PREPARED FOR THE USE OF THE

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INTRODUCTION

The bills described in this pamphlet have been scheduled for a public hearing on July 12, 1982, before the House Ways and Means Subcommittee on Select Revenue Measures.

There are five bills scheduled for the hearing: H.R. 617 (relating to the definition of artificial bait for purposes of the excise tax on fishing equipment); H.R. 2402 (relating to time for payment of excise tax on fishing equipment); H.R. 4917 (relating to industrial development bonds for facilities for local furnishing of gas); H.R. 5985 (relating to taxes paid to the Virgin Islands); and H.R. 6218 (relating to insurance organizations for veterans).

The first part of the pamphlet is a summary of the bills. This is followed by a more detailed description of each bill, including present law, issues, explanation of the bill, effective date, and estimated revenue effect.

I. SUMMARY

1. H.R. 617—Messrs. Rousselot and Lewis

Definition of Artificial Bait for Purposes of the Excise Tax on Fishing Equipment

Under present law, a 10-percent excise tax is imposed on the sale of fishing rods, creels, and reels, and on artificial lures, baits, and flies by the manufacturer, producer, or importer thereof (sec. 4161(a)).

The bill would exclude from the definition of "artificial bait" any substance which contains 85 percent or more by weight of plant or animal material which can be ingested by fish.

2. H.R. 2402—Messrs. Jones (of Okla.), Hagedorn, Pickle, and Vander Jagt

Postponement of Time for Paying Excise Tax on Fishing Equipment

Present law imposes a 10-percent excise tax on the sale of fishing rods, creels, and reels, and on artificial lures, baits, and flies by the manufacturer, producer, or importer thereof (sec. 4161(a)). This tax generally is payable relatively soon after the fishing equipment is sold.

The bill would postpone the time for payment of the excise tax on fishing equipment until March 31, June 30, and September 24 for calendar quarters ending on December 31, March 31, and June 30, respectively. Tax for the quarter ending September 30 would be payable on a date prescribed by Treasury regulations.

3. H.R. 4917—Mr. Rangel

Tax Exemption for Industrial Development Bonds for Facilities for the Local Furnishing of Gas

Under present law, tax-exempt industrial development bonds (IDBs) may be used to provide facilities for the local furnishing of gas (sec. 103(b)(4)). Such a facility is defined as property for the furnishing of gas which is part of a system providing service to the general populace in a service area comprising no more than two contiguous counties. The bill would amend the definition of facilities for the local furnishing of gas to include property for the furnishing of gas which is part of a system providing service to the general populace in a service area comprised of a city and one contiguous county.

4. H.R. 5985—Messrs. de Lugo, Holland, Heftel, and Schulze

Reduction of Certain Withholding Taxes Paid to the Virgin Islands; Separate Application of the Foreign Tax Credit Attributable to Certain Virgin Islands Taxes

The Treasury takes the position that present law imposes a 30-percent tax on the U.S. recipient of certain Virgin Islands source passive investment income, and that present law also imposes withholding at the source by the V.I. payor of such income. The bill would reduce this tax to 10 percent and impose a withholding obligation on the V.I. payor of such income. The bill would allow the V.I. Government to further reduce this 10-percent rate in its discretion.

Under present law, a taxpayer can credit against its U.S. tax liability foreign income taxes on a dollar for dollar basis, but the credit is limited so that it can only offset U.S. tax imposed on foreign source income. The bill would provide, for V.I. taxes paid, an elective alternative to the overall foreign tax credit limitation. The elective credit would consist of two elements: a credit for V.I. withholding taxes that could offset U.S. tax on U.S. source income, and a credit, subject to a per-country limitation, for income taxes paid to the Virgin Islands by subsidiaries of U.S. corporations.

5. H.R. 6218—Mr. Duncan

Treatment of Veterans Insurance Organizations

Under present law, a post or organization of war veterans may qualify for exemption from income tax if at least 75 percent of its members are war veterans, and substantially all of the other members are veterans, cadets, or spouses (or widows or widowers) of war veterans, veterans, or cadets (sec. 501(c)(19)). For this purpose, a war veteran is any person, whether or not a present member of the Armed Forces, who served in the U.S. Armed Forces during a period of war (including the Korean and Vietnam conflicts). To qualify for the exemption, such an organization may be operated exclusively to provide insurance benefits for its members or their dependents.

The bill would add a new category of tax-exemption for associations organized prior to 1880, 75 percent of the members of which are present or past members of the Armed Forces or dependents of present or past members of the Armed Forces, and the primary purpose of which is to provide insurance and other benefits to veterans or their dependents.

II. DESCRIPTION OF BILLS

1. H.R. 617—Messrs. Rousselot and Lewis

Definition of Artificial Bait for Purposes of the Excise Tax on Fishing Equipment

Present law

Under present law, a 10-percent excise tax is imposed upon the sales price of fishing rods, creels, and reels, and on artificial lures, baits, and flies (including parts or accessories of such articles sold on or in connection therewith, or with the sale thereof) by the manufacturer, producer, or importer (sec. 4161(a)).

There is no tatutory definition of "artificial bait" to which the tax applies. However, Treasury Regulations (Treas. Reg. § 48.4161(a)-2(d)) define the term "artificial lures, baits, and flies" to include all artifacts, of whatever materials made, that simulate an article considered edible to fish, and that are designed to be attached to a line or hook to attract fish so that they may be captured. Thus, the term includes such artifacts as imitation flies, blades, spoons, spinners, etc., and edible materials that have been processed so as to resemble a different edible article considered more attractive to fish, such as bread crumbs treated so as to simulate salmon eggs, and pork rind cut and dyed to resemble frogs, eels, or tadpoles.

The Internal Revenue Service has taken the position that bait which contains very little artificial substance may be subject to the excise tax. In Revenue Ruling 71-321, 1971-2 C.B. 369, the Service held that edible food items which are shaped or treated to give the appearance or odor of insects, flies, worms, frogs, etc., are artificial lures or baits. In addition, in Revenue Ruling 77-302, 1977-2 C.B. 374, the Service held that a floating fish bait that is manufactured from a semi-soft cheese food to which ingredients are added to provide the desired consistency, color, scent, and buoyancy and which is then packaged by weight and sold in a solid form that the user may shape or form, as with a fish hook, is an artificial bait or lure subject to the manufacturer's excise tax.

Issue

The issue is whether certain substances should be excluded from the term "artificial bait," for purposes of the excise tax.

Explanation of the bill

This bill would exclude from the definition of "artificial bait" any substance which contains 85 percent or more by weight of plant or animal material which can be ingested by fish. Thus, those types of substances would be exempt from the 10-percent tax.

Although this provision may benefit other taxpayers, it is intended primarily to benefit the Don Rich Company, Inc., of La Canada, California, which produces "Zeke's Floatin' Bait." This bait has a base of processed cheese to which is added certain artificial ingredients which make the cheese easier to thin and mix and which give the bait its floatation characteristics.

Effective date

The bill would apply with respect to sales made after December 31, 1979.

Revenue effect

It is estimated that this bill would reduce budget receipts by a negligible amount.

2. H.R. 2402—Messrs. Jones (of Okla.), Hagedorn, Pickle, and Vander Jagt

Postponement of Time for Paying Excise Tax on Fishing Equipment

Present law

Under present law, a 10-percent excise tax is imposed upon the sales price of fishing rods, creels, and reels, and on artificial lures, baits, and flies (including parts or accessories of such articles sold on or in connection therewith, or with the sale thereof) by the manufacturer, producer, or importer (sec. 4161(a)).

Treasury regulations require returns of manufacturers excise taxes, including the tax on the sale of fishing equipment, to be filed quarterly, unless the Internal Revenue Service requires more frequent filing by an individual taxpayer (Treas. Reg. § 48.6011(a)–1). Quarterly returns are due on the last day of the first months after the quarter ends (Treas. Reg. § 48.6071(a)–1).

Although returns generally are filed on a quarterly basis, the regulations require monthly, or semimonthly, payment of the tax in certain cases (Treas. Reg. § 48.6302(c)–1). If an individual is liable in any month for more than $100 of manufacturers excise tax and is not required to make semimonthly deposits, the individual must deposit the amount on or before the last day of the next month at an authorized depository or at the Federal Reserve Bank serving the area in which the individual is located.

If an individual had more than $2,000 in manufacturers excise tax liability for any month of a preceding calendar quarter, such taxes for the following quarter must be deposited (regardless of amount) on a semimonthly basis. The taxes must be deposited by the ninth day following the semimonthly period for which they are deposited. In addition, if the semimonthly period is in either of the first two months of the quarter, any underpayment of excise taxes for a month must be deposited by the ninth day of the second month following such month. Underpayments in the third month of the quarter must be deposited by the end of the following month.

No special rules are provided to defer payment of the excise tax with respect to sales of taxable articles on credit.

Issue

The issue is whether the time for payment of the excise tax imposed on the sale of fishing equipment should be postponed.

Explanation of the bill

The bill would amend present law to require payment of the excise tax on fishing equipment on a quarterly basis, as follows:

(1) March 31, in the case of articles sold during the quarter ending the previous December 31;

(2) June 30, in the case of articles sold during the quarter ending the previous March 31;

(3) September 24, in the case of articles sold during the quarter ending the previous June 30; and

(4) On a date prescribed in Treasury regulations in the case of articles sold during the quarter ending September 30.

The bill would not change the present time for filing returns of manufacturers excise taxes or the time for payment of such taxes on articles other than fishing equipment.

Effective date

The provisions of the bill would apply to fishing equipment sold by manufacturers, producers, or importers on or after October 1, 1981.

Revenue effect

The bill would not affect the aggregate fiscal year receipts of the manufacturers excise tax on fishing equipment.

Other Congressional action

A similar provision passed the House in the 96th Congress (sec. 7 of H.R. 5505). Also, a similar provision is contained in the Senate Finance Committee amendment to H.R. 4961, approved on July 2, 1982.

3. H.R. 4917—Mr. Rangel

Tax Exemption for Industrial Development Bonds for Facilities for the Local Furnishing of Gas

Present law

Under present law, interest on State and local government obligations is generally exempt from Federal income tax. However, tax exemption generally is denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

An exception to the denial of tax exemption for interest on IDBs applies in the case of IDBs which are used to provide certain exempt activity facilities. Such facilities include facilities for the local furnishing of electric energy and gas (sec. 103(b)(4)(E)).

A facility for the furnishing of electric energy or gas is defined in Treasury regulations as property for the furnishing of electric energy or gas which is part of a system providing service to the general populace in a service area comprising no more than two contiguous counties. (Treas. Reg. § 1.103–8(f)(2)(iii)(d)). In the Revenue Act of 1978, the definition of a faciltiy for the local furnishing of electric energy was modified to also include property for the furnishing off electric energy which is part of a system which provides electric energy to the general populace in a service area comprising no more than a city and one contiguous county.

Issue

The issue is whether the definition of a facility for the local furnishing of gas should be amended to include a facility for the furnishing of gas which is part of a system which provides service to the general populace in an area comprising no more than two contiguous counties or a city and one contiguous county.

Explanation of the bill

The bill provides that the local furnishing of gas from a facility would include the furnishing solely within an area comprised of a city and one contiguous county. Thus, under the bill, tax-exempt financing would be made available in the case of a facility for the furnishing of gas (which otherwise meets the requirements of sec. 103) provided that the service area of the facility comprised no more than two contiguous counties or a county and one contiguous city.

The principal beneficiaries of the bill would be the Brooklyn Union Gas Company and the Consolidated Edison Corporation.

Effective date

The bill would apply to obligations issued after the date of enactment.

Revenue effect

It is estimated that the bill would reduce budget receipts by $2 million in fiscal year 1983, $5 million in 1984, $8 million in 1985, $12 million in 1986 and $15 million in 1987.

Other Congressional action

A similar provision is contained in the Senate Finance Committee amendment to H.R. 4961, approved on July 2, 1982.

4. H.R. 5985—Messrs. de Lugo, Holland, Heftel, and Schulze

Reduction of Certain Withholding Taxes Paid to the Virgin Islands; Separate Application of the Foreign Tax Credit Attributable to Certain Virgin Islands Taxes

Present law

Virgin Island taxation in general

In the Virgin Islands, the U.S. Internal Revenue Code is generally applied as a local territorial tax code, except that tax proceeds are paid into the treasury of the Virgin Islands. In applying the Internal Revenue Code in the Virgin Islands, the name "Virgin Islands" is generally substituted for the name "United States" wherever it appears in the U.S. Code. Some court decisions and IRS documents refer to this system of taxation as a "mirror image" system.

Corporate and individual "inhabitants" of the Virgin Islands are taxed on their worldwide income by the Virgin Islands and are exempt from any income tax liability to the Federal Treasury, even on their U.S.-source income. All corporations chartered in the Virgin Islands are considered to be inhabitants of the Virgin Islands. In certain circumstances, a United States corporation may also qualify as an inhabitant of the Virgin Islands.

The U.S. Internal Revenue Code limits the power of the Virgin Islands government to grant relief from its income tax (sec. 934). The Virgin Islands may not grant rebates for taxes attributable to income derived from sources within the United States. With respect to non-U.S. source income, the Virgin Islands may not grant corporate tax rebates except to U.S. and V.I. corporations that meet a so-called "80–50 test." This test allows the Virgin Islands to grant tax rebates to only those U.S. and V.I. corporations that have derived for the past three taxable years (or applicable part thereof) at least 80 percent of their gross income from V.I. sources and at least 50 percent of their gross income from the active conduct of a trade or business within the Virgin Islands. Acting within the constraint of the 80–50 test, the Government of the Virgin Islands has established further criteria for tax rebates, such as a $50,000 minimum investment and certain employment criteria.

Taxation of passive income in the Virgin Islands

U.S. law generally imposes a 30-percent tax on the gross amount of dividends, interest, royalties, and other passive investment income paid by U.S. persons to non-resident aliens and foreign corporations when that income is not effectively connected with the conduct of a U.S. trade or business by the foreign person. This 30-percent rate is often reduced, or eliminated, by income tax treaties. U.S. law also generally imposes on the payor of such passive investment income a duty to withhold the tax due (secs. 1441 and 1442.)

Under the mirror system, the Virgin Islands imposes a similar 30-percent tax on passive investment income paid by V.I. persons to non-V.I. persons, including U.S. persons. The Virgin Islands cannot now forgive this tax, since the tax is upon the recipient and not upon the company operating in the Virgin Islands. A U.S. recipient of passive income from the V.I. may generally take a foreign tax credit for any such tax (subject to limits) against its U.S. tax liability. Although there is some dispute about the underlying tax liability of the recipient of passive investment income from the Virgin Islands, it is the Internal Revenue Service's position that the recipient is liable for the tax (Rev. Rul. 78–327, 1978–2 C.B. 196).[1]

In addition, there is a dispute about the authority of the Virgin Islands to withhold this tax (as opposed to the authority to impose the underlying tax). This dispute has been the subject of litigation. The U.S. Court of Appeals for the Third Circuit held that the Virgin Islands did not have the power to withhold this tax.[2] The basis of this decision was a Treasury Regulation that provided that U.S. persons were not required to withhold on payments of passive investment income to V.I. persons: the Third Circuit mirrored that regulation to hold that V.I. persons did not have to withhold on payments to U.S. persons. The Treasury Department has since revoked the underlying Regulation. Therefore, according to the IRS, V.I. persons who pay passive investment income to U.S. persons must withhold tax at a 30-percent rate. However, some persons have questioned the validity of the IRS revocation of that underlying Regulation. The revocation occurred simultaneously with issuance of a Revenue Procedure that continued the rule that U.S. persons need not withhold on payments of passive investment income to V.I. persons. Therefore, some persons allege that the revocation of the Regulation was a sham and that the Virgin Islands does not have the power to require withholding of the tax. It is understood that these issues are again in controversy.

Guamanian taxation of passive income

Like the Virgin Islands, Guam is a possession of the United States and has a tax system generally mirroring the Internal Revenue Code. Until 1972, passive investment income paid by Guamanian persons to U.S. persons was subject to a 30-percent Guamanian tax. As is the case with V.I. taxes today, this tax was creditable (subject to limits) against U.S. tax liability through the foreign tax credit mechanism. In 1972, finding that the effect of the Guamanian passive income tax had been to discourage U.S. investment in Guam, Congress repealed the tax.[3]

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[1] No inference should be drawn from this discussion as to the correctness of the view of either party about this dispute or about the dispute as to the related withholding obligation.

[2] *Vitco* v. *Government of the Virgin Islands*, 560 F. 2d 180 (3d Cir. 1977), *cert. denied*, 435 U.S. 1980 (1978).

[3] Congress' method of repealing the Guamanian tax was to repeal the 30-percent U.S. tax on passive investment income paid by U.S. persons to Guamanian persons. Repeal of the Guamanian tax thus occurred through "mirroring" of repeal of the U.S. tax.

Foreign tax credit

U.S. citizens, residents, and corporations are generally taxable on their worldwide income. To avoid double taxation of foreign income, U.S. persons may generally take a credit against their Federal income tax liability for the amount of foreign income taxes paid on income from sources outside the United States. Foreign taxes include taxes paid to the Virgin Islands and other possessions of the United States.

A so-called deemed-paid foreign tax credit is allowed when a foreign corporation distributes a dividend to a U.S. corporation that owns at least 10 percent of the voting stock of the foreign corporation (sec. 902). Such dividends carry with them, for the purpose of the U.S. foreign tax credit, a proportionate amount of foreign taxes paid by the foreign corporation. Foreign corporations include corporations organized in the possessions, including the Virgin Islands.

Since 1921, the tax law has limited the use of foreign tax credits so as to prevent such credits from offsetting U.S. tax on U.S. source income. The foreign tax credit is limited under an overall limitation so that it can offset U.S. tax only on worldwide foreign source income. Under this overall limitation, the amount of foreign tax credits which a taxpayer can apply against its U.S. tax liability on its worldwide income is limited to its U.S. tax liability multiplied by a fraction the numerator of which is worldwide taxable income from sources (including V.I. sources) outside the United States and the denominator of which is worldwide taxable income. Under this limitation, the taxpayer thus aggregates its income and taxes from all foreign countries, including the Virgin Islands. A taxpayer may credit taxes from any foreign country as long as the total amount of foreign taxes applied as a credit in each year does not exceed the amount of tax that the United States would impose on the taxpayer's foreign source income. In cases where the limitation on foreign tax credits reduces the amount of tax that can be used by the taxpayer to offset U.S. tax liability in any one year, the excess credits not used may be carried back for two years and carried forward for five years.

Issues

The principal issue is whether the 30-percent Virgin Islands tax on payments of passive investment income by V.I. persons to non-V.I. persons should continue or be reduced by statute. A related issue is whether the V.I. Government should have the discretion to further reduce any remaining tax. Another related issue is whether any reduction in tax should be limited to payments by V.I. persons to U.S. persons. A final issue is whether certain foreign taxes should be allowed to offset U.S. tax on U.S. source income, thus effecting a direct transfer of U.S. revenues to the taxpayer.

Explanation of the bill

Limitation of tax rate on passive investment income to 10 percent

The bill would generally limit the Virgin Islands tax on amounts received by non-V.I. persons from sources within the Virgin Islands, such as interest, dividends, rents, and other passive investment income which is not effectively connected with the conduct of a trade or busi-

ness in the Virgin Islands to 10 percent of the gross amount received. The bill would continue the current 30-percent rate for dividends paid out of earnings and profits accumulated before the effective date. It would treat post-effective date dividends as first coming out of pre-effective date profits.

The bill would allow the Government of the Virgin Islands, in its discretion, further to reduce this 10 percent rate (or to eliminate the tax altogether). The Government of the Virgin Islands would have the discretion to reduce (or eliminate) the tax on the basis of criteria it chose. The bill would also limit the complementary withholding tax on such income to the reduced 10 percent (or lower) rate.

The bill would make clear the Virgin Islands' right both to impose the tax and to collect it by requiring withholding.

Separate limitation on the foreign tax credit attributable to Virgin Islands taxes

The bill would allow a foreign tax credit for certain Virgin Islands taxes to offset U.S. tax on U.S. source income. The bill would create an elective alternative to the current overall foreign tax credit limitation. Upon election, the taxpayer's credit for V.I. taxes paid would consist of two elements: a credit for V.I. withholding taxes and a deemed-paid foreign tax credit for V.I. taxes paid by a subsidiary.

The credit for V.I. withholding taxes could offset U.S. tax on income from U.S. sources. This would be intended to create an additional incentive to investment in the Virgin Islands to those taxpayers whose foreign tax credits already eliminate U.S. tax on their foreign income.

The credit for Virgin Islands deemed paid income taxes would be subject to a special "per-country limitation" so that those taxes could only affect U.S. income taxes imposed on V.I. source income. Thus, this credit could not exceed an amount equal to U.S. tax on worldwide income multiplied by a fraction the numerator of which is the taxpayer's grossed-up deemed paid dividends from the Virgin Islands and the denominator of which is the taxpayer's worldwide taxable income.

In general, if the total available credit (the sum of the two elements) exceeded the taxpayer's U.S. liability, the taxpayer would carry the credit back or forward to other (post-enactment) years during which the taxpayer made the Virgin Islands limitation election.

If a taxpayer elected the special foreign tax credit limitation under the bill, that election would remove V.I. income and taxes from the calculation of the taxpayer's overall foreign tax credit limitation.

Effective date

The reduction in Virgin Islands tax rates would generally apply to payments made after the date of the enactment. The elective Virgin Islands foreign tax credit limitation would apply to taxable years ending after the date of enactment.

Revenue effect

A revenue estimate is not availaible at ths time.

5. H.R. 6218—Mr. Duncan

Treatment of Veterans Insurance Organizations

Present law

Present law (sec. 501(c)(19)) exempts from Federal income tax any post or organization of war veterans, or an auxiliary unit or society of, or a trust or foundation for, any such post or organization. To qualify for this exemption, the following criteria must apply: (1) the organization must be organized in the United States or any of its possessions; (2) at least 75 percent of its members must be war veterans, and substantially all of the other members must be veterans, cadets, or spouses (or widows or widowers) of war veterans, veterans, or cadets; and (3) no part of the net earnings of the organization can inure to the benefit of any private shareholder or individual. For this purpose, a war veteran is any person, whether or not a present member of the Armed Forces, who served in the United States Armed Forces during a period of war (including the Korean and Vietnam conflicts).

In addition, in order to be exempt, such an organization must be operated exclusively for one or more of the following purposes: (1) to promote the social welfare of the community; (2) to assist disabled and needy war veterans and their families; (3) to provide entertainment, care, and assistance to hospitalized veterans; (4) to carry on programs to memorialize deceased war veterans; (5) to conduct programs for religious, charitable, scientific, literary, or educational purposes; (6) to sponsor or participate in activities of a patriotic nature; (7) to provide insurance benefits for their members or dependents; or (8) to provide social and recreational activities for their members.

Other exempt organizations

Present law also provides tax-exemption for two other organizations that provide life, sick, and accident benefits for their members. Fraternal beneficiary societies that operate under a lodge system for the exclusive benefit of its members and provide for the payment of life, sick, accident, or other benefits to the members are exempt from tax under section 501(c)(8), and voluntary employees' beneficiary associations that provide for the payment of life, sick, accident, or other benefits to the members, if no part of the net earnings inures to the benefit of any private shareholder or individual, are exempt from tax under section 501(c)(9).

Issue

The issue is whether an income tax exemption should be recognized for associations (organized prior to 1880) of past and present members of the Armed Forces, or of their dependents, the primary purpose of which is to provide insurance and other benefits to veterans or their dependents.

Explanation of the bill

The bill would add a new category of tax exemption for associations organized prior to 1880, 75 percent of the members of which are present or past members of the Armed Forces or dependents of present or past members of the Armed Forces, and the primary purpose of which is to provide insurance and other benefits to veterans or their dependents.

The provision is intended to benefit the Army Mutual Aid Association and the Navy Mutual Aid Association.

Effective date

The provisions of the bill would be effective upon enactment.

Revenue effect

It is estimated that this bill would reduce budget receipts by less than $5 million annually.

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